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Regionalism vs. Multilateralism

An overview of the effects of Regionalism

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ABSTRACT

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The Purpose of this dissertation was to first find the motives behind and causes for regionalism and to explore the advantages and disadvantages of the phenomenon. Secondly, the intension was to determine the benefits of a possible bilateral FTA between Australia and China and whether a bilateral trade agreement would be more beneficial for the Australian economy than waiting for a multilateral WTO regulated framework.

The research was conducted through an extensive literature review. The first part of the research focused on international trade, history of RTAs and the motives behind regionalism. The research also focused on the traditional “stepping stone” versus “Stumbling Block” debate. The second part focused on Australian economy, trade policies and trade relations between Australia and China. The final part of the research explored the possible Australia – China FTA and on the benefits and limitation of the agreement on the Australian economy.

The Study found that there is a pattern in the formation of RTAs and that regionalism is largely a response to globalisation. The research also suggested that although regionalism in certain cases may hinder trade and the formation of a multilateral framework, in general it is trade creating. In addition, a correlation between China’s growth and Australia’s economic welfare could be detected and the benefits from a bilateral FTA were found to outweigh the disadvantage of one and therefore also be more beneficial than waiting for a multilateral framework.

There are always limitations when a study is carried out using secondary sources. The lack of an empirical study, the limited amount of quantitative research present and the vast amount on prior research in the topic are great limitation. Although an extensive amount of studies have been conducted on regionalism, it is still possible to research and find new perspectives because regionalism as a phenomenon is multifaceted.

Keywords: Regionalism, Regional Trade Agreements, Multilateralism, Free Trade Agreement, Economy

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Tämän päättötyön tarkoituksena oli ensiksi löytää motiiveja alueellisuuteen sekä tutkia ilmiön hyötyjä, että haittoja. Toiseksi, tarkoituksena oli arvioida mahdollisen Australian ja Kiinan välisen vapaakauppa alueen hyötyjä Australian talouteen ja päätellä onko vapaakauppa alue hyödyllisempi Australialle kun odottaa WTO:n säätelemää maailmanlaajuista järjestelmää.

Tutkimus tehtiin käyttäen laajaa ja kriittistä katsausta joka perustui vain toisen käden tiedosta. Ensimmäisessä osiossa keskityttiin kansainväliseen kauppaan, alueellistumisen historiaan, alueellistumisen motiiveihin, sekä perinteiseen hyöty/haitta väittelyyn. Toinen osio perustuu Australian taloudesta ja kauppa politiikasta ja Australian ja Kiinan välisestä kaupasta. Viimeisessä osiossa tutustuttiin mahdolliseen Australia-Kiina vapaakauppa alueeseen sekä sen hyötyihin, että haittoihin Australian taloudelle.

Tämän tutkimuksen tulokset osoittivat, että on olemassa eräänlainen säännönmukaisuus alueellistumiseen ja, että alueellistumista motivoi globalisaatio. Tutkimus myös osoittaa, että vaikka alueellistuminen voi haitata kansainvälistä kauppaa, se useimmiten on hyödyllistä maille ja edistää kaupankäyntiä. Myös korrelaatio Kiinan kehityksen ja Australian taloudellisen hyvinvoinnin välillä on mahdollista löytää ja tutkimus osoittaa, että mahdollinen kahdenvälinen vapaakauppa alue olisi palkitsevampaa Australialle.

Kun käyttää tutkimuksissa toisen käden tietoa, rajoituksia löytyy aina. Suurimmat rajoitukset johtuvat empiirisen tutkimuksen puutteesta, kvantitatiivisen tutkimuksen puutteesta sekä jo olemassa olevasta suuresta määrästä kirjallisuutta samasta aiheesta. Vaikka kirjallisuutta tutkimuksia tästä aiheesta löytyy paljon, aiheesta on vielä mahdollisuus löytää uusia näkökulmia koska alueellisuus kehittyy jatkuvasti ja on monipuolinen aihealue.

Avainsanat: Alueellisuus, alueellinen kauppasopimus, vapaakauppasopimus, talous

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Figure 1- Total Imports and Exports

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1. INTRODUCTION

With the growing importance of recent events in the world economy, regional trade areas (RTAs) are becoming more vital for the conduct of international trade. RTAs cover more than half of international trade and operate parallel to multilateral agreements under the World Trade Organisation (WTO) (OECD, 2011). While the WTO pursues trade liberalisation relying on the stimulus from an open economy to increase competition, nations are actively pursuing RTAs to secure existing trade flows and to open up new markets.

Why regionalism occurs has divided economists and other scholars researching the subject, because like many other global occurrences, there is no single reason for the appearance of RTAs but an accumulation of events that have led to the phenomenon. As Crawford and Fiorentino (2005 cited in Pomfret, 2007: 1) conclude, “regional trade agreements are a major and perhaps irreversible feature of the multilateral trading system”, and therefore the topic continuously attracts new research.

There is an on-going debate between the trade creating effect of RTAs and on the trade diverting effects of RTAs. Bilateral trade agreements offer instant reciprocal gains and allow countries to negotiate rules and procedures that the multilateral framework cannot achieve. They can also begin a deeper integration between countries and especially in the case of natural partners will usually be largely trade creating and minimally trade diverting. In addition, RTAs may promote a multilateral framework through discrimination as countries left outside these agreements, pursue a multilateral framework to allow access to new markets.

On the other hand, Regionalism, instead of interpreting it as working parallel to the multilateral framework it may also be perceived as a substitute for it. There is no arguing that RTAs are a violation of GATT’s fundamental principle of non-discrimination (Appendix 1) but as long as an exemption exists, RTAs will be an increasing phenomenon in world trade. There is a common fear of RTAs distorting trade by shifting production from most

effective suppliers to less effective ones which would increase consumer prices that would lead to a trade surplus which would in turn decrease profits that cannot compensate the inefficiency.

Australia and China are natural trading partners and China's industrial growth and demand for primary products have boosted the Australian economy during the past decade. Australia and China have signed many trade agreements but lack a free trade agreement which would be expected to eliminate tariffs in the trade of goods and services. Australia is one of the most open economies in the world with taxes generally falling between 0-5 % (DFAT, 2011) however, Australia restricts access to its markets through other protective measures such as rules of origin (ROOs).

1.2 Aim and the structure of the research

The purpose of this dissertation is to explore the advantages and disadvantages of regionalism and why regionalism occurs. It is also to explore the effects of an Australia-China FTA on the Australian economy and determining whether a FTA is more beneficial to the economy than waiting for a multilateral WTO regulated framework. The goal of this study is to gather information of the two different perspectives on regionalism and to apply these arguments to a possible free trade agreement (FTA) to determine whether one is plausible using generally accepted theory.

Because the research topic is vast and multifaceted, this dissertation focuses on an economic perspective and therefore, many viable studies on regionalism will be left out. One can research the subject from a political perspective as well but taking the nature of- and resources for the study, the political perspective is mentioned but not analysed.

The Structure of the study:

- The second section is an introduction to international trade. It provides an overview of WTO's multilateral trade agenda and the regulations of GATT, GATS and TRIPS. It will also briefly introduce the history of WTO and GATT and describe the effects of the stalled Doha rounds on multilateral trade.

- The Literature review will include the analysis of reasons for regionalism as well as the “stepping stone” vs. “Stumbling block” debate. The section continues with an introduction to Australia’s economy and trade policies and the trade relations between Australia and China. This will lead the reader to an overview of the possible FTA, and finally the positive and negative implications of the Australia-China FTA on the Australian economy.
- The fourth section; methodology will explain how the research was conducted; it will explain why the research was chosen and the limitations to the research.
- The fifth section; Discussion and analysis will focus on summarising the findings during the literature review and pinpoint the most important findings.
- The sixth section; the conclusions will include answers to the research questions and suggestions for further research.

1.3 Limitations

The study of regionalism and multilateralism is a vast topic and would require an extensive amount of time and resources to conduct an in depth study into the phenomenon. Because this was not possible under the circumstances, this dissertation focuses on providing a variety of perceptions and critical analysis of them in regards to the topic. Because the study focuses on several different factors and attempts to combine theory and a common debate with a current FTA Negotiation, none of these could be focused on as much as they individually deserve.

2. INTERNATIONAL TRADE THEORY

2.1. Introduction

“International trade is the exchange of goods and services between the residents of a given country and those of the rest of the world” (Dutta, 2006: 81).

Several classical theories exist on international trade that are still applicable in today’s turbulent trade scene (Appendix 2). The theories include Adam Smith’s theory on Absolute Advantage (1776). David Ricardo’s (1817) theory on Comparative Advantage, that argues that an absolute advantage is not necessary for trading goods and services with another country and both countries will benefit from specialisation in one industry. Heberler (1936) criticises both theories by stating that both Smith’s and Ricardo’s theories are simplistic and based on a false assumption of homogeneous factors (Dutta, 2006: 81).

A key aspect in trade is the theory behind motives for international trade. As Subhendu Dutta (2006) explores in Hecksher (1919) and Ohlin’s (1933) *Modern theory of International Trade*, the primary reason for countries to conduct international trade is the difference in prices which is a direct result of supply and demand in each country. Horvat Branko (1999) also touches on the subject and both economists agree on the source of supply differences by referring to Hecksher and Ohlin’s theory. Dutta states that the supply differences arise from natural endowments, degree of efficiency, and level of technology, labour skills and factor abundances (Dutta, 2006: 81). The General Equilibrium theory (modern theory of international trade) has been criticised by Heberler due to its ignorance of transport costs and therefore should only be viewed as a “complementary theory” (Economic Concepts, 2012) and not a “substitute of the Classical Theory of Comparative Cost” (Economic Concepts, 2012).

