

## The future of the multilateral trading system in a multi-polar world

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Veröffentlichungsversion / Published Version  
Arbeitspapier / working paper

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SSG Sozialwissenschaften, USB Köln

### Empfohlene Zitierung / Suggested Citation:

Schott, J. J. (2008). *The future of the multilateral trading system in a multi-polar world*. (DIE Discussion Paper, 8/2008). Bonn: Deutsches Institut für Entwicklungspolitik gGmbH. <https://nbn-resolving.org/urn:nbn:de:0168-ssoar-362398>

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# The future of the multilateral trading system in a multi-polar world

Jeffrey J. Schott

Bonn 2008

Discussion Paper / Deutsches Institut für Entwicklungspolitik  
ISSN 1860-0441

**Schott, Jeffrey J.:** The future of the multilateral trading system in a multi-polar world / Jeffrey J. Schott. –  
Bonn : DIE, 2008. – (Discussion Paper / Deutsches Institut für Entwicklungspolitik ; 8/2008)  
ISBN 978-3-88985-398-1

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This project was conducted under the German Development Institute's research program "Anchor countries as drivers of regional economic integration – Consequences for regional and global governance, and for developing countries", financed by the German Federal Ministry for Economic Cooperation and Development. An earlier version of this paper was presented at the German Development Institute's conference on "Regional Economic Integration Beyond Europe" in Bonn, December 19–20, 2007.

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## Abbreviations

AGOA	African Growth and Opportunity Act
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of South East Asian Nations
EFTA	European Free Trade Association
FDI	Foreign Direct Investment
FTA	Free Trade Area
FTAA	Free Trade Area of the Americas
GAO	General Accountability Office
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
MERCOSUR	Mercado Común del Sur
MFN	Most favored nation
MTN	Multilateral Trade Negotiations
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Cooperation and Development
RTA	Regional Trade Agreement
SAFTA	South Asia Free Trade Agreement
WTO	World Trade Organization

## Abstract

### **The future of the multilateral trading system in a multi-polar world**

This paper assesses the future of the world trading system in the face of diminishing returns from current multilateral trade negotiations and the proliferation of bilateral and regional trade agreements (RTAs). It traces the evolution of the postwar trading regime from the early decades of the General Agreement on Tariffs and Trade (GATT) that were dominated by the United States and the European Communities to the new World Trade Organization (WTO) in which developing countries have begun to play a more important role, especially in the current Doha Round of multilateral trade negotiations (MTNs).

The paper discusses the substantive and tactical reasons why the Doha Round has progressed so grudgingly and is unlikely to achieve its ambitious objectives. It then examines why developing countries increasingly have turned to RTAs to complement WTO talks, whether these pacts benefit or hinder MTNs, and how RTAs affect the influence of developing countries in the WTO.

The final section of the paper looks at the WTO going forward and posits that, after the Doha Round, the trading system in the 21st century requires substantial reform. The problems of the Doha Round and the proliferation of regionalism confront WTO members with three central challenges:

First, multilateralize multilateralism. There are a vast number of exceptions that take the WTO far away from the ideal of a universal system with a single set of rules. The paper suggests that officials focus on the broad exceptions to most-favored nation (MFN) and national treatment in Articles XX and XXI, especially the provisions covering border security and environmental issues.

Second, multilateralize regionalism. The challenge is to make the design and implementation of RTAs more WTO-friendly. The paper calls for greater transparency of RTAs through more frequent and rigorous WTO reporting requirements, and new disciplines on discriminatory rules of origin. The paper offers two correctives: cut MFN tariffs and thus reduce the margin of preference for RTA members; or, alternatively, require that RTA members harmonize and lower the MFN tariffs down to the level of the lowest rate applied by any of the RTA members.

Third, modernize multilateralism. The WTO agenda needs to be refocused on the problems of international commerce in the 21st century. WTO rules on taxes and subsidies need to be recast to cover concerns about currency manipulation, regulatory abuse or neglect, and labor market practices as well as to meet the new challenges of climate change initiatives. In addition, WTO members will have to address trade and security linkages before pre-shipment inspection and visa requirements become major obstacles to international flows of goods, services, and people. To do so, the WTO will have to collaborate more effectively with other international economic organizations.

