



Bilateral trade agreements and the rise of global supply chains^{*}

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ABSTRACT

This paper investigates the influence of the rise global supply chains on bilateral trade agreements. Given that a few multinational firms are responsible for a major share of world trade, our findings suggest that these firms may support regulatory harmonization across different Preferential Trade Agreements (PTAs) to lower trade costs or resist harmonization – and encourage certain non-tariff measures – to prevent new competitors from entering markets. The finding partly explains the persistence of regulatory divergence. Building on institutional and comparative trade hypothesis, the findings of the paper present new tendencies in the foreign trade policy: the impact of the rise global supply chains on the political economy of trade, motivations for countries in cooperating on trade policies, and the increasing importance of bilateral agreements in the foreign trade policy. Additionally, the findings suggest that the political economy of regulatory convergence may be more complex than is sometimes suggested in the prior literature.

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1.0 Introduction

Trade interfaces with many other policy areas, such as macroeconomic policy, intellectual property, environmental protection, health, and employment. In some of these policy areas, there are well-developed multilateral regimes, while in other areas multilateral cooperation is more incipient and institutional frameworks are less developed. The fragmented, decentralized and non-hierarchical nature of the international trade system makes the pursuit of coherence particularly challenging; fragmentation has the advantage of allowing for experimentation as different policies can be tested at the bilateral, regional and multilateral levels. Several institutions and policy processes are in place to enforce better surveillance of exchange rates and reduce global imbalances. However, the question arises as to whether these will be used to set up a more cooperative system of exchange rates at the international level, and what role the World Trade Organisation (WTO) will play in this system.

There are a growing number of WTO disputes involving measures relating to environmental goods or policies. The challenge of securing agreement is made acuter by the need to resolve difficult questions about the effectiveness of different policies and their impact on trading partners, the answers to which depend on several factors, such as the technology involved, the characteristics of the sector and the markets at issue. Under a model of multilateral level governance, which was originally developed in the context of European integration, policy-making can take place at many different levels (international, national and various sub-national levels) and involve diverse actors (including non-state actors). While these additional layers of governance – and the

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resulting policy dispersion – can better target policies and encourage policy experimentation, they can also make coordination more difficult. This policy will also have an impact on international trade. Without some level of agreement at the multilateral level, the trade impact of these national or domestic measures is likely to lead to frictions between WTO members and may eventually result in formal disputes being brought to the WTO.

Since the early 2000s, the development of various firm models has made it possible to explore the effects of differences in firms on the political economy of trade. Trade opening has two opposing effects on domestic firms within the same industry. First, the cost of exporting decreases, which allows more firms to export and increases the sales of established exporters. Secondly, competition increases, which harms domestic firms. Which of these channels dominates for an individual firm depends on firm characteristics, such as size. Thus, lobbying competition arises not only between sectors but also within sectors in which some firms benefit, and some lose due to trade. This effect might especially arise in the context of fixed costs because they raise entry costs and thereby shield existing producers or exporters from competition.

The least and most productive firms oppose more open trade when it comes to a reduction of NTMs because the competition effect outweighs the sales effect. It is the firms close to the export cut-off, i.e. those that just break even considering the costs of exporting, which benefit from trade opening and support it. This results we can use to explain a persistent feature of trade policy, namely the reluctance to accept opening trade in homogeneous goods. The emergence of supply chains exacerbates the issue and might weaken reciprocity in trade negotiations. It must be underline that as the largest firms are engaged in global production networks, they support NTMs to protect their foreign affiliates. The mechanism is like the one described above: multinational affiliates have fewer problems to overcome fixed exporting costs compared with less productive competitors.

Large firms promote NTMs not only to reduce domestic competition but also to shield their foreign affiliates from the export competition. One implication of the argument is that market access based rules of reciprocity might be insufficient to address the distributional effects of NTMs because reciprocal tariff concessions cannot account for them. Overall, these theoretical studies suggest that while the largest firms benefit from tariff reductions, they may not support the reduction of NTMs that influence fixed costs. Large firms can more easily pay the sunk costs of adapting products to different specifications and benefit afterward from less competition.

