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## 6 Recent developments in trade policy

Before the global financial crisis and associated contraction in trade and economic activity, the primary focus of trade policy had been on achieving liberalisation through multilateral, regional and bilateral agreements. And, while there has been sometimes strenuous debate concerning appropriate strategies and extended negotiation processes, the underlying tendency has been towards more liberal global product and financial markets.

The global financial crisis and contraction in world trade has brought a new set of pressures on governments to manage market dislocation and contracting activity. Many responses introduced to address these broad economic problems involve significant market interventions that advantage selected businesses or industries, at the expense of other kinds of activity. Such measures could also, if sustained, counter liberalisation efforts and potentially impede the income and growth of nations, including developing countries.

At the same time, governments continue to apply themselves to concluding the Doha Round of multilateral trade negotiations and warn of the dangers of greater protectionism.

This chapter reports on the following developments in trade policy since *Trade & Assistance Review 2006-07*, including on:

- some trade policy responses to the global financial crisis;
- continued efforts to conclude the Doha Round of multilateral trade negotiations;
- ongoing negotiation by the Australian Government of several new preferential trade agreements and the intention to commence negotiation on further agreements;
- global trends in the formation of preferential trading agreements including the formation of new agreements involving Australia's trading partners; and
- the review of Australia's export policies and programs (the 'Mortimer' review) commissioned by the Australian Government, including the review's recommended approach to trade negotiations.

Because rules of origin are important in determining the margin of preference available to firms undertaking preferential trade, this chapter also reports on

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Commission analysis of preferential rules of origin for the agreements between Australia and the United States, New Zealand, Thailand and Chile.

## **6.1 Responses to the global financial crisis**

Recent sharp declines in world economic activity and global trade flows have placed increasing pressure on governments to provide substantial domestic assistance packages. In particular, although government actions initially focused on certain financial markets, policy responses have applied more widely, including trade policy.

While such policies aim to bolster financial markets and aid economic recovery, aspects of them provide assistance to selected activities and could ultimately increase the severity and duration of the crisis. The risks associated with emerging protectionism in product and financial markets are heightened by the interdependent nature of global markets.

A December 2008 report from the Organisation for Economic Cooperation and Development (OECD) warned of the consequences of increased protectionism:

Open markets for trade and investment are a key driver of economic growth and development. Keeping markets open will therefore be an essential condition for recovery and long-term growth. Yet, just as the need to maintain open markets is greatest, concerns about the consequences of liberalisation and the perception that liberalisation may have even contributed to the current crisis have been growing. If these concerns result in a wavering commitment to multilateralism and in rising protectionism, the crisis will become even worse and recovery will be delayed. (OECD 2008, p. 8)

In a recent speech, the Australian Trade Minister made a similar point:

... If instead we allow trade reform to stall, and let protectionist measures fill the policy vacuum, then countries will turn inwards and the decline in trade flows will exacerbate the current crisis. (Crean 2009).

Other governments have also warned of the risks of a re-emergence of protectionism and have committed to progress trade negotiations and coordinate their responses to the global financial crisis in an endeavour to avoid such an eventuality. For example, at a meeting in November 2008, leaders of the Group of Twenty (G-20) members affirmed the ‘... critical importance of rejecting protectionism and not turning inward in times of financial uncertainty...’ and agreed that ‘... within the next 12 months, we will refrain from raising new barriers

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to investment or to trade in goods and services' (G-20 2008).<sup>1</sup> At the April 2009 meeting of the G-20, the leaders re-affirmed their commitment to an 'open world economy' (G-20 2009).

Nevertheless, domestic pressures have led some countries to raise their barriers to trade. In the context of the financial crisis and its impact on the global economy, the WTO reported on some trade-related developments since September 2008 (box 6.1). The Director-General of the WTO stated that:

... there is no indication of an imminent descent into high intensity protectionism, involving widespread resort to trade restriction and retaliation. The multilateral trade rules under the WTO continue to provide a strong defence, and a unique insurance policy, against that happening. (Lamy 2009)

Despite this general finding, the WTO reported that in the two months to April 2009, there had been 'slippage' with a range of new tariff and non-tariff measures introduced (WTO 2009a, 2009c). These raise the threat of equivalent or retaliatory actions leading to further reductions in trade that would exacerbate the global recession.

While the measures that the WTO identified largely relate to trade in goods, the stress on financial markets has led governments to intervene in a variety of ways (box 6.2). The WTO suggested that:

The most significant actions taken, mainly in OECD countries, in response to the financial crisis and onset of economic recession have involved financial support of one kind or another to banks and other financial institutions and to certain industries, notably the automobile industry (WTO 2009a).

Such financial market responses are distinct from those that seek to protect domestic industries from imports. In general terms, many are designed to relieve short-term financial stress, and in particular to limit the risks of financial contagion. Most of the financial market responses also do not discriminate between domestic and foreign-owned firms, so that the risks of retaliatory actions are low.

Notwithstanding that these measures are intended to relieve financial stress in the short run, they also clearly provide assistance to the financial sector, and just as trade barriers can distort international trade by changing relative returns, these measures can artificially influence capital flows within and across borders.

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<sup>1</sup> The G-20 members are: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, South Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States and the European Union.

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Consideration needs to be given by governments as to means of strengthening commitments and their observance, both through WTO processes and domestic institutional arrangements.

### **Box 6.1 Recent protectionist measures identified by the WTO**

The WTO identified more than 80 new protectionist measures across a number of member countries, including 17 of the G-20 countries. The report found that these measures varied substantially, traversing border protection and government purchasing policies. While it is beyond the scope of this *Trade & Assistance Review* to comprehensively report on recent interventions, the following examples provide an indication of the breadth and nature of recent policy changes.

#### **Measures at the border**

- In November 2008, India increased import duties on iron, steel and soy products.
- In December 2008, Vietnam raised import tariffs on steel.
- In January 2009, the EU reintroduced export subsidies on dairy products.
- Also in January 2009, Russia, increased import duties on cars and trucks. (Russia is not a member of the WTO but is a member of the G-20.)

#### **Government purchasing preferences and direct support to industry**

Some governments have explicitly included increased protection for local industry as part of their policy response to the global financial crisis. For example:

- The United States' *American Recovery and Reinvestment Act 2009*, worth approximately A\$1.2 trillion (US\$787 billion), contains a 'Buy American' provision which requires all iron, steel and manufactured goods used in any public works to be produced in the United States.<sup>2</sup>
- In February 2009, the French Government agreed to provide Renault and Peugeot-Citroen with A\$13 billion (€6.5 billion) in low interest loans in exchange for pledges that the companies would not close any factories or lay off workers in France for the duration of the loans.

*Source:* WTO (2009a, 2009c).