2.2. Multilateral Trade Agenda

The creation of the WTO (WTO, 2011) in 1995 at the end of the Uruguay rounds conducted under the General Agreement on Tariffs and Trade (GATT) negotiations, was the largest reform in multilateral trade since the Second World War (WTO, 2011). WTO lays the foundation for international trade through its foundation of a multilateral trading agenda. All 154 members (by 31.01.2012) (Strong and Herd, 2012), must abide by the set of rules set out in the General Agreement on Tariffs and Trade (GATT), General Agreement in Trade on Services (GATS) and the Agreement on Trade-Related Aspects of International Property Rights (TRIPS),(Appendix 3) (WTO, 2011).The principles of the trade agenda include rules on most favoured nation, national treatment, freer trade, transparency, promoting fair competition and encouraging development and economic reform (Appendix 1).

2.2.1. From GATT to WTO

GATT, created after World War Two was a provisional agreement between states set up to provide the rules for ever increasing global trade during the boom period after the world wars. From the creation of GATT in 1948 to the end of it in 1994, the global economy grew faster than it had thus far and what it would in the future (WTO, 2011). The original intention was to create a third institution, International Trade Organisation to handle world trade along with the two Bretton Wood institutions; The World Bank and the International Monetary Fund (IMF). During the first round of GATT negotiations, rules for 45,000 tariff reductions were created affecting a fifth of world Trade (WTO, 2011).

Although GATT managed to decrease tariffs and promote global trade, many argue that GATT was not successful. Baldwin (2004) points out that until 1970s GATT was a rich man's club, promoting the welfare of the most powerful nations. Talks concentrated on food and manufacturing and until 1990s the main focus was manufacturing although the global economy saw an increase in services and investment, which would have required closer regulation. Also, the WTO (1997) reminds that the GATT was formed in the 1940s

and by 1980 “was not relevant to the realities of world trade as it had been in the 1940s.” GATT also lacked a dispute settlement system and had loopholes, especially in agriculture that allowed countries to violate provisions of the GATT, without fear of repercussions (WTO, 2011).

2.2.2. The Case for Open Trade (WTO)

Statistics prove a correlation between open trade and economic growth; hence the WTO promotes liberation in trade so aggressively. Even during the GATT years, world trade grew on average by 8% annually (WTO, 2011). The WTO firmly believes in comparative advantage and that all countries will benefit from an increase in competition overseas markets provide for countries. Because markets and technology develop, comparative advantage can shift from country to country thus supporting free trade which works as a stimulus for nations to advance from competing in one sector to another (WTO, 2011). According to the WTO, protectionism leads to bloated markets, where producers supply consumers with outdated, unattractive and expensive products (WTO, 2011). Bagwell and Staiger (2003) and Ossa (2010) all concluded that the optimal result would be a successful multilateral trade agreement based on simple policies that would allow countries to agree on tariff reductions and market access (World Trade Report, 2011).

2.2.3. Doha Rounds- WTO

The most recent trade negotiations began in Doha, Qatar in 2001 (WTO, 2011). The aim of the Doha rounds was to further liberalise trade and create a multilateral trade system through the introduction of lower trade barriers and amended trade regulations. Originally the negotiations began on a basis to reach an agreement on all trade aspects under a single undertaking, meaning that all aspects were treated as one package. No country could pick and choose the agreements that suited them best. The negotiations are slow due to the nature of the single undertaking. Differences have gradually been narrowed, but the negotiations are dragging because no nation is willing to take on all obligations (WTO, 2011).

The main topics of the Doha rounds comprise agriculture, services, market for non-agricultural products, trade related aspects of intellectual property rights, relationship between trade and investment, trade facilitation, RTAs, trade and environment and other trade related matters (WTO, 2011). All the above topics were included in the WTO rules prior to the Doha negotiations, but allowed countries to use the present loopholes to create trade diversion. The WTO rules on RTAs is an essential topic during the Doha rounds due to the enabling clause in the GATT that allows members to create RTAs, which the WTO finds trade prohibiting. The rules can be interpreted differently and since most governments are parties to RTAs this is an urgent matter to be discussed in the negotiations (WTO, 2011).

3. LITERATURE REVIEW

3.1. Regionalism

“Regional Trade Agreements are a major and perhaps irreversible feature of the multilateral trading system.” (Crawfords and Fiorentino, 2005 cited in Pomfret, 2007: 1)

A large amount of research exists on the reasons for regionalism and why it increases political and economic stability. Syssner (2006: 16) recognises the lack of research behind the “ideological foundation or value-basis of regionalism”. Syssner compares regionalism to political projects and focuses on the observable features behind it. The research is valid but lacks the economic aspects while admitting that the study of why countries enter regions and what regionalism brings to a country is “not irrelevant or uninteresting”, (Syssner, 2006: 16). The idea behind Syssner’s research is interesting and is supported by Colin H. Williams (cited in Syssner, 2006: 20) who agrees on the political aspect by stating that “regionalism is the attempt to optimise the interest of a region’s population through the manipulation of the political process”.

Although there is a lack of published literature on the ideological foundation of regionalism, a vast amount of literature on the political motives behind regionalism can be found. According to Baylis, Smith & Owens (2011: 431) “regional agreements are often more to do with strategic or political alliances than trade liberalisation”, thus disregarding the importance of economic benefits and focusing on the stepping stone effect from a political aspect.

3.1.1. A Brief History

Regionalism is not a new phenomenon, Georg Koopman and Lars Vogel (2008) find in their research that the first wave of regionalism occurred in the second half of the 19th century when the *Cobden Chevalier Treaty*, signed between the United Kingdom and France in 1870, performed as a catalyst for multiple bilateral treaties signed by the two countries and other European nations. Other research states that regionalism has occurred in several different phases.

Economic events have a tendency to follow patterns; therefore the study of regionalism from a historical perspective is valid. Regionalism has followed a wave pattern throughout the past few centuries and is expected to continue so, especially due to the stalling of the DOHA rounds.

Richard Pomfret (2007) realises that although the “cornerstone” for GATT has been the non-discriminatory principle of most favoured nation, three waves of regionalism have occurred since the signing of the GATT in 1947. 1950s saw the first wave of regionalism when six European Nations began economic integration that led to the establishment of a common market, European Coal and Steel Community (ECSC) in 1951 (Europa, 2011), followed by the creation of the European Economic Community (EEC) in 1957 (Schiff and Winters, 2003: 5) which then led to the creation of other RTAs (WTO, 2011). Seven other countries formed the European Free Trade Association (EFTA) in 1960, also the Generalised System of Preferences (GSP), signed in 1971 which allowed tariff preferences for developing countries created a surge in RTAs due to the benefits for developing countries.

The second wave of regionalism occurred after the US left the GATT in the 1980s and with the creation of the Northern American Free Trade Agreement (NAFTA) in 1993. The Expansion of EU in 1995 to 15 countries further increased the surge in regionalism. By 1998, 55 to 60 % of world trade was conducted between regional partners (Schiff & Winters, 1998: 178). The third large wave occurred in early 2000 led by East Asia which had managed to regain growth after the Asian Crisis of 1997. China’s economic growth also accelerated the formation of Regionalism in East Asia along with the diminishing importance of the Asia Pacific Economic Co-Operation (APEC).

3.1.2. Causes for Regionalism

After the unsuccessful Doha rounds that started in November 2001, multilateral trade has come to a standstill as there are continuous disagreements on the related topics (WTO, 2011). With the growing importance and recent events in the global economy, RTAs are becoming more vital for the conduct of international business. FTAs cover more than half of the international trade and operate parallel to global multilateral agreements under

the WTO (OECD, 2011). RTAs such as FTAs are especially attractive to small neighbouring countries with similar concerns that can reach larger markets as well as find new ways of operating through regionalism (OECD, 2011).

Literature provides many causes for regionalism including the unsuccessful Doha rounds. Farrell et al. (2005: 2) list regionalism as a response to globalisation "...and a reaction to the diverse aspects of global processes in their entirety." Similarly Baylis et al. (2011: 431) argue that regionalism is the result of countries attempting to manage internationalisation. However they also realise several other causes for regionalism including "management of independence" by former colonies and "management of interdependence" (Baylis. et al., 2011: 431).

In recent years, trade liberalisation has been conducted through the establishment of RTAs (Freund & Ornelas, 2010) and seems to be correlated to multilateral trade talks (Mansfield & Reinhardt, 2003) although not included in the DOHA rounds.

Competition for countries to enter RTAs is increasing as countries fear exclusion from markets (Koopman and Vogel, 2008: 1). Globalisation has also increased the need for RTAs due to global production networks because RTAs offer governance for important issues during the process (World Trade Report, 2011). Economists and political scientists have identified several independent factors that have affected the increase in regionalism (World Trade Report, 2011). Firstly, beggar-thy-neighbour policies are neutralised through RTAs. The theory behind the policy is that trade agreements and policies conducted by one country affect the neighbouring countries as well.

The following scenarios can also be avoided by creating co-operating trade agreements between nations. First, Bagwell and Staiger (1999 cited in World Trade Report, 2011: 94) argue that if all countries apply as restrictive trade measures, it has little net effect on the trade volumes which would reduce aggregate welfare. This is known as the terms of trade prisoner dilemma. Secondly, Johnson (1953 cited in the World Trade Report, 2009: 21) writes that the Nash equilibrium where unilateral actions of countries cancel each other out is caused by a country with market power that diverts fair trade by improving "its terms of trade (i.e. lower the costs of its imports relative to exports)" to "increase

national income". Venables (1987) noted that if all countries try to pursue mutual policies such as attract production for example, no country will succeed, a phenomenon called the "production relocation effect" (World Trade Report, 2011: 96). The main economic motives for RTAs occur due to access to larger markets especially now that there is an increase in predictability and transparency (World Trade Report, 2011: 94).

A WTO member has trade agreements with an average of 15 countries (Freund and Ornelas, 2010: 2). All members of the WTO except Mongolia are members of RTAs showing the importance of these in global trade (World Bank, 2011). Smaller RTAs such as bilateral agreements provide countries with immediate reciprocal gains, compared to multilateral agreements (Dieter, 2009: 395). Dieter also argues that politically it is impossible to conduct multilateral negotiations because they are time taking. The political cycle is much shorter than that of multilateral negotiations. Dieter's research also shows that transnational companies are aggressively pursuing RTAs in order to gain market access to closed markets. Even those companies that seek more protective measures seek for RTAs because implementing a multilateral agenda will expose them to more competition, which in some cases could lead to a disadvantageous position (Dieter, 2009: 395).