Methodologically inclusive account breaks new ground in the new political economy models on contemporary foreign trade policy. In paper presents new tendencies in the international business, the impact of the rise global supply chains on the political economy of trade and countries motivations for cooperating on trade policies and the increasing importance of bilateral agreements in the foreign trade policy. The general theoretical approach will be of broad interest to economists interested in international and institutional questions as well as to political scientists.

The rest of the paper is structured as follows. Section 2 presents new tendencies in the foreign trade policy. Section 3 present the impact of the rise of global supply chains on the political economy of trade and motivations for countries to cooperate. Section 4 presents the increasing importance bilateral agreements in the foreign trade policy. Section 5 concludes the paper outlining several policy implications of this study.

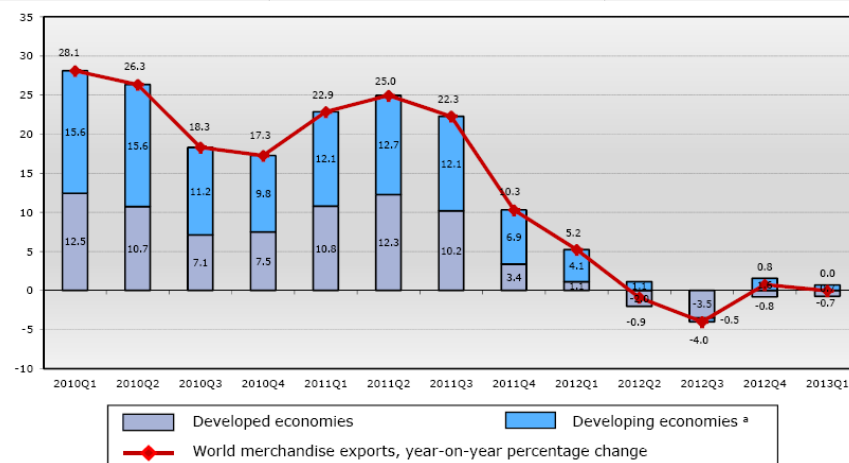
2.0 New tendencies in the foreign trade policy

Countries and producers increasingly specialize in certain stages of production depending on their comparative advantage (Krist, 2013; Jackson, 2013). It is importance and magnitude of this development for foreign trade policy. It is also important to underline that transport and energy costs, for instance, are reasons why supply chains remain more regional than global. Krugman (1991) brings increasing returns together with capital and labor migration and transport costs into one model. Krugman's (1991) model has become a workhorse of economic geography and international trade. The model is too complex to explain here, but the reasons for that complexity are clear to see – when everything becomes "endogenous" small initial differences can make for big effects. To minimize transport costs, for example, firms want to locate near consumers, but consumers want to locate near work. Thus, there are multiple equilibria, and at a tipping point, the location decisions of a single firm or consumer can snowball into big effects. A related trend also is the new form of regionalism that is sometimes referred as integration process development (Baldwin, 2012).

The differences among firms involved in the trade are also important for the future development. The picture that arises from the trade literature and the data is that even if many firms are indirectly involved in trade-related activities, only relatively few are exporting or importing and these firms tend to be larger and more productive than others (Figure 1). Such firms also have a role in technology advancement and the diffusion of know-how through supply chains. Trends in the composition of trade show that trade in services has grown faster than trade in goods over the last two decades (Krist, 2013). In this context, important is how advances in

information and communication technology have enabled a rapid expansion of services trade (Jackson, 2013). This trend might in the future be spurred by rising energy costs. Moreover, the share of services in both manufacturing firms' inputs and outputs has increased. Digitalization and 3D printing are examples of the increasing gray zone between goods and services. Whether they are classified as one or the other is significant as different regulatory regimes might apply. Regarding natural resources, it shows that their price has increased and that the price of food products has become more volatile. The open question is how higher and more volatile agricultural commodity prices raise concerns regarding food security in developing countries (Eagleton-Pierce, 2013).