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<sup>2</sup> Exceptions apply if the quantity and quality of the locally sourced iron, steel or manufactured goods is deemed insufficient or unsatisfactory, if their use would raise the overall cost of the project by more than 25 per cent, or if their use would be inconsistent with the public interest or violate the United States' obligation under international trade agreements.

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**Box 6.2 Examples of recent support to the finance sector and other industries**

Between October 2008 and March 2009, via a combination of programs (the Troubled Asset Relief Program, Systemically Significant Failing Institutions, Automotive Industry Financing Program and the Targeted Investment Program) the United States Government has purchased more than A\$469 billion (US\$323 billion) worth of stock and debt from troubled United States institutions and corporations.

The *Guarantee Scheme for Large Deposits and Wholesale Funding* was announced by the Australian Government in October 2008 to ensure the stability of the Australian financial system. The scheme provides eligible authorised deposit-taking institutions (ADIs) with a Government backed guarantee of certain deposits and wholesale funding instruments. Australian-owned banks and Australian-incorporated ADIs, which are subsidiaries of foreign banks, are treated equally. In March 2009, a similar scheme was extended to State Government issued securities.

In October and November 2008, the Canadian Government announced it would purchase up to A\$88 billion (CN\$75 billion) in mortgages already guaranteed through the Government's mortgage insurance program.

In February 2009, the UK Government introduced the Asset Protection Scheme with both the Royal Bank of Scotland and Lloyds TSB signing up. The scheme will see the Government guarantee A\$1.2 trillion (£575 billion) in bank assets, in return for a number of undertakings, including a commitment from institutions receiving assistance to increase lending, specifically to UK based households and businesses.

In January 2009, the Australian Government announced the *Australian Business Investment Partnership* (ABIP) which would provide re-financing to support viable major commercial property projects in Australia and financing arrangements in other areas of commercial lending if those arrangements are unanimously agreed by the members of ABIP.

*Sources:* US Dept of Treasury (2009), Swan (2008g, 2009), Rudd (2009a), CMHC (2008) and HM Treasury (2009a, 2009b).

## 6.2 The World Trade Organization and the Doha Round

Since the signing of the General Agreement on Tariffs and Trade (GATT), membership of the GATT (and since 1995, the WTO) has grown from 23 countries in 1947 to more than 150 countries today. For over 60 years it has provided a stable, rules-based system for the conduct of international trade. It also provides a forum to liberalise trade through negotiation of new multilateral trade agreements.

Successive multilateral trade agreements negotiated under the auspices of the GATT/WTO framework have led to progressive liberalisation in 'bound' most

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favoured nation (MFN) tariff rates and other trade arrangements of member countries. These bindings form the basis for the conduct of trade and an internationally recognised benchmark for unilateral liberalisation by trading nations. An important, some would suggest crucial, role of negotiations under the GATT/WTO is to provide a means to bind tariff rates and other arrangements to levels more closely aligned to lower applied rates and liberalised arrangements. Indeed, these bindings, achieved over multiple previous GATT/WTO negotiating rounds, provide some protection against the risks of a rise in protectionism.

Launched in 2001, the WTO Doha Round set an ambitious negotiating agenda — some of the topics set for negotiation included agriculture, services, market access for non-agricultural products, trade related aspects of intellectual property, investment, competition policy, transparency in government procurement, trade facilitation, regional trade agreements, dispute settlement and other issues. The increased complexity of the issues under negotiation, combined with the growth in WTO membership, has resulted in a diversity of objectives and priorities.

For more than eight years now, the Round has inched towards agreement — at the World Economic Forum in January 2008 trade ministers from the United States, the European Union, Brazil, India, Australia and a number of other countries called for a new push to secure a conclusion to the Doha Round (ICTSD 2008). In July 2008, trade ministers convened in Geneva with a list of 20 topics to negotiate. They reached agreement on 18 but, ultimately the meeting collapsed due to a disagreement among a small, but influential, number of countries over the agricultural special safeguard mechanism (SSM), which would allow developing countries to temporarily increase tariffs in response to significant import surges or price falls. A further ministerial meeting planned for December 2008 was cancelled as the global financial crisis worsened, and agreement on the contentious issues remaining appeared out of reach.

Negotiations on agricultural domestic subsidies and market access issues are among the more contentious issues in the current round (WTO 2008a). Achieving agreement would deliver many beneficial reductions in ‘existing’ trade barriers, including the elimination of agricultural export subsidies and reductions in the levels of domestic support for agricultural producers. Reforms in these areas are considered particularly important for Australia and other members of the Cairns Group of agricultural exporters.

More broadly, an agreement would limit the reinstatement of barriers that have been reduced ahead of multilateral reform efforts. For example, the European Union’s reintroduction of export subsidies for butter, cheese and milk powder (in January 2009) would have been prohibited by the Doha Round’s current proposal to eliminate agricultural export subsidies. In this way, an agreement could limit the

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ability of countries to implement protectionist responses to the crisis and reduce fears of a rash of ‘beggar-thy-neighbour’ responses. According to the Director-General of the WTO:

... the best contribution to reviving economic growth around the world is to conclude the DDA [Doha Development Agenda] as one of the most appropriate collective stimulus packages. ... Completing the DDA is also the surest way we have of safeguarding our individual trade interests and the multilateral trading system against the threat of an outbreak of protectionism (Lamy 2009).

Nonetheless, the difficulties in reaching timely agreement serve to illustrate common concerns of the WTO framework, including: that trade liberalisation is often seen by constituents in members’ home countries as a harmful (rather than desirable) outcome; and that the offer and acceptance approach to negotiations can portray a liberalising proposal, likely to benefit the proponent, as a ‘concession’.

Notwithstanding these concerns, unilateral liberalisation by WTO members can move ahead of bound commitments. This suggests that while the WTO negotiating framework is the focus of multilateral liberalisation, achieving significant reductions in trade barriers will depend on the actions of members — either to lead reform or to adopt meaningful liberalisation proposals advanced through the WTO framework.

## **Increasing the transparency of trade policy**

### *International transparency*

Recently, the WTO produced reports documenting trade related developments since the start of the global financial crisis (WTO 2009a, 2009c). The WTO relies on members voluntarily providing information for these reports. Twenty-four members provided information for the most recent report.

Some have called for the WTO to have greater authority to collect and report on trade policy developments. A recent report by World Bank staff argues for the G-20 members to provide quarterly reports on new trade restrictions to the WTO (Gamberoni and Newfarmer 2009). Similarly, Baldwin and Evenett (2008) propose that WTO members should be required to report weekly to the WTO all forms of import and investment protection and, indeed, go further by suggesting that new measures should only be permitted on a temporary and ‘safeguard’ basis, providing countries with:

... an “exit strategy” from the crisis-induced protection ... When the world pulls out of the recession – say in 2010 – the mechanism would give leaders a list of the barriers to be dismantled. History suggests that this would be helpful. Much of the damage from

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the 1930s tariffs came well after the Great Depression passed as the tariffs stayed in place for decades. (Baldwin and Evenett 2008)

The sanctioning of temporary protectionist measures risks undermining the G-20's commitment to not increase barriers over the next 12 months. Nevertheless, greater transparency on trade policy responses may create pressures that enforce a greater adherence to these short-term commitments.