3.2. Trade Creation versus Trade Diversion

"The capacity of states is an impediment to cooperation, and will, along with the nature of the regional and international environment, crucially affect the success or failure of any regional project..." (Lepgold cited in Farrell et al., 2005: 34)

The main arguments in literature and research focus on the effects of RTAs. RTAs such as bilateral agreements can be perceived as a threat to the WTO's multilateral agenda, and especially a violation against GATT's principle of non-discrimination (WTO, 2011). Much of the research focuses on 'shallow trade' such as FTAs although WTO recognises in the 2011 World Trade Report that the main motive for trade agreements isn't tariff reduction between countries anymore. The report also emphasises on the lack of relevance of traditional theory to current "deep integration" arrangements (World Trade Report, 2011: 5).

Further research is needed on the “relationship between the growth of international production networks and the formation of deeper policy arrangements among countries” (World Trade Report, 2011: 114). As Baldwin (2010 cited in World Trade Report, 2011: 187) concludes, “Twenty-first century regionalism is more about reducing frictional trade barriers and the cost of doing business and removing domestic entry barriers than about tariff reductions”, further proving the need for more research in current trends of regionalism and the consequences forming trade agreements have on the multilateral framework in trade.

3.2.1. Regionalism as a stepping stone for trade

The two major schools of thought in the classical debate of stepping stones versus stumbling blocks are Larry Summer’s School-of-thought arguing that discriminatory liberalisation is trade liberating, and the Jagdish Bhagwati school-of-thought supporting the view that discriminatory liberalisation is trade discrimination (we will return to this later), (Baldwin, 2004). Research supporting Larry Summer’s argument has been conducted globally and strongly supports the school of thought. Krishna (2003 cited in Freund and Ornelas, 2010: 12) conducted a research by calculating economic gain with the traditional gravity model (appendix 3) using 24 hypothetical United States bilateral trade agreements, showing that 80% of the agreements would have been welfare enhancing. Bilateral trade agreements are also beneficial for trade parties in need of instant gratification, Heribert Dieter’s (2009: 395) research paper concluded that bilateral agreements provide immediate reciprocal gains for a country’s economy, and can be a useful political tool.

Caroline Freund and Emanuel Ornelas (2010) research paper on RTAs is one of the most recognised recent research papers arguing the benefits of bilateral trade agreements. Trade agreements between ‘natural trade partners’ result in minimal trade diversion and is largely trade creating. Natural partners are countries that already conduct a large amount of trade between each other (Krugman, 1991). Using a model showing natural trade partners spread over several continents, Krugman (1991) concludes that bilateral trade agreements between natural trade partners enhances trade because the “gains from freeing intraregional trade are larger and the costs of reducing interregional trade

are smaller” (Krugman 1991 cited in Freund and Ornelas, 2010: 12). Freund and Ornelas (2010) also recognise the benefits of bilateral trade agreements towards a multilateral framework. Regional and bilateral trade agreements allow countries to negotiate on rules and procedures that the multilateral framework cannot conduct due to preceding complicated trade rules (WTO, 2011). The study by Freund and Ornelas (2010) further supports the WTO view of bilateral agreements supporting a multilateral framework by concluding that discrimination, if present, can encourage outside countries to join a multilateral framework in order to minimise or eliminate the cost of discrimination. The research also shows that a bilateral trade agreement can be the beginning of deeper integration, including services, migration and investment.

Finally, a study by Baier and Bergstrand (2004 cited in Freund and Ornelas, 2010: 13) carried out to research which country pairs would most likely gain from forming RTAs using the general gravity model (appendix 4) also concluded that forming RTAs is the first step towards deeper integration which is trade creating for countries. They were the first to empirically show “the impact of country- pair’s economic characteristics on the likelihood of the pair having an FTA” (Baier et al., 2011: 1). The research showed that countries that are geographically close to each other and especially if they are remote from the rest of the world are more likely to gain from an RTA. Also the larger the GDP of a country and the difference in the size of the GDP between trade partners, perform as a success factor. Economic similarities seem to be key aspects, Baier and Bergstrand (2005: 24) conclude that a larger difference between the relative factor endowment and the larger the difference in absolute capital and labour costs compared to the rest of the world are, the more likely it is that the formation of an RTA is trade creating.

3.2.2. Regionalism as a stumbling block for trade

Major research has a focus on proving RTAs to be trade creating, however it is common to find studies that also argue this. The best known research in this topic is carried out by the same researchers presenting arguments to support both points of view. As mentioned earlier, the second school of thought; the Jagdish Bhagwati (Baldwin, 2004: 2) argues that discriminatory liberalisation is discriminatory. According to theory, regionalism acts as a

substitute for multilateralism and shifts the focus away from a multilateral trade scheme. Furthermore, Ornelas (2005a cited in Freund and Ornelas, 2010: 26-27) discovered using Krishna's model (1998) that those countries left outside RTAs may turn against multilateralism if the external tariffs are decreased to such a level that compensates trade discrimination towards them.

According to Bhagwati RTAs contradict the mercantilist view by opening up the market for imports even though theory claims imports to be unfavourable to nations and emphasises on the strength of exports (Baldwin, 2004). Baldwin further criticises RTAs by concluding that import competing sectors lower production volumes and increase unemployment as national tariffs are lowered.

A similar approach has been taken by McLaren who in 2002 researched the effects of RTAs on sector specific investment. He argues that "a trading bloc induces private agents in each country to invest and specialise towards each other" (McLaren 2002 cited in Freund and Ornelas, 2010: 26-27). Also Levy (1997) and Krishna (1998) realise that an RTA can be destructive because producers who would otherwise support multilateral trade can turn against it because liberalised trade would counteract the rents and protection created through regionalism (Freund & Ornelas, 2010: 26). RTAs can also alter world trade and decrease production by shifting production away from the most efficient suppliers which would increase consumer prices leading to a trade surplus and thus resulting in small profits that do not cover costs of the inefficiency (Viner 1950 cited in Freund & Ornelas, 2010: 5).

Benefits of RTAs are measured through the increase in trade and the ratio between the profits and costs of forming a trade agreement. As Freund and Ornelas (2010: 2) conclude, "standard gains from trade liberalization are not guaranteed". If gains are achieved at the expense of non-members, the RTA is not successful. In addition, the volumes of trade and transportation costs may not be a sufficient way of calculating success (Bhagwati & Panagariya 1996 cited in Freund and Ornelas, 2010: 12), especially referring to trade theory and the shift of comparative advantage which often takes place in many industries.

Farrell et al. (2005: 34-35) also recognise the disadvantageous situation of weaker states entering trade agreements with strong economies. The “hegemons” or “dominant” states are likely to abuse the capacity of regionalism and while some countries enter regions to advance their economies, the entry may also result in the loss of identity and sovereignty.

A major argument against RTAs has been the cost of nationalising a product. Rules of Origin (ROO) are defined in the WTO Agreement on Rules of Origin as:

“those laws, regulations and administrative determinations of general application applied by any Member to determine the country of origin of goods provided such rules of origin are not related to contractual or autonomous trade regimes leading to the granting of tariff preferences going beyond the application of paragraph 1 of Article I of GATT 1994” (WTO, 2002).

Rules of Origin are separately decided upon for each trade agreement; hence countries must obey several different sets of rules when creating bilateral trade agreements. Disputes about ROOs are difficult to solve, especially in bilateral trade agreements involving developing countries as they are not supported by the Advisory Centre for WTO Law which in a multilateral case would provide advice for developing countries (Dieter, 2009).

Studies prove that the bureaucratic measures taken by exporters to prove the origin of products create distortion in trade. A study by the Canadian government showed that only 30% of the preferential trade agreement (PTA) rules are in use due to the cost of proving the origin of a product compared to the cost incurred by the already low tariff levels (Dieter, 2009: 398). Dieter further emphasises the trade diversion created by ROOs by claiming that constantly diverging rules from new trade agreements decrease production in a company.

ROOs are a form of protectionism and act as foreign subsidies to the final producers of the goods in the export industry (Dieter, 2009). According to Freund and Ornelas (2010: 37), ROOs also protect the “domestic intermediate industry”. However, the effect of ROOs in an intermediate industry of a country depends on the type of competition in the

intermediate and final goods market and therefore, the outcome is unpredictable and cannot be generalised (Vousden 1987 cited in Freund and Ornelas, 2010: 37). Krueger's literature (1999 cited in Freund and Ornelas, 2010: 37) further supports Dieter's notion of protectionism by concluding that "ROOs effectively extend protection from high-tariff to low-tariff FTA countries, because exporters in the low-tariff country are effectively subject to the same conditions as firms in the high-tariff country".

3.3. Australian Economy

3.3.1. Main Trade Statistics

Australia is a high income country (OECD, 2012) with an annual average growth rate of 3.7% between 1992 and 2007 outperforming the average annual OECD growth (2.6%) during the same time frame (Conley, 2009: 113). Australia is one of the most successful economies in the world and one of the only countries to have achieved a steady growth for seventeen consecutive years (Conley, 2009: 111). During the Economic Crisis between 2008 and 2009, growth fell to 1.4% from 3.8% but already in 2009/2010 recovered to 2.3% (WTO Trade Policy Review, 2011: vii). Growth is boosted by the rise in commodity prices due to the continuing demand for commodity exports from China which "pushed Australia's terms of trade to its highest level in 60 years" (World Trade Organization Trade Policy Review, 2011: vii).