Figure 1: Contributions to year-on-year growth in world merchandise exports, 2010Q1 - 2013Q1
(Percentage change in US\$ values)



^a Includes significant re-exports. Also includes the Commonwealth of Independent States (CIS).
Note Due to scarce data availability, Africa and Middle East are under-represented in world totals.

Source: WTO Secretariat estimates, based on data compiled from IMF International Financial Statistics; Eurostat Comext Database; Global Trade Atlas; and national statistics. WTO Secretariat, 2013
Developed economies, Developing economies^a

Another major trend in international trade is the rise of several emerging economies and the associated increase in their shares in world trade (Jackson, 2013). Especially China but also India and Brazil have transformed the balance of power in the multilateral trading system (Jackson, 2013). Between 1980 and 2011, for example, China's share of world merchandise exports and imports increased tenfold, making the country the largest exporter of the world (Jackson, 2013; Kupchan, 2014).

It can observe that comparable development has occurred in foreign direct investment. Inflows into developing countries and outflows from these countries now represent a major share of total foreign direct investment (FDI) (Jackson, 2013), and FDI between developing countries is rapidly expanding. Related to this development are the industrialization of developing countries and de-industrialization of developed countries which, once again, is closely interconnected with global supply chains. However, this growth is limited to only a few economies. It has caused greater differences among developing countries, with growing emerging economies and struggling least-developed countries (LDCs).

Distributional effects of trade play an important role in the broader socioeconomic context. It is important examines the extent to which the recent sharp increase in the unemployment rates of developed countries may be linked to trade and what this could mean for attitudes towards trade. While there is no conclusive evidence that trade contributes significantly to changes in long-run unemployment or income inequality, public concerns about current levels of unemployment and income distribution in several countries are likely to have a bearing on trade policy-making. Another ongoing trend is the increasing importance of consumer concerns (regarding the environment or food safety, for example) which has led to a proliferation of public policy measures that affect trade (WTO, 2011b). Global supply chains might exacerbate the issue when large firms impose private standards throughout their respective supply chains. A further trend is fierce competition for scarce natural.

3.0 Global supply chains, the political economy of trade, and motivations for cooperation

The industrialization and spectacular growth of emerging economies, together with the fast expansion of services trade and FDI, are inextricably related to the next intensive growth of production. The focus here will be on how the rise of global supply chains has had an impact on the political economy of trade and countries

motivations for cooperating on trade policies (Jones, 2015). There is both theory and evidence suggesting that participation in global supply chains tends to strengthen anti-protectionist forces (Jones, 2015). These forces have helped to drive some multilateral trade opening in the WTO (Jackson, 2013), both in specific sectoral as well as in broader accession-related negotiations (with 32 governments joining the WTO since its creation on April 15, 1995, in Marrakesh) (Jackson, 2013). The main impact, however, has been on unilateral tariff reductions (mostly among developing countries) and the proliferation of preferential trade agreements (PTAs) and bilateral investment treaties (WTO, 2011; Krist, 2013; Jones, 2015; Deudney, 2014). A considerable amount of trade opening has thus taken place outside the WTO.

The internationalization of supply chains was very important for fast economic development and industrialization of developing countries. Before the emergence of supply chains – and the information and communication technology (ICT) revolution that underpinned it – industrialization involved building a strong industrial base often behind the protection of tariffs and other NTMs (Jupill, Mattli, Snidal, 2013). The unbundling of global production made it possible for countries to industrialize by joining international supply chains (Jones, 2015).

There are three mechanisms through which production unbundling can lead to unilateral tariff reductions. First, the offshoring of production is likely to alter lobbying over trade policy in the host country. The relocation of production transforms importers of the products concerned into exporters. Thus, lobbying in favor of import tariffs on these goods decreases and pressure to reduce upstream tariffs increases. This effect, however, is more limited in cases where governments set up export processing zones to exploit the growing industrialization opportunities offered by supply chains (Jones, 2015). Secondly, a fall in coordination and communication costs may also have an impact on lobbying. With high trade costs, producers of final products may support infant industry protection of intermediate products if they believe that it could lower the price of domestically produced intermediate goods compared with imports. However, a fall in coordination and communication costs can break the coalition of interests behind high trade barriers, and lead downstream producers to lobby against tariffs on intermediate goods. Thirdly, offshoring improves the competitiveness of developed countries' products by reducing their costs, thus undermining import substitution strategies in developing countries (Jackson, 2013). Developing country governments may either respond by lowering the tariffs on final goods, or, alternatively, by lowering upstream tariffs to improve the competitiveness of final domestic goods.