### *Promoting domestic transparency*

A similar, longer term initiative that attempts to build support for trade liberalisation involves the creation of 'domestic transparency mechanisms' within member countries. In a recent comparative review of country approaches to trade policies, it has been suggested that:

...to advance better trade policies, the emphasis has to shift onto domestic processes. The reason is domestic processes will always be more influential in changing the political economy of reform than external scrutiny. Stoeckel and Fisher (2008, p. xvii)

Such mechanisms would embody processes and institutions *within* member countries to promote a better understanding of, and accounting for, the domestic tradeoffs involved in trade liberalisation and its potential benefits.

Such a course of action is not a new idea. The notion of establishing domestic transparency mechanisms was advocated more than two decades ago by two eminent international study groups reporting on ways to overcome the then impasse in progressing multilateral trade negotiations (Leutwiler 1985, Long 1987, discussed in *Trade & Assistance Review 2005-06*). They also suggested that the transparency mechanisms be established using GATT/WTO processes.

At a practical level, it is one which Australia itself has followed in its approach to formulating industry assistance policy and assessing the potential benefits and implications of other national economic reforms. It has been achieved primarily through the operation of the Productivity Commission and its predecessors.

The recent *Review of Australia's Export Policies and Programs* (the Mortimer review) considered the issue of domestic transparency from the perspective of a number of bilateral capacity building exchanges. In that context, its view was that a campaign to promote a domestic transparency body in each country would be 'resource intensive and unlikely to attract support in the short term' (Mortimer 2008 p. 90). Instead, the review suggested the same goal could be advanced through existing structures, specifically through bilateral capacity-building programs between the Australian Government and other governments in the region.

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The Director-General of the WTO recently recognised the potential benefits of domestic transparency mechanisms as a means of achieving trade liberalisation. Nevertheless, he also recognised that there was not general support for the sponsorship of country processes within the WTO framework (WTO 2009b).

While recognising that there are obstacles and difficulties in establishing domestic transparency mechanisms appropriate to country circumstances, the Commission considers that there would be merit in giving greater weight to the concept of such mechanisms as a means of promoting trade liberalisation, nationally and internationally.

### **6.3 Developments in Australia's preferential trading arrangements**

Since the formation of the GATT in 1947, development of Australia's international trading relations has mainly been undertaken within the multilateral GATT/WTO framework. Nevertheless, Australia has also negotiated and maintained a limited number of bilateral and regional agreements with trading partners, which generally provide preferential entry for goods from member countries.<sup>3</sup>

Prior to 2003, Australia was party to three agreements, with Papua New Guinea, South Pacific countries and New Zealand, of which only the latter was a reciprocal agreement. Since then, Australia has signed preferential trade agreements with Singapore, Thailand and the United States. In addition to providing tariff preferences, these trade agreements cover many non-merchandise trade areas such as intellectual property, government procurement and trade in services.

Further, in 2008, the Australian Government concluded trade agreements with Chile and, jointly with New Zealand and the Association of South East Asian Nations (ASEAN). The Australian Government also intends to expand Australia's participation in similar preferential arrangements.

Details of the recently concluded agreements, ongoing negotiations and plans for expanded participation are outlined below.

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<sup>3</sup> The term 'trade agreement' is not well defined. The Commission uses the overarching term 'preferential trade agreement' as most of these agreements provide preferential access to goods from member countries, over goods sourced from non-member countries. It should be noted that such preference occurs even if the agreement cuts tariffs to zero between the member countries. At the same time, the Commission notes that some agreements, such as the Asia Pacific Economic Cooperation (APEC) agreement, do not in general discriminate among countries, while others in part focus on aligning competition policy or harmonising and mutually recognising standards.

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### *ASEAN–Australia–New Zealand Free Trade Agreement (AANZFTA)*

Mooted as a possibility more than 15 years ago, formal negotiations for a trade agreement covering goods, services and investment commenced in 2004 between the members of ASEAN, Australia and New Zealand. The original architects of the agreement envisaged an open, outward-looking agreement (DFAT 1997).

Negotiations were concluded in August 2008 and the agreement was signed in February 2009. It is expected to enter into force in late 2009 or 1 January 2010. The agreement has a broad coverage, including provisions on goods, services, investment, intellectual property, competition policy, economic cooperation and dispute settlement. It provides for the reduction and elimination of bilateral tariffs on a high proportion of tariff lines (over 90 per cent of tariff lines for all countries, except for the three least developed countries, where tariff elimination coverage is 85 to 88 per cent of tariff lines). There are also improvements to existing WTO commitments across a range of services sectors.

### *Chile*

The Australian Government announced its intention to negotiate a trade agreement with Chile in December 2006. The agreement was signed in July 2008. Chile was Australia's 40th largest two-way merchandise trade partner in 2007-08. The trade agreement has eliminated bilateral tariffs on 97 per cent of two-way merchandise trade. Tariffs on all existing bilateral merchandise trade will be eliminated by 2015.

The agreement also includes provisions on services, investment, government procurement, intellectual property and product specific preferential rules of origin (DFAT 2009b).

### *China*

In 2005, following a feasibility study, the Australian Government commenced negotiations for a trade agreement with China. In 2008, China emerged as Australia's largest trading partner when two-way trade reached \$58 billion. The negotiations cover market access for goods and other issues affecting trade in goods, services and investment and intellectual property, as well as transparency of administration, procedures for dispute settlement and other institutional issues.

The 13th round of negotiations were held in December 2008, with progress towards agreement reported in some areas such as customs procedures, sanitary and phytosanitary (SPS) issues and technical barriers to trade while other areas,

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including the core issues of market access for goods and for services and investment have continued to lag (DFAT 2009c).

### *Gulf Cooperation Council (GCC)*

Negotiations for a trade agreement between Australia and the GCC commenced in 2006, following notification of a decision taken by the GCC Supreme Council that the United Arab Emirates (UAE) should not continue negotiations for a trade agreement with Australia on a bilateral basis — instead a GCC-wide agreement was suggested (incorporating, in addition to the UAE, Bahrain, Kuwait, Oman, Qatar and Saudi Arabia).

While acknowledging the potential challenge of concluding a trade agreement in line with Australia's preferred model, the Australian Government signalled its intention to pursue a comprehensive agreement. The last round of negotiations were held in February 2009 where progress was made on a range of issues including quarantine matters, customs procedures, rules of origin, financial services and dispute settlement provisions (DFAT 2009d).

### *Japan*

In 2007, following a feasibility study, the Australian and Japanese Governments commenced negotiations on a trade agreement. Japan is Australia's largest export market and seventh largest services export destination.