Australia's main curse is weak exports. According to Emerson (2006: 37) the growth in volumes during the past decade has decreased compared to volumes in the decade before. Between 1986 and 2000 the volume of exports increased by 12% annually but between 2000 and 2004 it had decreased to 4% annually (Emerson, 2006: 37). Australia greatly relies on export of primary products and between 2001 and 2006, the export of primary products increased from 59.7% to 62.2% (Conley, 2009: 115). Primary exports totalled A\$ 181,491 million in 2010/2011 compared to A\$ 138,416 million in 2009/2010 portraying the rebound from the economic crisis (appendix 5). Australia's main exports are minerals and fuels comprising 47.5% of total exports in 2010 (DFAT, 2011). Export in primary products especially iron ore and gold will continue a steady growth while China develops. Between 1999 and 2007 Australia's export in iron ore to China increased eight

fold as well as China's mineral imports from Australia rose from A\$ 2.3 billion in 2000 to A\$ 13.2 billion in 2007 (Conley, 2009: 117).

During recent years, Australia's exports in trade and services have levelled with the imports but looking at the statistics between 2005 and 2011 it is evident that generally imports exceed exports thus creating trade deficits for Australia. Australian imports totalled A\$ 276,627 million compared to A\$ 297,545 million in imports in 2010/2011 (DFAT, 2011) which is an improvement from the trade deficit from 2009/2010 (appendix 5). Australia's largest import in goods and services is personal travel which accounted for A\$ 21,679 million in 2010/2011 leaving crude petroleum second comprising A\$ 19,301 million of total trade. Australia's main import countries are China (15.5%) and US (13.1%) (DFAT, 2011) with goods accounting for 84.8% and services 15.2% of the total amount.

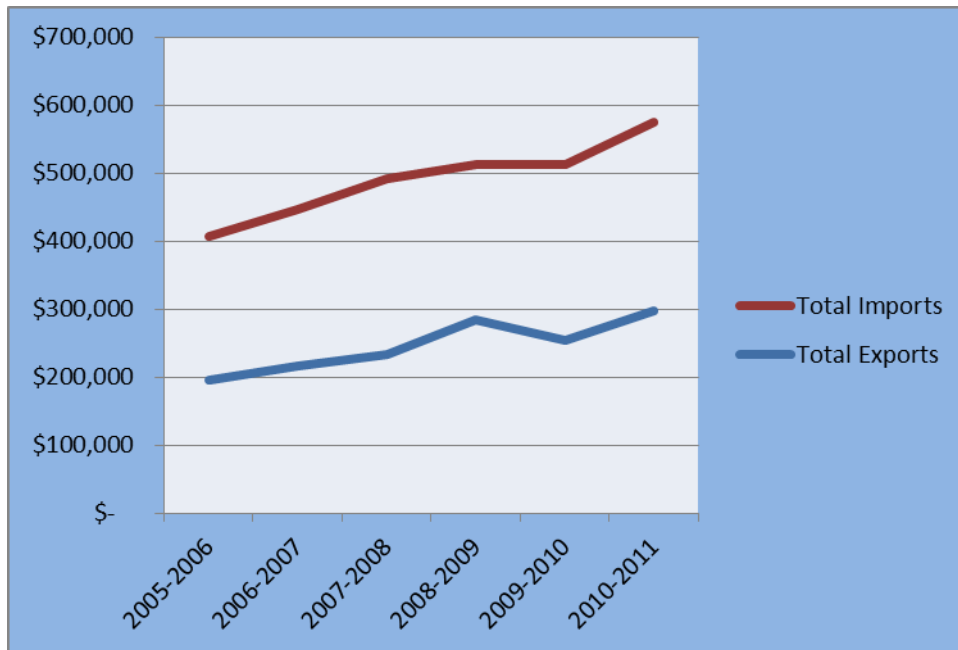


Figure 1 Total Imports and Exports (Source: DFAT, 2011)

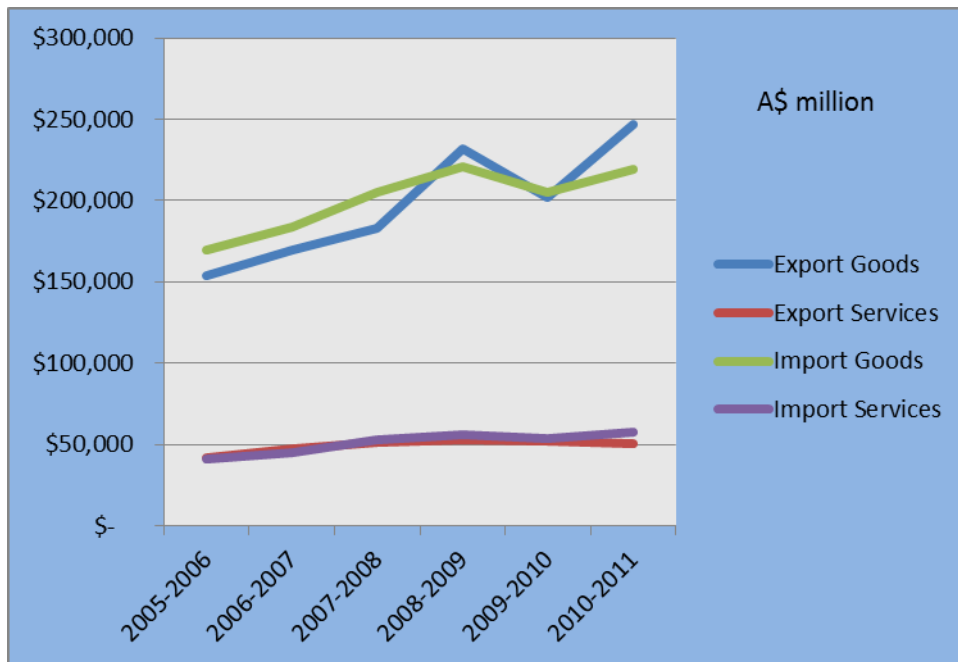


Figure 2 Exports and Imports in Goods and Services (Source: DFAT:2011)

3.3.2. Australia's Trade Policy

Australia is one of the original members of the WTO (since 1995) and has been an active member during the DOHA rounds (WTO, 2011). Australia recognises the benefits from successfully concluding the DOHA rounds, especially for businesses and employees (WTO Trade Policy Review, 2011: 22). Australia also supports less developed nations by providing duty free treatment for imports from the least developed nations and is a member of Asia Pacific Economic Co-operation (APEC), the Cairns Group, Friends of Ambition (NAMA), Friends of Fish (FoFs), and Joint Proposal of Intellectual Property (WTO, 2011).

Australia is one of the most open and transparent economies in the world however, further regulatory reform has taken place in order to remove barriers restricting trade and to improve productivity (WTO Trade Policy Review, 2011: 18). As with many other economies, Australia is committed to pursuing a multilateral framework but has put more emphasis on increasing preferential trade relations through the conclusion of agreements with partners and trade regions (WTO Trade Policy Review, 2011: 18). Australia has low tariffs on most goods and services varying between 0-5%, however tariffs over 5% could

in 2005 be found in textiles, clothing, footwear and motor vehicles (DFAT and Ministry of Commerce China, 2005: 17).

Although Australia levies small taxes, it protects trade through other non-tariff measures based on "...vaguely defined but not prescriptive national interest criteria, and restricts ownership in a few sensitive areas" (WTO Trade Policy Review, 2011: 18). Protectionist methods include ROOs regimes, tariff rate quotas, import licensing regimes, customs evaluation, shipment inspection, technical barriers, sanitary and phytosanitary measures and trade remedies (DFAT and Ministry of Commerce China, 2005: 19).

3.3.3. Bilateral and Regional Trade Agreements

Since the 1990s Australia's trade policy has stood on three pillars. The first is the reduction of domestic protection such as tariffs and other regulations to enhance productivity. The second is the importance of a multilateral trade framework that would allow greater access to foreign markets and the third is a "non-discriminatory approach to bilateral and regional trade" (Emerson, 2006: 167-168). As mentioned earlier, Australia is an active member of the Doha round and has taken initiative to liberalise trade as the OECD quotes:

Much of Australia's trade liberalisation policies have been unilateral, undertaken regardless of other countries' actions. Such an approach reflects the recognition that the benefits of trade come from opening up the economy to cheaper imports, than waiting for the other countries to open their markets (OECD cited in Emerson, 2006: 168).

Although the pillars were created two decades ago under a different government, the current government has a similar stance on trade policy. Julia Gillard's government policy statement of April 2011 reads as follows:

There is no good reason for discrimination and therefore no good reason to sacrifice jobs and income through trade diversion. Applying the non-discrimination principle, in negotiations with trading partners the Gillard government will not seek exclusive or entrenched preferential access to other countries' markets. Non-discriminatory trade agreements after better long-run returns for Australia are more likely to result in trade creation instead of diverting trade from other countries that in the absence of tariffs would be lower-cost producers. However, the Gillard government will vigorously pursue better access to other countries' markets for our exporters of agricultural produce, of manufactured products and of services (Julia Gillard 2011 cited by DFAT, 2011).

3.4. Australia and China Trade Relations

“There can be no denying that Australia has been lucky to be in a position to take advantage of China’s industrialisation and to be located near the Asian Region” (Conley, 2009: 126). Much of the literature on Australian economy also provides insight to the trade between Australia and China, especially during the past decade when the rise of China has greatly increased the welfare of Australia. Especially China’s demand in the mining sector has increased Australian economic growth. Between 1999 and 2007 China’s imports of iron ore increased 8-fold and the total of mineral imports grew from A\$ 2.03 billion in 2000 to A\$ 13.2 billion in 2007 (Conley, 2009: 117). Government statistics also show positive growth in total trade between China and Australia with a total year on year growth of 24.6% in 2010 (DFAT, 2011).

To narrow down the deficit Australia runs with China, “Australia must become more than just a supplier of natural resources for Asia’s industrialisation” (Conley, 2009: 129). Furthermore, committed and increased investment in China will diversify Australia’s exports to China and thus encouraging and securing further growth. As mentioned earlier, Australia is lucky to be in a position to take advantage of China’s industrialisation; however, Australia can also take advantage once China’s economy shifts up the value chain (KPMG and The University of Sydney China Studies Centre, 2011). Due to China’s

drive to diversify its foreign currency holdings, Chinese companies are pursuing “overseas investment in countries rich in offerings that satisfy its requirements and have a positive policy and social environment for Chinese investment”. (KPMG and The University of Sydney China Studies Centre, 2011: 10).