Empirical evidence seems to confirm that lobbying is indeed an important determinant of trade policy. There is evidence suggesting that supply chains can explain why the recent financial crisis did not lead to significant protectionism even though many countries had prudence in their applied tariffs, meaning they could raise them without violating their WTO commitments (Jones, 2015).

While unilateral tariff reductions have clearly been a positive step in the direction of more open trade, they may also have complicated multilateral, reciprocity based tariff reductions in the WTO. It must be underline that developing countries have already significantly reduced their applied tariffs, giving developed country exporters less to fight for in multilateral negotiations (Jackson, 2013). Developed country exporters also see less value in asking developing countries to commit to lower tariffs because they do not believe that developing country governments have strong incentives to raise them (Jones, 2015).

It is interesting to underline that foreign investment may lead governments to unilaterally reduce tariffs, thereby lowering the incentive to exchange tariff reductions in the WTO. Existing theoretical work suggests that a government's optimal tariff decreases when its constituents hold an ownership stake in a foreign market, leaving it with less incentive to manipulate the terms of trade (Krist 2013). Extending terms of trade model of trade agreements to account for international ownership shows that by eroding large countries' motives to improve terms of trade by raising tariffs, international ownership can also reduce their incentive to sign trade agreements. It must be emphasizing that calculations of reciprocity in tariff negotiations should consider patterns of international ownership as well as trade flows.

Unilateral tariff reductions, in as much as they were not bound in the WTO, have tended to increase the level of prudence in developing countries' tariffs – i.e. the difference between the level at which tariffs are bound and the level at which they are applied – which has in turn complicated the Doha Development Agenda (DDA) non-agricultural market access negotiations (Jones, 2015).

In the DDA's early days, the discussion focused on the question of whether and how credit should be granted for autonomous trade opening (Mattoo & Olarreaga, 2001). Even when WTO members gave one's consent to negotiate reductions of their bound, rather than applied, tariff rates, the underlying problem did not disappear

but merely reappeared under a different guise. Members started arguing about the value of reductions in bound rates that do not imply equivalent reductions of the corresponding applied rate.

The changing dynamics of trade policy brought about by the internationalization of supply chains have not only resulted in unilateral tariff reductions but also in negotiated tariff reductions in the WTO (e.g. the Information Technology Agreement) and, even more significantly, in fast-proliferating PTAs (WTO, 2011; Jones, 2015). While in many cases, particularly in Asia, these PTAs are aimed at mutual integration and rule-making, they typically also include a traditional tariff component. In other cases, such as PTAs in Africa, tariffs are central to the agreements. Preferential tariffs raise several challenges for the multilateral trading system. One concern, extensively discussed in the economic literature, on the systemic effects of preferential tariff reductions, relates to the linkages between discriminatory and nondiscriminatory tariff reductions.

Several different mechanisms have been identified through which PTAs either foster or hinder multilateral trade opening. While the evidence on the relative size of these effects is inconclusive, there is a shared sense among observers that the coherence between PTAs and the WTO needs to be improved (WTO, 2011; Krist, 2013; Jones, 2015).

4.0 Increasing importance bilateral agreements in the foreign trade policy

Theoretical approaches that provide a rationale for trade agreements (Krist, 2013; Jones, 2015) offer interesting insights into the impact of emerging new trading powers (Jackson, 2013). An early contribution in this area was made by Krasner (1976). He analyses the linkage between distributions of potential economic power, defined by the size and level of development of individual states, and the structure of the international trading system, defined regarding openness. He argues that while a hegemonic system (in which one dominant player holds sway of smaller states) is likely to lead to an open trading system, a system composed of a few very large but unequally developed states is likely to lead to a closed structure (Kirshner, 2013). Since Krasner, however, the open economy politics literature has been largely silent on how the rise of emerging powers in the 21st century is affecting international economic relations.