The eighth negotiating round was held in March 2009, at which the two sides exchanged services and investment market access requests. Steady progress has been made on a range of issues, but discussions on agriculture issues have proved difficult (DFAT 2009e).

### *Malaysia*

In 2005, following a scoping study and public consultation process, the Australian and Malaysian Governments announced that they would negotiate a 'high quality, comprehensive agreement'. Initial negotiating rounds focussed on information exchange and identification of areas of priority to both countries.

In October 2008, following a two-year negotiating pause (due to a focus on other negotiations), at a meeting of the Malaysia–Australia Joint Trade Committee in Kuala Lumpur, it was agreed that negotiations would be reopened in 2009. Both sides agreed that to be worthwhile a bilateral trade agreement would need to 'add value' to the recently concluded AANZFTA (DFAT 2009f).

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### *Trans-Pacific Partnership agreement*

In September 2008, the Australian Government announced it would consider participating in negotiations towards a Trans-Pacific Partnership (TPP) agreement. Following a public consultation process, the Government announced that it would participate in the initiative.

The TPPA is intended to expand the *Transpacific Strategic Economic Partnership Agreement* between Brunei Darussalam, Chile, New Zealand and Singapore (which entered into force in 2006). It has been mooted as a possible way to 'build towards the Free Trade Area of the Asia Pacific' (USTR 2008). In addition to Australia, Peru and Vietnam will be participating in the negotiations (DFAT 2009g).

### *Korea*

In March 2009, the Australian and Korean Governments agreed to start negotiations on a trade agreement. This decision was made following two rounds of preparatory talks, and the release in April 2008 of a joint non-government feasibility study. The first round of negotiations is scheduled to take place in Australia in May 2009 (DFAT 2009h).

### *Other trade agreements under consideration*

The Australian Government is also currently considering the potential to commence a number of other preferential trade agreements:

- In April 2009, the Australia and Indonesian governments released a joint feasibility study examining the merits of a bilateral trade agreement. The study stated that:

an ambitious and comprehensive FTA could improve trade and investment links, deepen bilateral and regional economic integration and provide positive outcomes in key agricultural and manufacturing sectors of importance to both Australia and Indonesia'. (DFAT 2009i)
- At the 2008 Pacific Islands Forum Leaders' meeting, officials agreed to formulate a detailed roadmap on the Pacific Agreement on Closer Economic Relations (PACER) Plus with a view to Leaders agreeing at the August 2009 Forum to the commencement of negotiations.
- In August 2007, Australia and India commenced a joint feasibility study on the merits of a trade agreement.

In April 2008, the Australian Government announced that it would conduct a review of the administration of Australia's dairy export quotas to the United States and the

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European Union. Among other things, the review is to examine the appropriateness, effectiveness and efficiency of the current quota management arrangements and to identify areas where improvements to the arrangements can be made. This will involve looking at the concepts underpinning quota controls, the quota allocation process and the ongoing administration of the quotas (Burke 2008b).

## **6.4 Assessment of Australia's recent trade agreements**

Establishing the effects of Australia's increased involvement in trade agreements is significantly more complex and uncertain than establishing the effects of multilateral or unilateral reform. Preferential trade agreements (PTAs) can capture some of the well known benefits associated with trade liberalisation, but unlike multilateral or unilateral reform, they can also divert trade to more costly suppliers, distort production decisions, entrench support for less ambitious multilateral reform, and divert skilled and experienced negotiating resources. Thus, depending on a number of factors, the conclusion of any particular PTA may have mixed results on productivity and efficiency.

### **Global trends in PTA formation**

The spread of bilateral and regional trade agreements has led to a significant increase in the number of global trade relationships potentially affected by preferential arrangements — both directly (trade between members) and indirectly (trade between members and non-members).

Over the 40 year period from 1962 to 2006, the number of trade agreements in force and notified to the WTO has grown from 9 to more than 220 today.<sup>4</sup> In addition to the agreements notified to the WTO, there is a substantial number of other regional and bilateral agreements that define trade relations between countries, for example, APEC and agreements between some members of the former Soviet Union. In addition, the scope of each agreement has developed from covering tariff

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<sup>4</sup>The nine trade agreements in force in 1962 were the Central American Common Market (CACM), the European Free Trade Area (EFTA), the Treaty of Rome (from which the EU evolved), EFTA—Finland Association, the Latin American Free Trade Area (LAFTA), the Canada — Australia trade agreement, the Ghana — Upper Volta trade agreement, the EEC — Greece interim agreement and the Equatorial Customs Union (comprised of the Central African Republic, Chad, Congo and Gabon). The WTO reports 223 agreements notified to the WTO and in-force in 2008, but this underestimates the actual number of agreements in-force as not all agreements are notified to the WTO — using Medvedev (2006) another 105 agreements not notified to the WTO are identified.

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preferences in merchandise trade only to include many non-merchandise trade provisions<sup>5</sup>.

### *Extent of global trade influenced by trade agreements*

The proportion of bilateral trade links potentially directly affected by one or more trade agreements increased from 3 per cent in 1962 to 16 per cent in 2006. Trade agreements also have the potential to influence bilateral trade-flows *indirectly* through exclusion and trade diversion. Increasingly, the reach of trade agreements into the international trading system is through these overlapping links between members and non-members.

With the increase in multiple and overlapping membership of agreements, the incidence of bilateral trading links potentially directly and indirectly affected by one or more trade agreement increased from 59 per cent in 1962 to 96 per cent in 2006.

Furthermore, because of the economic size and the extent of global trade that occurs between members of regional and bilateral trading agreements, the influence of those agreements on the volume of global trade is greater than their influence on the proportion of bilateral trade links.

The Commission's analysis shows that the value of global trade potentially directly affected by one or more trade agreements increased from 17 per cent in 1962 to just over 50 per cent of global trade flows in 2006 (almost US\$6 trillion) (figure 6.1 left panel).<sup>6</sup> The value of global trade potentially directly and indirectly affected by trade agreements increased from 83 per cent in 1962 to more than 99 per cent in 2006 (figure 6.1 right panel). Available information also indicates that the proportion of trade, by value, influenced (both directly and indirectly) by two or more agreements has steadily increased.