China’s plan to move up the value chain will be pursued through “developing and acquiring new sciences and technologies” as well as managerial know-how, by “developing new environmental technologies and solutions to harmful waste and pollution” as well as through “increased access to education and lifting the quality and depth of their own education” (KPMG and The University of Sydney China Studies Centre, 2011: 8). Australia is in a great position to provide much of the services China needs to develop. Already in 2010, education constituted for 74.4% of service exports to China (DFAT, 2011). Also, Australia is well known for its state of the art practices in innovation especially in “technological innovation, sciences and environmental technologies”, (KPMG and The University of Sydney China Studies Centre, 2011: 11).

Australia’s next challenge is to decide how to accommodate and regulate Chinese investment in the Australian mining sector. China’s large capital reserves provide China with an opportunity to invest while the rest of the world is still recovering from the financial turmoil. In theory, larger investment from Chinese government in the mining sector would not affect Australian economy negatively because much of the mining sector is already foreign owned, the challenge lies in any “major buyer of resource” because they “will control supply and prices leading to lower revenue for Australians” (Conley, 2009: 156).

3.5. Australia China Free Trade Agreement

The negotiations for an Australia – China FTA began in 2005, (He, 2010: 1). Thus far, sixteen rounds of negotiations have been carried out with restricted success. Although the FTA is a fairly new concept in trade between Australia and China, the two governments have signed several agreements regarding trade of which the 1973 Trade Agreement “has served as the basis for the bilateral trade and economic relationship” (DFAT and Ministry of Commerce, China, 2005: 5), and is enhanced by further bilateral

agreements such as the Trade and Economic Framework between Australia and the People's Republic of China 2003 (DFAT and Ministry of Commerce, China, 2005: 135).

As established previously, China is Australia's main trading partner; therefore an inclusive trade agreement would secure two-way trade from which both countries would benefit.

The main drivers for a bilateral trade agreement are pre-existing agreements and mutual active commitment through Asia Pacific Economic Co-operation (APEC) (He, 2010: 2).

China benefits from a trade agreement by securing a stable supply of energy resources and is able to "gain international credibility" (Burrows & Kirk, 2005: 27-28).

Simultaneously, Australia is able to increase the already over A\$58 million (DFAT, 2011) export-bound trade to China as well as to gain more market access to the region. As China continues its growth and development, the demand for STMs and ETMs from Australia which act as "the key industrial inputs into the production process" grows (He, 2010: 5). Another objective for Australia is to lower tariffs and protectionist methods at China's end and to make China's markets more accessible as well as to tackle problems behind the Chinese border (Burrows and Kirk, 2005: 17).

According to the '*Australia – China FTA Joint Feasibility study*' conducted by DFAT and China's Ministry of Commerce, both China and Australia recognise the benefits of a bilateral FTA, however both are active supporters and members in the multilateral trade talks. Through existing bilateral free trade agreement negotiations, there is potential for WTO-consistent FTAs to deliver benefits at a more rapid pace. Such agreements can, in turn, support and reinforce multilateral liberalisation (DFAT and Ministry of Commerce, China, 2005: 6).

Australia and China already have a complimentary trade relationship with both countries having a comparative advantage in different sectors and due to the different stages in economic development, a diversified interest in mutually beneficial industries. While Australia "predominantly exports unprocessed rural and resource commodities and some high value manufactures to China...China in turn predominantly exports labour-intensive or processing-derived manufactured goods to Australia..." (DFAT and Ministry of Commerce, China, 2005: 9).

Although both countries are open to trade liberalisation and especially Australia is globally one of the most open economies, Australia uses other protectionist methods to regulate trade. In mining and energy for example where tariffs are generally low, between 0% and 5% (DFAT and Ministry of Commerce, China, 2005: 17) non-tariff measures include “standards and technical regulations, quarantine admin, customs admin and valuation, transparency of admin and appeal and dispute resolution as well as Intellectual Property Rights measures” (DFAT and Ministry of Commerce, China, 2005: 17). An FTA between Australia and China would “in accordance with relevant WTO provision...be expected to eliminate tariffs on substantially all trade between the two countries”, (DFAT and Ministry of Commerce, China, 2005: 15).

3.5.1. Benefits of an FTA for Australia

An FTA between Australia and China would be beneficial to both countries and will allow Australia to reinvigorate its economy. A study by KPMG Australia and the University of Sydney China studies centre, 2011 recognises and analyses how further co-operation between Australia and China would benefit both countries.

According to the study (2011: 29), Australia “offers an attractive environment” for investment in infrastructure. Due to political and economic stability, Australia encourages foreign investment and serves as a more secure destination for investment compared to less developed economies (KPMG and University of Sydney China Studies centre, 2011: 29). The amount of investment through foreign direct investment and partnerships such as joint ventures or pure financing would benefit the Australian economy, especially considering the importance of advanced infrastructure in the development of transport routes for primary resources.

The study puts further emphasis on an opportunity for China and Australia to create the largest mineral market in the world by combining China’s financial capacity and Australia’s wealth of minerals. China’s consumption of energy is boosting the demand for more exports in energy and natural resources from Australia. As China increases higher value production, their commitment to reducing pollution will force the need for clean energy and nuclear energy production in which Australia can offer expertise. In addition,

the reforms in China's banking sector offers opportunities for Australian banks, especially with the internationalisation of the Chinese currency, Renmimbi (KPMG and University of Sydney China studies centre, 2011: 38).

Although Australia and China have a solid economic relation, China's direct investment in Australia has been minimal. According to the study, "the opportunity to boost investment cooperation is high and should be encouraged to bolster our trade relationship", (KPMG and University of Sydney China studies centre, 2011: 47). Still at the end of 2009, total Chinese investment represented less than 1% of foreign investment in Australia (KPMG and University of Sydney China studies centre, 2011: 47). Also, Australian investment in China has been small compared to many other countries. According to Conley (2009: 155), "Australian investors need to be encouraged to invest in Asia, the Government can do this by organising stable investment frameworks to accompany trade treaties".

The *Joint feasibility study* conducted by Department of Foreign Affairs and Trade (DFAT) and the Ministry of Commerce, China also conclude similar benefits for Australia from a possible Australia-China FTA. The study's key conclusions include that both Australia and China would achieve large economic boosts through a FTA. A FTA would also have a positive input on employment in both countries, and by concluding the implementation of liberalisation across all sectors sooner, these benefits would be larger. Economic modelling conducted during the research also shows that "an Australia-China FTA would have a negligible impact on the rest of the world's real GDP and welfare and would be trade creating for the whole world..." (DFAT and Ministry of Commerce, China, 2005: 127). The study also emphasises on the outcomes of a bilateral trade agreement by concluding that a bilateral framework would deliver significant trade and economic benefits in a timeframe much shorter than could be achieved through multilateral liberalisation (DFAT and Ministry of Commerce, China, 2005: 126).

Hoa (2007) used the General Gravity Theory (Appendix 4) in his research '*Australia – China Free Trade Agreement: Who Gains and Who Loses*' to gain quantitative results to show the effect of an FTA between the two countries. He recognised the need for both qualitative and quantitative research on the trade impact of bilateral agreements in Asia, especially because regionalism and bilateralism is a common trend and because no

research has been reported. The results show that Australia would gain more than China from increasing co-operation.

Contradicting Hoa's research, Mai from the Centre of Policy Studies concluded in a study prepared for DFAT, that China would benefit more from an Australia – China FTA (Appendix 7) (Mai, 2005 figure 7.1). The impact is analysed by simulating three aspects of an FTA using the Monash Multi-Country (MMC) model developed at the Centre of Policy Studies. The three aspects analysed are the effects of removing border protection on merchandise trade, investment facilitation and service trade liberalisation. Mai agrees with DFAT's and the Ministry of Commerce, China's results that a faster implementation of the FTA would lead to early positive gains. It must be kept in mind that the modelling is based on instant removal of the borders, however according to the study, long term differences in fast versus gradual implementation show insignificant differences in the results. The study also shows that an increase of US\$ 18 billion in real GDP would be the result of an FTA between 2006 and 2015 (Mai, 2005: 25). The *'Joint Feasibility Study'* by DFAT and the Ministry of Commerce, China, 2005 supports this by concluding that independent economic modelling suggest an increase of 0,012% points in Australia's average annual real GDP by 2015 if tariff rate quotas would have been removed in 2006 (DFAT and Ministry of Commerce, China, 2005: 28). The modelling also suggests an increase of 15% in total Chinese imports from Australia, (DFAT and Ministry of Commerce, China, 2005: 28).

3.5.2. Negative Implications of an Australia – China FTA

Australia has unsuccessfully signed FTAs that have negative implications on the economy. This is a factor to take into account when analysing the necessity and feasibility of a free trade agreement with the second largest economy in the world, especially considering the problems mentioned earlier about dominant states. Without a doubt, China is the dominant nation in the possible FTA, therefore a thorough identification of possible threats is crucial.

Australia is a member in six FTAs and is undergoing negotiations for another nine FTAs (DFAT, 2012). A trade agreement signed with Singapore in 2003 resulted in doubling of Australia's deficit with Singapore and after signing the Australia-Thailand FTA in 2005, Australia's deficit with Thailand tripled (Conley, 2009: 153). Needless to say, Australia's large trade with US, another FTA partner has resulted in a trade deficit as well. This pattern of failure to level out trade with FTA partners is a concern in the possible FTA with China. Australia already "runs a deficit with China" (Conley, 2009: 153), the unsolved question is how much larger will the deficit grow after the signing of the possible FTA.