The fact that governments respond to the internationalization of supply chains by signing deep integration agreements at the regional level is broadly consistent with the limited amount of theory available on this topic (WTO, 2011b; Jones, 2015). It is important to underline that, deep rather than shallow integration agreements and more individualized rules are needed to address the policy problems associated with the internationalization of supply chains (Antràs & Staiger, 2012). Countries intensively involved in supply chain trade may find it increasingly difficult to rely on broad GATT/WTO principles alone to address their trade-related problems and may turn to more narrowly focused PTAs to achieve the deep and customized bargains they need (Jones, 2015).

An important result of the terms of trade theory (Krist, 2013) is that shallow integration, i.e. tariff commitments, can achieve internationally efficient policies (Bagwell & Staiger, 1999). However, Antràs & Staiger (2012) find that this result does not hold in the presence of offshoring and, more generally, when international prices are determined through bargaining. If producers are locked into trade relationships with foreign firms – and prices are set via bargaining – there are incentives to manipulate the markets of both the intermediate and the final product to shift the bargaining surplus. Governments might also try to pursue redistributive goals via a trading partner's policies.

Deep integration agreements are needed to resist these pressures. However, this, in turn, means that negotiations must cover a wider array of internal/domestic measures than are typically covered trade agreements (Krist, 2013). Thus, the rise of offshoring raises both a direct and an indirect challenge for the WTO (Jackson, 2013). It puts direct pressure on the WTO to evolve towards deeper integration and more individualized agreements. It also puts indirect pressure on the WTO to evolve in this direction, as member governments increasingly turn to PTAs to solve their trade-related problems.

It is interesting to explore the effect of proliferating deep regional agreements on coherence in international trade governance (Jackson, 2013). The WTO suggested that new international trade rules are being negotiated and decided outside the WTO where power differences are greater and where the principles of non-discrimination and reciprocity are absent. It also argued that PTAs be here to stay. Governments will need to ensure that regional agreements and the multilateral trading system are complementary and that multilateral disciplines minimize any negative effects from PTAs (Krist, 2013). While the available literature suggests that deep integration rules are often non-discriminatory – for instance, provisions in the services or competition policy areas are often extended to non-members – certain provisions in regional agreements can contain

discriminatory aspects that clash with the multilateral trading system. It has been shown that PTAs which make it more difficult to apply contingency measures to PTA partners may divert protectionist measures towards non-members (Prusa & Teh, 2010).

Deep provisions can also have several adverse systemic effects. For example, the important effects of regional regulatory harmonization can make it more difficult to multilateral rules. PTAs may not include third-party most-favoured nation (MFN) clauses, thus effectively discriminating against other countries. Developed country exporters may view bilateral and regional rather than multilateral agreements as faster and easier routes for achieving their objectives, further weakening the principle of non-discrimination.

Regarding services supply chains, some argue that their growth creates an additional need to re-examine and modernize current rules for services trade, as these rules were designed for the world where services were exported as final products from national firms, not the world where multiple firms supply stages of services production from multiple locations. Recent research on how differences in firms have an impact on trade policies reveals a related concern. Ciuriak et al. (2011) point at another difference between deep integration at the regional and the multilateral level (Ciuriak et al., 2011). If a trade is perceived by most voters as causing unemployment and increasing inequality, governments could refrain from pursuing further trade opening and may even be tempted by protectionism. Regarding increased pressure for protectionism, there is some evidence that the WTO has played a significant role in recent years in preventing protectionist barriers. WTO rules and governments commitments, together with reinforced monitoring mechanisms, may account at least in part for the limited protectionist reactions to the crisis. One problem that may arise in the future is if governments turn to measures that are currently undisciplined or untested by WTO rules. Pressure on the WTO to impose or apply disciplines in new areas would increase, as is the case now regarding exchange rate misalignments. Another possibility would be for governments to use more intensively public policies for protectionist purposes.