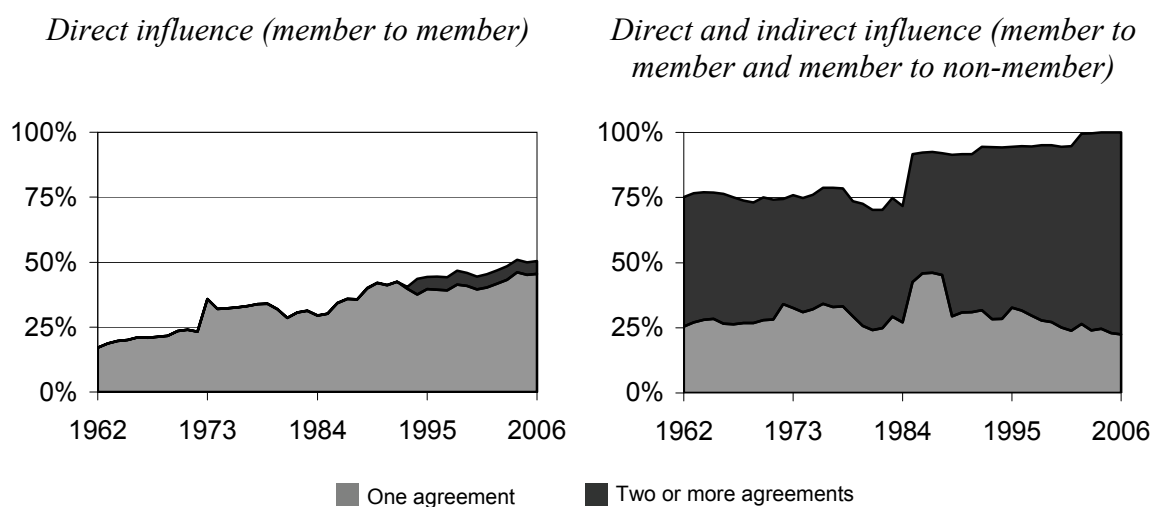
The pervasiveness of membership of agreements amongst major trading countries and regional groups, and the extent of trade influenced by those agreements, underlines the potential influence that bilateral and regional arrangements can have on trading relations between countries — including between member and non-member countries.

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<sup>5</sup> In addition to regional and bilateral trade agreements there is a range of other agreements and memoranda of understanding between countries governing economic relations between the parties. For example, according to UNCTAD data, there are around 5 500 International Investment Agreements (IIA) in force (UNCTAD 2009).

<sup>6</sup> In 2006, global exports were valued at US\$11 762 billion (WTO 2007b).

Figure 6.1 Trade agreements' influence on global trade, 1962 to 2006<sup>a</sup>



<sup>a</sup> Volume of merchandise trade in US dollars<sup>7</sup> - exports from 263 countries, 416 regional and bilateral trade agreements based on 311 notified to the WTO and 105 not notified to the WTO (Medvedev 2006).<sup>8</sup>

Sources: Trade data: from UN Comtrade database. Trade agreements: from WTO (Renard, C., WTO, Geneva, pers. comm., 14 Nov 2008) and Medvedev (2006).

One concern with the recent proliferation of preferential trade agreements in particular is that by a strict interpretation, they violate the WTO's most favoured nation treatment principle (PC 2004b). Nevertheless some argue that any reduction in barriers to trade is likely to provide net benefits, and that eventually, 'global free trade' will emerge. However, a number of factors weaken this 'building block' hypothesis.

- The diverse and overlapping rules that govern preferential trade relationships, along with the administration and enforcement of these rules, increase transaction costs. Because of these costs, PTAs will still distort trade and reduce productivity, even if they have a global coverage.

<sup>7</sup> Non-US currencies are converted to US dollars using an average annual exchange rate which is calculated by weighting the monthly exchange rate with the monthly volume of trade.

<sup>8</sup> Using a comprehensive sample of trade agreements and the United Nations' Comtrade database, it is possible to estimate the proportion of bilateral trade links and volume of global trade flows that are potentially influenced by regional and bilateral trade agreements. The PTA sample was compiled from a WTO sourced list of all notified trade agreements (approximately 311 in force and expired) (Renard, C., WTO, Geneva, pers. comm., 14 Nov 2008) and from Medvedev (2006) (approximately 105 in force and expired) for trade agreements not notified to the WTO, for a total of approximately 416 agreements. In addition to the membership of each agreement, the dates of entry and exit of each member was recorded to allow *dynamic* exploration of the effect of preferential trade agreements on global trade flows. Trade data was compiled from the United Nation's Comtrade database for the period 1962 to 2006 and contains 263 countries (although some countries are not reported for the full period).

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- In addition, the negotiation of preferential arrangements divert skilled and experienced negotiating resources, resulting in reduced engagement in multilateral negotiations. Further, the beneficiaries of the preferences created may reduce support for an ambitious multilateral reform agenda.

In the Commission's assessment, the long-term success of Australia's engagement in global trade and investment markets depends on an understanding of both the direct and indirect effects of preferential trading arrangements.

## **Review of Export Policies and Programs**

In February 2008, the Australian Government announced a review of Australia's export policies and programs (the 'Mortimer' review). Among other things, the review was asked to assess the net benefits of Australia's recent bilateral trade agreements and develop new benchmarks for future bilateral and regional trade agreements.

This section reports the review's assessment of Australia's recent bilateral trade agreements (chapter 3 reports on other topics covered by the review). In the context of the review's assessment that Australia's export performance had been disappointing, it examined the trade and investment creating potential of trade agreements through the prism of design features, recent trends in bilateral trade with agreement partners and the experiences of selected businesses.

It focused on Australia's recent bilateral trade agreements with Singapore, Thailand and the United States. Using a count of the number of chapters and annexes in each of these agreements, and 27 others as an indicator of comparative comprehensiveness, the review concluded that the three trade agreements under consideration were relatively comprehensive in nature. It also observed that the agreements covered most agriculture and manufacturing products — though there were extended phasing periods for some key products. Further, it analysed the coverage and extent of the agreements by benchmarking the concessions offered in each bilateral agreement against the non-discriminatory liberalisation measures achieved under the auspices of the WTO.

The review concluded that the three agreements had a high liberalisation potential, noting that concessions were at least comparable to, and in some cases more far-reaching than, those achieved under the comparison agreements. While these considerations reflected on the design of agreements entered into by Australia, in the Commission's view they do not necessarily provide a reliable indicator of the likely economic effects of those agreements.

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To examine the likely outcomes of the agreements, the review commissioned two trade intensity studies and a survey of businesses to assess how the agreements may be affecting individual firms.<sup>9</sup> The results from the trade intensity studies did not, in the review's assessment, demonstrate a substantial change in the intensity of trade between partners following the entry into force of the agreements.

It suggested, however, a number of factors may be confounding the analysis, including:

- the relatively short period since the agreements entered into force;
- insufficient liberalisation at this stage under the agreements to make any substantial impact on trade (but that this might change as the phase-down process continued for Australia's agreements with Thailand and the United States);
- the possible influence of other trade agreements enacted by all three partner countries with other countries; and
- the influence of other factors that have had an impact on trade (eg exchange rate movements).

With respect to the impact of other trade agreements, the review suggested that it was possible that the agreements with Australia may have enabled Australia's exports to hold their place in each of the three markets, and that Australia's performance actually might have been worse in the absence of the agreements.