According to Martin Feil (2010: 213), the only genuine free trade agreement Australia has is the Closer Economic Relationship with New Zealand. All merchandise trade is tariff free as long as the ROOs can be established. The productivity commission stated that FTAs with Thailand, Singapore, Chile and the US "should only be called trade agreements" because they haven't managed to eliminate non-tariff barriers in trade in goods or services (Feil, 2010: 214). Along with a FTA, it would be impossible to stop the increase in Chinese investment in the resource sector especially since China is demanding for a similar agreement as the US has regarding investment. The deal would raise the "limits of a proposal requiring scrutiny by Foreign Investment Review Board (FIRB) from A\$ 50 million to A\$ 800 million" (Conley, 2009: 183). "A single major buyer of resources will control supply and prices, leading to lower revenue for Australians", (Conley, 2009: 157) meaning that the government will need to fight to keep prices as high as possible. One major buyer would distort trade and decrease the revenue to Australia even though the resource sector is already majority foreign owned.

4. RESEARCH METHODOLOGY

The research is exploratory in nature because it focuses on “gaining insight and familiarity with a subject” with an aim to “look for patterns, ideas, or hypotheses rather than testing or confirming a hypothesis”, (Collis and Hussey, 2009: 5). The Research is a fundamental research (Phophalia, 2010: 4) of the benefits of creating bilateral trade agreements instead of waiting for the success of a multilateral trade agenda with a special focus on the benefits for the Australian economy and trade through a possible Australia China Free Trade Agreement.

The research is conducted through an extensive and critical literature review by using a vast amount of prior literature including books, studies, academic journals, government research and trade publications. Much of the research focuses on gathering theoretical knowledge, analysing and interpreting former literature; however, some statistical data is also gathered to further support the research and to create a quantitative perspective to the study.

The study began with a personal interest in international trade, especially in trade agreements between countries and the effect of these on the sought after multilateral trade agreement. Australia-China FTA was chosen as an example due to the growing importance of China in the global trade especially in the Asia pacific region. China is the second largest economy in the world and investment from China to any country will play a vital role in the country’s economy as stated by John Brumby, the former premier of Victoria and the director of Huawei on August 18, 2011, “I believe, Australia’s story over the coming decades will be profoundly shaped by our relationship with this still-rising giant” (Australia-China Business week, 18.08.2011). Also, because the Free trade agreement is only under negotiations, data or information of the actual benefits is not available enabling research to focus on theory and assumptions on the welfare gain of such an agreement.

Syssner (2006) identifies several advantages in using written texts as the basis for research. According to Syssner (2006: 44), written documents can be considered “more reasonable statements than verbal language”. Also, while analysing pre-existing text, one

can assume that the text is already carefully revised. Researching through a vast amount of existing literature which has been the key method in this research allows one to collect a larger amount of data than through a short empirical study (Syssner, 2006).

4.1. Use of the chosen methods

First literature on international trade, regionalism and regional trade agreements are analysed using theory and on the basis of benefits and disadvantages regionalism brings to countries. A critical analysis of economic perspectives into prior studies on regionalism is carried out through fundamental research, keeping in mind that the object is to “finding out new knowledge which has more or less theoretical orientation and use” (Phophalia, 2010: 4) and to “generate theoretical knowledge and understanding of the subject matter” (Phophalia, 2010: 4). Throughout the study, the reader will continuously be reminded of the underlying comparison of regionalism; whether regionalism is a ‘stepping stone’ or a ‘stumbling block’.

The second part focuses on Australian economy and trade between Australia and China. Several different methods have been used to analyse the information available. An extensive list of literature on trade between China and Australia has been analysed using econometrics and compiling statistical information from trade data using information from government pages as well as the WTO and the OECD along with local newspaper articles and seminars. In this part, the research also focuses on recognising patterns and correlation between Australia’s economy and China’s increasing investment and trade with Australia by using trade data and historical records.

The final part of the research prior to analysis and discussion focuses on gathering information and analysing the potential benefits and disadvantages of the Australia China Free Trade Agreement using prior studies conducted by government and non-governmental bodies during the negotiations of the agreement. Conclusions drawn from this will be constructed after discussion and analysis.

4.2. Limitations

Ideally an empirical study would have been carried out into the benefits of a bilateral trade agreement, but because it is only under negotiations, this was not a feasible approach to the research. Also using econometrics such as the General Gravity Theory (introduced in the literature review and explained in Appendix 4) would have provided a more quantitative and therefore scientific approach to the study but due to time, data and cost restrictions this was not plausible and could have proved to be too ambitious and advanced for the nature of the study.

Due to the nature of the study and the primary use of secondary sources, many of the conclusions and analyses drawn from the research can be questioned because information is mainly gathered from the interpretations of past studies. This also means that a study into the benefits of a bilateral trade agreement wasn't fully conducted as the conclusions derived from the works of others. Primary data could have been manipulated to support hypotheses formed for the previous studies and therefore a highly critical view must be adopted when analysing the findings.

There are always limitations when conducting economic forecasting, because "future is uncertain in ways that we do not know yet" and "unanticipated shifts in the time series being forecast can lead to substantial discrepancies between forecasts and outcomes, with potentially large policy costs" (Hendry and Ericsson, 2003: 33). It must also be kept in mind that most economic measurements used in this study are gathered from different studies as well as separate government pages, with the use of so many secondary sources for information, the data provided in the research may not be completely accurate and without the access to the primary source causes a great limitation.

The lack of guidelines in a research with an extensive amount of previous texts and studies further limits the research (Syssner, 2006: 44) because it is difficult to narrow such an abstract research.

5. DISCUSSION AND ANALYSIS

A Wealth of research and literature is found on the topic; however, a consistent theme is the lack of “consistency in the methodologies and intellectual bases of the research or in its conclusions” (Schiff and Winters, 2003: 12). It is obvious that there is almost as many theories and conclusions in the research of regionalism and trade agreements as there are researchers, therefore it is always important to appreciate all points of view while reading through the literature. Although the focus is in a future with little or no barriers to trade, and even though very little has been achieved on a multilateral scale, “Regionalism must be viewed in the context of a global trading system that has delivered great benefits to the world over the past 50 years” (Schiff and Winters, 2003: 12).

5.1. Multilateralism

The creation of the WTO in 1995 has been the largest step towards multilateralism since the 1940s. It regulates international trade through a multilateral trade agenda and a set of rules and agreements that all 154 members must abide by. Although regulation of international trade began already in 1948 with the signing of GATT, it has been generally agreed that although taxes were decreased, GATT failed due to the level of authority an agreement without legal obligations could achieve.

WTO aggressively promotes trade liberalisation because statistics have proved a correlation between open trade and economic growth. Also, as competition increases with trade openness, it is possible for developing nations to gain comparative advantage and therefore increase the nation’s welfare. WTO also recognises the negative impact protectionist methods generate and agrees with much of the literature on the trade diverting effects of regionalism.

The failure of the Doha rounds which began in 2001 is an on-going problematic issue for the WTO. The focus of the negotiations is trade liberalisations achieved under a single undertaking, however as many scholars have noted, it is likely to be impossible to have 154 member states agreeing on all points in the single undertaking especially considering the differences in both the development stage of a country and the resources of the nation.

5.2. Regionalism

Regionalism has attracted studies for many decades and not least for the historical patterns that can be detected. Large economic fluctuations and changes seem to be the catalyst for the phenomenon. There is a difference between traditional regionalism which included colonisation and modern or neo regionalism which in theory should be welfare enhancing and trade creating for all members of a regional agreement. Regionalism follows a wave like pattern and has been developing since the colonial time. The pre-EU treaties and agreements seem to have been the first 'proper' regional trade areas or unions; this however is only the case if geographic regions are not included.

Regionalism is studied from many perspectives and is as popular a research subject as multilateralism is. Regionalism is mostly deconstructed by looking at the political and economic implications on both the members of a preferential agreement as well as on those nations left outside of it.

There is no correct answer to why regionalism occurs. Schiff and Winters (2003: 11) answer to the question of why write another book on regionalism by stating that "regionalism is still a very fertile area for research, with new results and interpretations emerging everyday...so a straight forward presentation of the more important recent developments is desirable". Also De Lombaerde (2006: 1) recognises the heterogeneous nature of regionalism and that it requires a "multidisciplinary approach".

The most common perception is that globalisation and the failure of a multilateral trade agreement push nations to seek regional partners, especially smaller economies that seek

regional partners in fear of exclusion. Regional agreements are also established to neutralise beggar-thy-neighbour policies, to avoid terms of trade prisoner dilemma, a production relocation effect and the Nash equilibrium, which are all situations where unilateral policies cancel each other out.

5.3. Trade Creation vs. Trade diversion

The traditional stepping stone vs. stumbling block debate on regionalism is the most common argument and research topic in regionalism. As De Lombaerde (2006: 1) explains, there is no evidence of regionalism contributing to the failure or success in a multilateral scheme. It is accepted that regionalism and preferential treatment is against the GATT principle of non-discrimination, however, also WTO has admitted that regionalism may encourage multilateralism and forming RTAs is beneficial for member states.

Larry Summer's school-of-thought which supports regionalism believes that regionalism is trade creating; a stepping stone. Much of the limited amount of empirical studies conducted in regionalism supports this argument. Krishna's research (2003) proved that a majority of hypothetical trade agreements would be welfare enhancing. Trade between natural partners is usually already intense and thus deeper integration would have a positive effect. Regionalism may also promote multilateralism through discrimination as countries left outside agreements will pursue multilateral trade negotiations.

Jagdish Bhagwati's school-of-thought opposing regionalism argues that regionalism is trade diverting and an obstacle to a multilateral framework. The general opinion is that regionalism is a substitute for multilateralism and therefore an obstacle as focus shifts away from a multilateral framework. Regionalism is against the mercantilist view and diverts production away from the most effective countries resulting in the increase in consumer prices which leads to a trade surplus and inefficiency.

Dominant countries can also through trade agreements manipulate trade to their own advantage, especially in agreements with developing countries leaving the country in a disadvantageous position. "Because bilateral agreements are not supported by the

advisory centre for WTO law that would otherwise provide legal advice to developing countries involved in a dispute “ (Dieter, 2009: 398), countries with little market power would need to protect themselves through other means.