Regarding trade negotiations, focusing exclusively on the efficiency effect of trade opening may no longer be possible. Distribution and labour-market effects will also need to be considered, and accompanying measures may need to be proposed to win the support of most voters for open trade. Although most accompanying measures fall outside the remit of the WTO, mechanisms available under the WTO to facilitate adjustments, such as implementation periods and flexibilities, may have a role to play.

Now it is time to consider the concept of a new WTO model development. Under this approach, countries willing to strengthen the trade rules regarding currency manipulation, state-owned enterprises, and other loopholes in the current rules, and to develop rules for the new issues such as digital commerce and regulatory coherence would negotiate an PTA among themselves that would supplement the current WTO system. The negotiations for the bilateral PTA could provide the basis for developing new WTO Plus system.

Negotiations for the bilateral PTA could be vehicles for establishing a WTO Plus system. These agreements establish effective rules regarding neomercantilism practices and eschew special interest provisions. Such a WTO Plus system would both open markets for countries willing to accept strengthened trade rules and put pressure on nonparticipating countries to further open their markets and adopt similar rules in a future multilateral trade round in the framework of the WTO.

5.0 Conclusion and policy implications

The economic incentives for multilateral trade liberalization remain strong, and the new international economy of more broadly shared economic power represents a major victory for its success in the framework of the WTO multilateral trade system, but the power in the WTO has a symbolic character. The rise of global supply chains and the symbolic character of the WTO has had an impact on the political economy of trade and countries motivations for cooperating on trade policies. Participation in global supply chains tends to strengthen anti-protectionist forces. The internationalization of supply chains is very important for fast economic development. This process also changed the political economy of trade policy, creating in many countries a strong incentive to undertake unilateral tariff reductions. The changing dynamics of trade policy brought about by the internationalization of supply chains have not only resulted in unilateral tariff reductions but also in negotiated tariff cuts in the WTO and, even more significantly, in fast-proliferating PTAs.

The preferential agreement raises several challenges for the multilateral trading system. It is important to underline that; deep rather than shallow preferential bilateral agreements and more individualized rules are needed to address the policy problems associated with the internationalization of supply chains. Countries intensively involved in supply chain trade may find it increasingly difficult to rely on broad WTO principles alone to address their trade-related problems and may turn to more narrowly focused PTAs to achieve the deep and customized bargains they need.

Governments will need to ensure that regional agreements and the multilateral trading system are complementary and that multilateral disciplines minimize any negative effects from PTAs. Differences in firms have an impact on trade policies reveals a related concern. While heterogeneous firms trade models suggest that more importance should be granted to extensive than to intensive margin responses to trade opening, there is evidence suggesting that PTAs have positive effects at the intensive margin and negative effects at the extensive margin, whereas the opposite is true of opening in the multilateral context. It is important to underline also that there are differences between deep integration at the regional and the multilateral level.

A few multinational firms are responsible for a major share of world trade. On the one hand, these firms should support regulatory harmonization across different Preferential Trade Agreements (PTAs) to lower trade costs. On the other hand, they might also resist harmonization – and encourage certain non-tariff measures – to prevent new competitors from entering markets. This may partly explain the persistence of regulatory divergence, and suggests that the political economy of regulatory convergence may be more complex than is sometimes suggested.

The bilateral and regional trade agreements have emerged as the alternative to multilateral WTO agreements. In this situation, institutional reforms will be necessary to restore the WTO's ability to complete multilateral trade agreements, including a more flexible application of the consensus rule. Aid for trade may also play an instrumental role in bringing more developing countries into WTO disciplines. It must be emphasizing that WTO members must develop new ways especially with developing countries, by financial, economic and trade aid for them also because of the importance of agriculture. It is important also to find common ground to negotiate for mutual gains from foreign trade and first of all from new models of foreign trade policy with the importance of the rise global supply chains and new forms of cooperation between developed, developing, and emerging countries like China, India, Brazil, Mexico, South Africa regarding also regulatory protectionism between USA and European Union.

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