The review's business survey found only limited evidence that the agreements had encouraged new entrants into bilateral trade in any of the three markets. The survey was sent to 105 firms engaged in bilateral trade covered by the three recent agreements and received 31 responses. There was some evidence, albeit limited, to suggest that other factors were more important to the businesses operations than the trade preferences delivered under the agreements.

On the basis of the information available and its own assessment, the review reported that the three agreements were 'of a world-class standard, and provide a strong basis for further expansion of trade and investment in the future' (Mortimer 2008, p. 99). It went on to recommend that Australia pursue a bilateral agreement with the European Union and plurilateral agreements such as the proposed Free Trade Area of the Asia-Pacific. More generally, it suggested that preferential trade agreements need not be mutually exclusive to the WTO process and outlined a number of criteria for compatibility and the negotiation of future agreements (box 6.3).

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<sup>9</sup> Trade intensity reflects trade flows (imports plus exports) as a proportion of GDP.

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**Box 6.3 The Mortimer review's recommendations concerning preferential trade agreements**

The review suggested an assessment of future agreements should be based on the trade agreement's potential to:

- counter trade diversion or deliver substantial commercial and wider economic benefits more quickly than would be possible through other efforts;
- be fully consistent with WTO provisions;
- deliver WTO-plus outcomes in the form of liberalising commitments that are broader and deeper than those undertaken in the WTO;
- provide for substantial liberalisation — including by eliminating virtually all tariffs and delivering new and significant access opportunities for services and investment — within a reasonable time period;
- allow, where possible, for the accession of third countries and be consistent with the goal of regional free and open trade and investment; and
- promote Australia's foreign and security policy interests.

It further made recommendations concerning the negotiation of future preferential trade agreements, such that they:

- promote similar provisions and approaches across agreements, and in particular:
  - harmonise rules of origin;
  - extend rules on mutual recognition to third parties; and
  - match provisions on access to services markets.
- encourage transparency and regulatory best practice;
- incorporate existing global standards; and
- allow expansion or accession of agreements to third parties.

*Source:* Mortimer (2008, pp. 102, 104).

Notwithstanding the conclusions and recommendations of the Mortimer review favouring the formulation of regional, plurilateral and preferential trade agreements, the Commission considers that there remain significant information gaps concerning the likely impact of these agreements, and the conditions under which they will deliver economic benefits in practice. There is a particular issue with how anti-competitive regulations needed to enforce trade preferences influence economic outcomes. Given that the links between the design of agreements and economic outcomes are difficult to judge, the Commission considers that further research on the economic costs and benefits of different types of agreements is warranted.

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## Analysis of recent rules of origin affecting Australia's trade agreements

With the design and coverage of regional and bilateral trade agreements being determined by the economic and political factors particular to each, there are significant differences across individual agreements and their supporting regulations.

As recognised in the Mortimer review, preferential rules of origin (RoO) are particularly prone to divergence. These rules are used to determine where a good has been made for the purpose of ensuring that only the products of countries which are party to an agreement obtain concessional entry under the agreement (box 6.4).

The review raised the complexity of rules of origin as an issue in the formation of preferential trade agreements and suggested that harmonisation would be beneficial (Mortimer 2008). It stated:

The main benefits would be to harmonise and rationalise some of the complexity inherent in the existing suite of FTAs in the region — for example, in relation to rules of origin. (p. 101).

... there are concerns at the risk of such agreements diverting trade rather than creating it, and to increased transaction costs for business as a result of multiple rules of origin. ... Rules of origin that are too complex or administratively burdensome can impose a compliance burden that diminishes the gains from the FTA. (p. 181, 195).

Rules of origin can equally be used as protectionist measures if they are so restrictive that only a very few products are eligible for preferential treatment. (p. 195)

In a similar vein, the Review of Australia's Automotive Industry, 'The Bracks Report', noted that:

... differences in trade rules increase administrative costs for importers and exporters alike, and can act as a barrier to trade. (p 54).

It recommended that 'Trade rules, such as rules of origin, should, wherever practicable, be harmonised across free trade agreements to reduce compliance costs to industry' (Bracks 2008, p. 57).

The Commission reported on issues relating to rules of origin in previous issues of *Trade & Assistance Review*. The 2003-04 *Review* reported on the restrictiveness of preferential rules of origin and used an index framework to illustrate the relative restrictiveness of rules of origin from various preferential trade agreements. In the analysis, agreements associated with multiple criteria for determining origin, more restrictive variants of individual criteria and product specific rules (such as in the North American Free Trade Agreement (NAFTA) and related agreements and agreements entered into by the European Union), were assessed as most restrictive.

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## Box 6.4 Key features of rules of origin

### *The need for rules of origin*

Rules of origin are used to establish criteria to determine which goods have sufficient local content to be accorded preferential tariff treatment under a preferential trade agreement.

In the case of customs unions (such as the European Union), where the treatment of goods imported from third parties has been harmonised, the common external tariff means that there is no advantage from transshipment and, in principle, no need for rules of origin to govern bilateral trade between members.

### *Assessing origin is difficult*

Production processes for many goods are now typically fragmented and use inputs sourced from several countries. Moreover, the nature and potential sources of inputs are continually changing, as is the technology and organisation of production itself.

Consequently, attribution of origin to a single country can be problematic. In these circumstances, governments are forced to rely on negotiated and necessarily imperfect rules of origin that attempt to reconcile the goals of the particular trade agreement.

### *Three common tests for determining origin*

- *The change in tariff classification (CTC) test* — a good is transformed if there is a change in tariff classification, using the Harmonized Commodity Description and Coding System. The CTC method can be applied at the 8-digit, 6-digit, 4-digit or 2-digit level of classification.
- *The specified process test* — a good is transformed if it has undergone specified manufacturing or processing operations which confer, or do not confer, origin of the country in which they were carried out. This test is sometimes used in respect of chemical products, for example.
- *The regional value content (RVC) test* — a good is transformed if a threshold percentage value of locally or regionally produced inputs is reached in the exporting country.

### *Special rules are common*

Rules of origin are often subject to considerable 'fine print' — such as special rules for particular tariff items, differences in the application of tolerance or absorption rules and so on.

Source: PC (2004b).

The 2004-05 *Review* reported on the WTO Consultative Board's comments on the threat posed by the proliferation of preferential trade agreements to the multilateral trading system. According to the Board, the most significant cost is that preferential trade agreements complicate world product markets and add substantial costs to

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businesses negotiating the ‘spaghetti bowl’ of different preferential rates and rules of origin.

The 2005-06 *Review* reported on the change in the Australia–New Zealand CER Agreement, from rules that were relatively free from deliberately restrictive product specific provisions to new rules that contain a variety of product specific provisions, sector specific tests and regional value-of-content provisions.

### *The restrictiveness of rules of origin*

While origin rules are a necessary part of a PTA, they act as regulatory (non-tariff) barriers to trade.