Nationalising a product is a widely discussed issue in regionalism because it is seen as a negative form of protectionism. Rules of origin are separately decided upon for each trade agreement and create a bureaucratic, costly and confusing procedure for trading countries. Although trade agreements are assumed to decrease and gradually remove border protection between trade partners, ROOs create another form of protectionism and in certain situations create an imbalance between partners because “exporters in low-tariff countries are effectively subject to the same conditions as firms in the high-tariff country” (Krueger 1999 cited in Freund and Ornelas, 2010: 37). Concluding from this, countries must carefully calculate the benefits of a bilateral trade agreement compared to the costs of one.

5.4. Australian Economy

Australia is a high-income country with annual growth that exceeds the OECD average and is the only country in the world with seventeen consecutive years of growth. Australia’s main exports are primary products and main partners the US and China. Australia’s main economic problem is its weak exports. Export volumes have decreased compared to previous decades although exports have recently levelled with imports decreasing Australia’s trade deficit.

Australia is one the most open economies in the world with a majority of taxes falling between 0% and 5% (DFAT, 2011). However Australia applies other protectionist methods especially in sensitive areas where it supports local production. Australia actively promotes multilateralism while simultaneously signing trade agreements with its largest trade partners.

5.5. Australia-China Trade Relations

Australia has been lucky to be able to take advantage from China's industrial growth. Total trade between China and Australia grows annually and in 2010, a growth of 24.6% was measured (DFAT, 2011). Australia is an ideal destination for foreign investment and China has expressed vast interest in investing both in infrastructure and the mining sector. Australia can also provide expertise in technological innovation, sciences and environmental technologies that China requires when moving up in the production chain. Australia will, if successful, experience large economic growth during the following decades due to China's immense demand.

5.6. Australia-China FTA

The FTA negotiations began in 2005 but have yet to reach a conclusion. A FTA would secure two-way trade and investment which would provide China with a stable supply of resources while increasing export trade from Australia to China and make China's markets more accessible for Australia. A FTA would also increase regulation and transparency in China making it a safer investment destination for Australian companies.

Key conclusions in independent studies prove that Australia would gain from a FTA. Research also shows that a FTA between Australia and China would be trade enhancing for the whole world. A FTA could create the largest mineral market in the world if Australia's wealth of minerals and China's vast financial capacity were combined. Currently China's investment in Australia only constitutes 1% of foreign investment and to increase this, China demands a similar investment scheme as the US has been granted through the Australia-US FTA. In order for the FTA to be a success for Australia, Australia will need to boost its manufacturing sector and increase investment in Asia.

Australia has an unsuccessful history with FTAs. Trade agreements with Singapore (2003), Thailand (2005) and the US have all doubled or tripled Australia's trade deficit with the countries. There is no reason to believe that it would be otherwise in China's case. Australia already runs a deficit with China despite large volumes of exported primary products. An FTA would be assumed to remove protectionist methods in Australia, exposing Australia's sensitive areas and allowing China to invest in manufacturing and possibly creating a "made-in-China" market, that Australia would not gain from.

6. CONCLUSION

The purpose of this study was to explore the advantages and disadvantages of regionalism and why it occurs and to explore the effects of an Australia-China FTA on the Australian economy and determining whether an FTA is more beneficial to the economy than waiting for a multilateral WTO regulated framework.

6.1 Why does regionalism occur?

It would seem that there is a domino effect in regionalism in other words, an action results in a reaction which then begins a series of events. The dissertation suggests that regionalism is a reaction to globalisation, because it offers governance in trade issues. This seems to be partly caused by the failure of the Doha rounds and partly due to the economic turbulence of recent years. The more regionalism occurs, the more agreements are signed in fear of exclusion from the world markets. It is suggested that small neighbouring countries with similar concerns form trade agreements to open up new markets and opportunities while transnational companies pursue them in order to open up closed markets. Even protectionist countries form trade agreements, because multilateralism would expose them to extensive competition. Extensive competition could also create a production relocation effect or a terms-of-trade prisoner dilemma which is avoided through regional trade agreements.

6.2 Is regionalism trade creating or trade diverting?

Research would suggest that from economic perspective, regional trade agreements are trade creating. Majority of quantitative research has shown that regional and bilateral trade agreements are welfare enhancing. Regional and bilateral trade agreements allow countries to negotiate on rules and procedures that a complicated multilateral framework doesn't allow and provide immediate results. Bilateral trade agreements seem to have a positive effect on natural trading partners and could lead to deeper integration including services, migration and investment.

It must however be kept in mind that regional trade agreements are heterogeneous and should be researched separately. If agreements are signed for other than trade enhancing reasons, regional trade agreements may also have negative effects. ROOs and the shift of production from the most effective suppliers can have a negative impact on an economy and as research would imply, the actions of a dominant market power may divert trade.

6.3 Effects of the Australia-China FTA on Australia's economy

This dissertation indicates that a bilateral trade agreement between Australia and China would have positive effects on Australia's economy. An inclusive trade agreement would secure Australian primary product exports to China especially in iron ore and gold. China's economic growth has already benefited the Australian economy and by signing a trade agreement, Australia could increase its chances of levelling out the trade deficit with China. China's interest in foreign investment would be an opportunity for Australia to develop its infrastructure which it hasn't been able to do in recent years. A FTA would also increase employment in Australia especially in the services sector because Australia's expertise in energy and nuclear energy is required as China's development continues and demand for clean energy technology and sciences grow. Research also suggests that the recent reforms in China's banking sector would offer Australian banks a great opportunity, however without a free trade agreement; control behind Chinese borders is difficult due to the lack of transparency which could be improved through a bilateral trade agreement. Concluding from this, it can be assumed that an Australia-China Free trade agreement would be more beneficial for the Australian economy than waiting for a multilateral trade scheme.

6.5 Final words on Regionalism and the Australia-China FTA

Although regionalism is a widely accepted method of creating and enhancing trade, it is a complex and multifaceted phenomenon. Governments must consider all aspects and implications when accessing trade negotiations. Political, social and environmental issues also affect the decision to enter a bilateral agreement and especially in the case of two countries with opposing political systems; communism and capitalism, making a

unanimous decision and an acceptable trade scheme will be difficult. China and Australia both realise the benefits the FTA would provide, but negotiations are still on-going and with both countries also supporting the multilateral trade agenda it is yet to be seen whether an inclusive trade agreement will ever be signed.

6.6 Further Research

This dissertation has a focus on the economic implications of regionalism from a wide and theoretical perspective. It is based on combining and finding common themes in prior research and literature. Due to the limited amount of empirical research in the field, further research must be carried out through combining data from existing trade agreements and theory behind regionalism. Research is needed on the effects of deep integration in the economy, politics and social aspects of a country.

Research has been conducted on the economic benefits and feasibility of a free trade agreement between Australia and China, but no research could be found on the political motives and effects of one. If resources allow, further research should be carried out in the political aspects of the possible FTA especially considering the existing FTA between Australia and US and how this may be a reason for the stalling of the negotiations, especially since much of government research would provide evidence for the economic success the FTA would be.

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9. APPENDICES

Appendix 1-WTO principles determining global trade (WTO 2011)

The principle of Most Favoured Nation (MFN)

Countries cannot discriminate between trading partners. This is the most important aspect of trade liberalisation. It is so important it is the first Article of the GATT, the Second in GATS and the fourth article in TRIPS (see appendix). It states that any tariff concessions given to one trade partner must be applied to all other nations as well. Some discrimination is allowed under exceptions.

National Treatment

Countries must treat foreign goods equally to domestic goods after they have entered a market. The principle does not apply to custom duties applied on products because it only applies to products that have already entered a market. Article 3 of GATT, Article 17 of GATS and Article 3 of TRIPS regulate this (see Appendix).

Freer trade: Gradually through negotiations

Since the signing of the GATT in 1947 there have been 8 successful rounds of negotiations for trade liberalisation. The ninth round; The Doha round is on-going. Development has been gradual and will continue so because WTO members are allowed to liberalise progressively. The GATT clauses especially give concessions to the developing countries through adjustment periods.

Predictability: Through binding and transparency

The rules of the WTO are binding therefore once a country becomes a member, the rules applies cannot be changed. Also transparency is needed for global trade especially when foreign direct investment is present.

Encouraging development and economic reform

Over three quarters of WTO member are developing countries therefore development is a major agenda of the global trade. Before the creation of WTO, developing countries weren't willing to take on the rules applicable to members because it didn't protect them from outside competition. Developing countries had an ideal tariff level and without beneficial factors from lowering the tariffs, they weren't willing to change. At the end of the Uruguay rounds in 1994, they were prepared to accept most obligations.

Appendix 2-Theory of International Trade

Theory of Absolute Advantage

The theory of Absolute Advantage by Adam Smith (1776) states that if a country has an absolute advantage in the production of a good or a service, and another country has an absolute advantage in the production of another good, the countries will benefit from trading with each other. Smith believed that countries should establish trade through specialisation in the production of the good each country has an absolute advantage in to gain economic welfare (Staley 1992: 52).

Theory of Comparative Advantage

The theory of comparative Advantage by David Ricardo (1817) argues that an absolute advantage is not necessary for two countries to benefit from trade with each other. Ricardo states that a country can only maximise its production and increase its economic welfare through specialisation in the production export of those goods “in which either its comparative advantage is more or its comparative disadvantage is less” (Dutta 2006: 81) than that of the other country (Dutta, 2006).

Theory of Opportunity Cost

The theory of Opportunity Cost by Heberler (1936) argues against both theories of absolute advantage and comparative advantage stating that they are based on the labour theory of value. Heberler argues that labour isn't a homogenous factor and that goods are produced by all factors of production; land, labour, capital and organisation (Dutta 2006: 84). Opportunity cost accounts this and once comparative advantage is defined according to this principle it doesn't matter whether it is calculated according to one factor or several.