For the purposes of this year’s *Trade & Assistance Review*, the Commission examined the relative restrictiveness of rules of origin for various preferential trade agreements using a previously developed index framework (PC 2004b). The index measures assist in evaluating the extent to which rules of origin-related regulatory barriers may restrict trade and are a useful way to assess alternative rules of origin regimes when price and quantity measures or empirical estimates of impacts are not available. An overview of the Commission’s index methodology is provided in box 6.5.

Results from the Commission’s index calculations, updated to include the most recently concluded agreements, show substantial variation in provisions and likely restrictiveness of origin rules across preferential trade agreements. They suggest that the restrictiveness of the new rules of origin in the CER trade agreement are on a par with other agreements recently entered into by Australia (that is with the United States and Thailand) but, if anything, are likely to be more restrictive than the pre-existing rules of origin governing trans-Tasman trade and the origin rules applying in trade between Australia and Singapore under the recently completed SAFTA agreement (figure 6.2). This reflects the product-specific nature of the rules, which often involve multiple criteria and more restrictive variants of certain criteria.

The indexes also indicate that NAFTA and related agreements, and agreements entered into by the European Union, have the most restrictive rules. These agreements tend to be associated with regimes that adopt multiple criteria for determining origin, more restrictive variants of individual criteria, and product specific rules, particularly in areas otherwise supported by higher tariffs.

### Box 6.5 A restrictiveness index

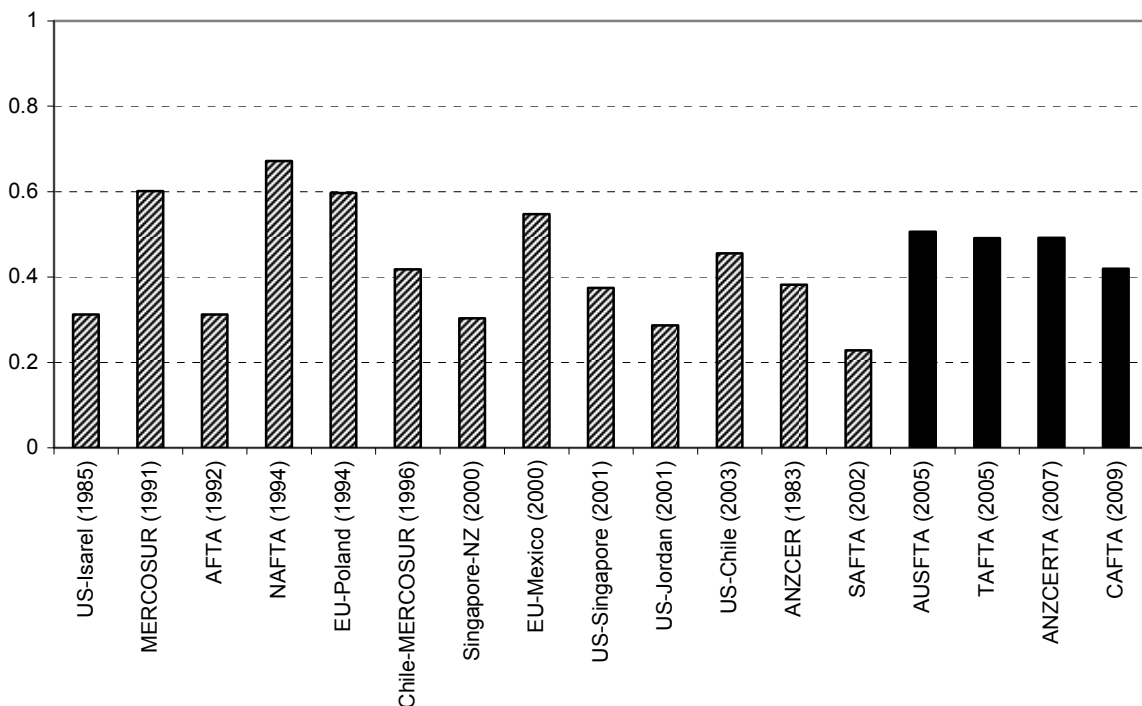
The overall index score for a particular set of rules of origin in the Commission's index reflects the number of restrictions that are applied, weighted by the relative importance of those restrictions. A higher overall index value is interpreted to indicate a more restrictive trading regime for the members of that preferential trading agreement. Within each restriction category, a score is assigned to the particular category of origin determination. The score ranges from 0 (least restrictive) to 1 (most restrictive). However, it needs to be appreciated that the information base for compiling the index — for example, for nominating the weights to be used — is limited. The results should therefore be seen as indicative of orders of magnitude, rather than as a precise measure of restrictiveness.

Rules of origin are not readily modelled in quantitative assessments of the welfare implications of agreements. Nevertheless, economic modelling of the possible welfare gains from an agreement that omit the restrictive effect of rules of origin will be biased because these rules reduce the degree of liberalisation implicit in the size of the tariff reductions.

Source: PC (2004b).

Figure 6.2 Restrictiveness of preferential rules of origin in selected preferential trade agreements

Index score ranges from zero (least restrictive) to 1 (most restrictive)



Source: Commission estimates, PC (2004b).

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### *Further analysis of recent rules of origin affecting Australia*

While the index analysis provides a useful broad indication of the relative restrictiveness of origin rules in each agreement, it does not highlight the diversity that occurs between and within various agreements — an important concern with overlapping rules of origin. To do this, a comparative analysis across agreements of the rules of origin applying to individual items within each agreement is required.

Analysis of four of Australia's recent agreements undertaken for this edition of *Trade & Assistance Review* demonstrates the diversity of approaches for conferring origin that Australian businesses must consider when sourcing inputs that attain concessional access. This diversity can be illustrated at the product level by reference to the rules required to confer origin for a single product (for example in the case of blankets and travelling rugs (box 6.6)). This complexity and non-uniformity is not an exception — the same pattern of prescriptive product specific rules is evident at an aggregate level (figure 6.3).

#### **Box 6.6 A comparison of Australia's rules of origin**

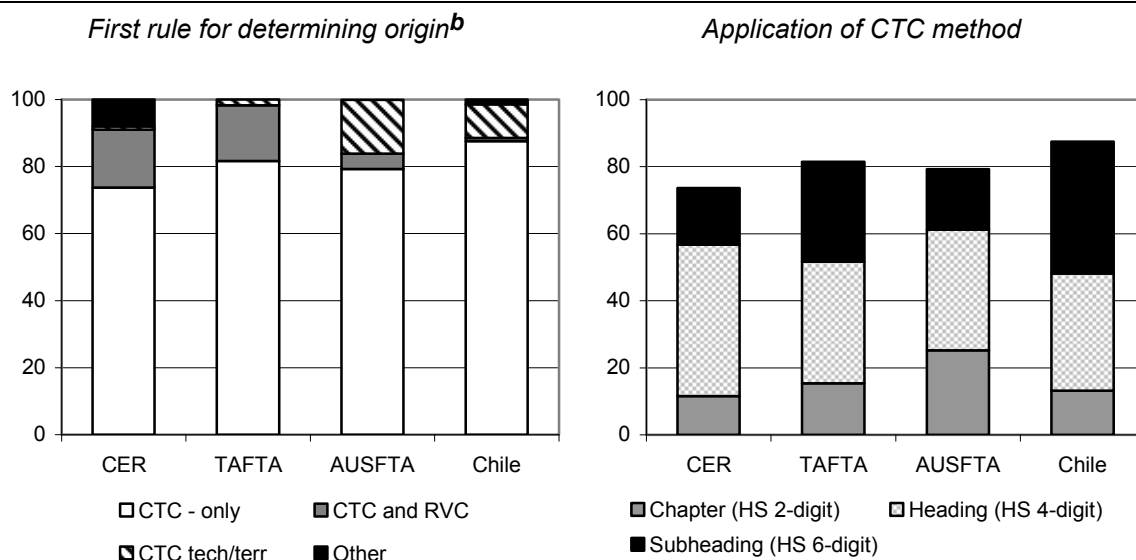
In order to qualify for concessional entry, *Blankets and travelling rugs* (as classified using the Harmonized System (HS) classification) must meet the following criteria:

- A change to subheading 6301 from any other chapter, except from heading 5106 through 5113, 5204 through 5212, 5307 through 5308 or 5310 through 5311, Chapter 54, or heading 5508 through 5516, 5801 through 5802 or 6001 through 6006, provided that the good is both cut (or knit to shape) and sewn or otherwise assembled in the US or Australia (Australia–United States).
- A change to heading 6301 from any other chapter, provided that, where the starting material is fabric, the fabric is pre-bleached or unbleached and there is a regional value content of not less than 55 percent (Thailand–Australia).
- A change to heading 6301 from any other heading except from headings 5007, 5111 through 5113, 5208 through 5212, 5309 through 5311, 5407 through 5408, 5512 through 5516, 5602 through 5603, 5801 through 5802, 5809 through 5811, 5903, 5906 through 5907 or 6001 through 6002; or a change to heading 6301 from any other heading provided there is a regional value content of not less than 55 per cent based on the build-down method (Australia–New Zealand).
- A change to heading 6301 from any other chapter provided that where the starting material is fabric, the fabric is raw and fully finished in the territory of the Parties (Australia–Chile).

Sources: ACS (2004a, 2004b, 2006, 2008a).

**Figure 6.3 Summary of methods used to determine origin in recent preferential trade agreements entered into by Australia<sup>a</sup>**

Per cent of items with non-zero MFN rates in the Australian tariff



<sup>a</sup> The recently concluded Australia-New Zealand-ASEAN agreement contains around 64 per cent of the rules of origin with a 'co-equal' first rule which presents a choice between an RVC or a CTC. <sup>b</sup> CTC refers to a change in tariff classification test. Tech/terr refers to territory or production tests that require particular production methods to be used within the territory of the PTA to qualify for preferential entry. RVC refers to a regional value content rule.

Source: Commission estimates.

The most frequent rule of origin (in Australia's most recent agreements) is the change in tariff classification (CTC) test. However, agreements often, but not always, specify rules of origin which require application of more than one rule (for example, a combination of a CTC rule and a regional value content (RVC) rule) or a CTC rule with an exception, which narrows the scope of the CTC rule by carving out specific products.<sup>10</sup>

Examining the individual agreements shows that:

- The AUSFTA and the Australia–Chile agreements contain a relatively high proportion of CTC rules with technical and territory tests, approximately 16 and 10 per cent, respectively, of rules for items with a non-zero MFN rate in the Australian tariff.
- The Australia–New Zealand and the Australia–Thailand agreements each contain less than 3 per cent of CTC rules with technical and territory tests.

<sup>10</sup> SAFTA only applies a single two tiered test of origin. The first tier requires that the product be manufactured in the member countries. The second tier requires the application of a regional value content rule.

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However, these agreements have higher proportions of CTC rules with regional value content tests, around 17 per cent, respectively, for items with a non-zero MFN rate in the Australian tariff.

The application of the CTC method also varies within the CTC-only rules (figure 6.3, right panel). A CTC rule applied at the chapter level (2-digit) is likely to be more restrictive than a CTC rule applied at the heading or subheading (4, 6 or even 8 digit) level as it would require a more substantial transformation to take place before the rule is met. The AUSFTA agreement contains the highest proportion of CTC-only rules applied at the more restrictive 2-digit chapter level. In contrast, the Australia–Chile and the Australia–Thailand agreements apply the greatest proportion of CTC-only rules at the less restrictive 6-digit subheading level.

As demonstrated above, the implementation of rules of origin in a selection of Australia’s agreements varies. The recently signed Australia–Chile agreement contains the least restrictive and greatest proportion of CTC-only rules, while the Australia–United States agreement contains a more restrictive and less uniform set of rules.

Some tariff lines have two or more rules applying (for example, a CTC rule and an alternative technical test). In some cases, there is a choice of up to eight rules to select between. The complexity of the rules are further increased by the incidence of these multiple rules for individual tariff items within agreements and different combinations of rules between agreements.

As the diversity and complexity of trade agreements which require rules of origin increases, the transaction costs of trading under these varying sets of rules is also likely to increase. Furthermore, the nature of the rules may serve to limit innovation in production processes and restrict competition as firms seek to adjust production processes to gain tariff preferences under particular agreements (PC 2004b).

## **6.5 Summing up**

Slower global economic growth has seen a steep decline in world trade and increased calls, across the world, for measures to protect domestic industries. If such calls are successful, then trade activity will fall further, and with it economic growth. In this context, the integrity and progress of multilateral trade reform is even more important.

Despite this urgency, the Doha Round has yet to conclude. Although Governments have committed to resist protectionist measures, trade barriers in some countries have increased. Governments have also implemented a range of measures to protect

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financial markets that might distort capital flows. To maintain the integrity of the global trading system, proposals to increase transparency, both of trade policies and awareness of the costs of protection to the countries concerned, have a clear role to play.

A longer term trend in international trade policy has been the formation of regional and preferential trade agreements. Australia itself has entered into a number of such agreements. However, the evidence for their net benefits remains unclear and more research is needed. Moreover, the global increase of such agreements may have served to divert attention from finalising the Doha Round.

In addition, the specific rules of origin that apply in preferential agreements are particularly concerning given their potential to raise transaction costs, restrict trade and inhibit innovation. The relative restrictiveness of rules of origin in Australia agreements varies. Some recently concluded agreements have relatively uncomplicated rules. Nevertheless, some recent changes to the CER agreement appear to have introduced more restrictive arrangements than those they replaced.