Modern Theory of international Trade

The General Equilibrium theory by Eli Hecksher and Bertil Ohlin argues that countries conduct international trade due to the difference in price (Dutta, 2006). They argue that differences in prices are due to climatic and technical know-how. The theory also emphasises the importance of resource allocation and differences in demand and supply of commodities and required factors. The H-O model agrees with Heberler by disregarding the theory of Comparative Advantage because it is too simplistic and doesn't take into account volatility of world markets.

APPENDIX 3-Principle of Most Favoured Nation and National Treatment

General Agreement on Tariffs and Trade 1994 (GATT)

Article I: General Most-Favoured-Nation Treatment

1. With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III, any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

General Agreement on Trade in Services 1994 (GATS)

Article II: Most-Favoured-Nation Treatment

1. With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.
2. A Member may maintain a measure inconsistent with paragraph 1 provided that such a measure is listed in, and meets the conditions of, the Annex on Article II Exemptions.
3. The provisions of this Agreement shall not be so construed as to prevent any Member from conferring or according advantages to adjacent countries in order to facilitate exchanges limited to contiguous frontier zones of services that are both locally produced and consumed.

Trade-Related Aspects of Intellectual Property Rights 1994 (TRIPS)

Article 4

Most-Favoured-Nation Treatment

With regard to the protection of intellectual property, any advantage, favour, privilege or immunity granted by a Member to the nationals of any other country shall be accorded immediately and unconditionally to the nationals of all other Members. Exempted from this obligation are any advantage, favour, privilege or immunity accorded by a Member:

- (a) deriving from international agreements on judicial assistance or law enforcement of a general nature and not particularly confined to the protection of intellectual property;
- (b) granted in accordance with the provisions of the Berne Convention (1971) or the Rome Convention authorizing that the treatment accorded be a function not of national treatment but of the treatment accorded in another country;
- (c) in respect of the rights of performers, producers of phonograms and broadcasting organizations not provided under this Agreement;
- (d) deriving from international agreements related to the protection of intellectual property which entered into force prior to the entry into force of the WTO Agreement, provided that such agreements are notified to the Council for TRIPS and do not constitute an arbitrary or unjustifiable discrimination against nationals of other Members.

General Agreement on Tariffs and Trade 1994

Article III: National Treatment on Internal Taxation and Regulation

1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.

General Agreement of Trade in Services 1994

Article XVII: National Treatment

1. In the sectors inscribed in its Schedule, and subject to any conditions and qualifications set out therein, each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.
2. A Member may meet the requirement of paragraph 1 by according to services and service suppliers of any other Member, either formally identical treatment or formally different treatment to that it accords to its own like services and service suppliers.
3. Formally identical or formally different treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member.

Trade-Related Aspects of Intellectual Property Rights 1994

Article III

National Treatment

1. Each Member shall accord to the nationals of other Members treatment no less favourable than that it accords to its own nationals with regard to the protection of intellectual property, subject to the exceptions already provided in, respectively, the Paris Convention (1967), the Berne Convention (1971), the Rome Convention or the Treaty on Intellectual Property in Respect of Integrated Circuits. In respect of performers, producers of phonograms and broadcasting organizations, this obligation only applies in respect of the rights provided under this Agreement. Any Member availing itself of the possibilities provided in Article 6 of the Berne Convention (1971) or paragraph 1(b) of Article 16 of the Rome Convention shall make a notification as foreseen in those provisions to the Council for TRIPS.

2. Members may avail themselves of the exceptions permitted under paragraph 1 in relation to judicial and administrative procedures, including the designation of an address for service or the appointment of an agent within the jurisdiction of a Member, only where such exceptions are necessary to secure compliance with laws and regulations which are not inconsistent with the provisions of this Agreement and where such practices are not applied in a manner which would constitute a disguised restriction on trade.

Appendix 4 - The General Gravity Theory

The Gravity Model of Trade is an important model in the arena of international economics. It is like the other gravity models that are present in the domain of social sciences. It makes predictions on the bilateral trade flows and these predictions are based on the distance within two units as well as their respective economic dimensions.

The equational representation of the Gravity Model of Trade is as follows:

$$F_{ij} = G * M_i * M_j / D_{ij}$$

In this formula G is the constant, F stands for trade flow, D stands for the distance and M stands for the economic dimensions of the countries that are being measured. The equation can be changed into a linear form for the purpose of econometric analyses by employing logarithms. In its linear form the equational representation of the Gravity Model of Trade would be as follows:

$$\ln(\text{Bilateral Trade Flow}) = \alpha + \beta_1 \ln(\text{Gross Domestic Product of Country 1}) + \beta_2 \ln(\text{Gross Domestic Product of Country 2}) - \beta_3 \ln(\text{Distance}) + e$$

The Gravity Model of Trade also includes factors like colonial history between the two countries, a number variables that are used for the purpose of accounting at the level of income, which means Gross Domestic Product per capita, tariffs, levels of price, contiguity and relationships in language.

The Gravity Model of Trade has been used in a wide number of areas like international relations for example. In the area of international relations the Gravity Model of Trade has been used in order to judge the effect of alliances and treaties on the trade activities. The model has also been used to analyze the efficiency of the trade agreements and organizations such as the World Trade Organization and the North American Free Trade Agreement.

The Gravity Model of Trade has been a success from the empirical point of view. However, there have been some reservations regarding the theoretical justifications that have been put forward in favor of the model. This model is normally used in order to assess the trends in the world of global trade.

Even though the theory covers factors like spatiality and geography, it has also been used to test matters that are related to pure economics. Over the years, the Gravity Model of Trade has played an important role in the estimation of trade patterns. (Economy Watch, 2010).

Appendix 5- Australia Trade Statistics

Year	2005-2006	2006-2007	2007-2008	2008-2009	2009-2010	2010-2011
Goods	\$154,044	\$169,620	\$182,922	\$231,623	\$201,751	\$ 246,975
Services	\$ 41,900	\$ 47,175	\$ 50,891	\$ 52,948	\$ 52,011	\$ 50,570
Total Exports	\$195,944	\$216,795	\$233,813	\$284,571	\$253,762	\$ 297,545
Goods	\$169,379	\$183,554	\$205,149	\$220,890	\$204,995	\$ 219,267
Services	\$ 41,254	\$ 45,148	\$ 53,017	\$ 56,328	\$ 53,388	\$ 57,360
Total Imports	\$210,633	\$228,702	\$258,166	\$227,218	\$258,383	\$ 276,627
						A\$ million

Total exports and Imports 2005-2011, (DFAT, 2011)

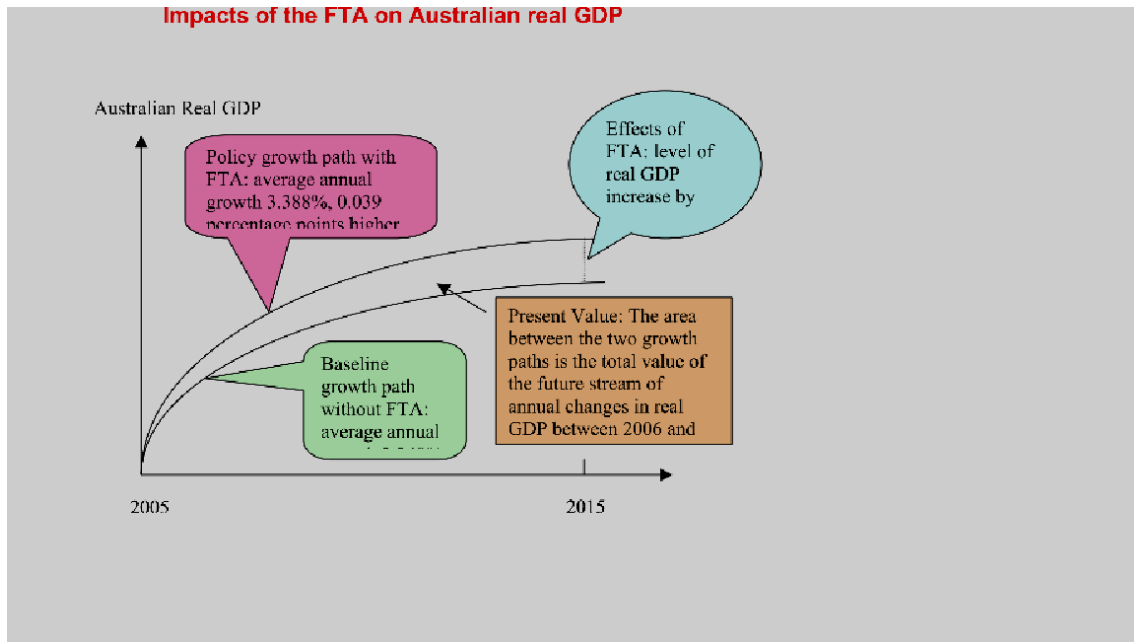
Year	Export Goods	Export Services	Total Exports
2005-2006	\$ 154,044	\$ 41,900	\$ 195,944
2006-2007	\$ 169,620	\$ 47,175	\$ 216,795
2007-2008	\$ 182,922	\$ 50,891	\$ 233,813
2008-2009	\$ 231,623	\$ 52,948	\$ 284,571
2009-2010	\$ 201,751	\$ 52,011	\$ 253,762
2010-2011	\$ 246,975	\$ 50,570	\$ 297,545
			A\$ million

Exports in Goods and Services 2005-2011 (DFAT, 2011)

Year	Import Goods	Import Services	Total Imports
2005-2006	\$ 169,379	\$ 41,254	\$ 210,633
2006-2007	\$ 183,554	\$ 45,148	\$ 228,702
2007-2008	\$ 205,149	\$ 53,017	\$ 258,166
2008-2009	\$ 220,890	\$ 56,328	\$ 227,218
2009-2010	\$ 204,995	\$ 53,388	\$ 258,383
2010-2011	\$ 219,267	\$ 57,360	\$ 276,627
			A\$ million

Imports in Goods and Services 2005-2011 (DFAT, 2011)

Appendix 6- Effects of an Australia-China FTA on Australia's real GDP



(Yinhua Mai 2005, figure 7.1).