## 1 Introduction

On January 1, 2008, the World Trade Organization (WTO) celebrated its 13th birthday. Like any teenager, it confronts growing pains and awkward social adjustments as it addresses the new challenges of globalization in the 21st century. This paper examines the world trading system in this dynamic era. Particular attention is given to the interaction of the two major channels of trade negotiations in the global system: the Doha Round of multilateral trade negotiations, and regional trade agreements or RTAs.<sup>1</sup>

The future of the multilateral trading system is a big topic and my analysis is accordingly highly condensed to meet the constraints of this short paper. I start with a brief discussion of the Doha Round, putting it into historical context, and then examine concerns about the proliferation of RTAs. I then summarize the extensive debate on whether regionalism complements or conflicts with the broad goals of the WTO system. In the final section, I outline three broad and interrelated initiatives that should be pursued to resolve the internal and external conflicts that risk diluting the WTO's salience as a forum for international negotiation in the years ahead.

## 2 The multilateral trading system in historical context

The great triumph of the General Agreement on Tariffs and Trade (GATT) was creating a prosperous multi-polar trading system from the uni-polar system that emerged from World War II. The early decades of the GATT could be called the age of US enlightened self-interest, in which the United States deployed *inter alia* generous development aid in tandem with extensive liberalization of trade barriers protecting the US market to help rebuild the war-torn economies of Western Europe and thus provide a stable economic base for democratic governance and a reliable buffer against Soviet expansionism.

In the early decades of the postwar era, US trade policies were generous to its former military foes and strongly supported the evolving European Community. Similarly, in the GATT, US and European policy was generous to a fault to developing countries, permitting them effectively to “free ride” on the trading system without undertaking substantive commitments to reduce barriers to their markets. US and European trade barriers came down sharply during the eight rounds of GATT negotiations, leaving only a small number of important trade restrictions that benefit well-entrenched domestic interest groups. Agriculture was a notable exception to this reformist movement, and textiles and clothing trade escaped the sharpest cuts until its armor-plated quota regime rusted away in 2005.

But there is no such thing as a free lunch in the GATT cafeteria. The cost of non-participation in the reciprocal negotiations (at least until the Uruguay Round) was significant: the GATT Rounds often left intact major barriers imposed by industrial countries that restricted competitive agricultural and manufactured exports of developing countries.

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1 I use the term “RTAs” to group together widely diverse trading arrangements that convey preferential status to exporters and investors in member country markets. The term encompasses traditional free trade agreements and customs unions as well as so-called “partial scope” agreements whose exceptions seemingly run counter to the spirit, if not the letter, of world trade rules.



Thus, developing countries protected their own markets, but in turn had to accept the maintenance of high foreign trade barriers against their most competitive exports. Though such policies never yielded big economic rewards, they were politically convenient. Many developing countries relied on protected home markets and commodity exports to support modest growth; some followed a strategy of export-led growth and became platforms for the assembly and export of light manufactures. Their success in turn provoked a wave of new protectionism in developed markets via so-called voluntary export restraints, anti-dumping and countervailing duties, and special protection regimes like the Multi-Fiber Arrangement.

The Uruguay Round (1986–1994) deviated from this pattern by requiring that all the issues under negotiation be considered part of a “single undertaking” to which all participants had to commit. This procedural rule dramatically reversed past negotiating dynamics. Developing countries could no longer be “free riders” as in past rounds. The addition of a proposal in the middle of the Uruguay Round to strengthen the institutional structure of the trading system by establishing a new World Trade Organization (WTO) underscored the importance of the single undertaking. Suddenly, developing countries had to accept the full complement of obligations (albeit with some special and differential treatment) included in the Uruguay Round package to qualify for membership in the new WTO. Saying no to the Uruguay Round accords was not an option, since all the big trading powers were switching to the new club. Changing institutions put developing countries in a unique and disadvantageous position and explains why they had to undertake commitments in some areas (e.g., intellectual property) that couldn’t be fully implemented and enforced. The WTO was thus born with a “development deficit”, one of several birth defects analyzed in a number of early WTO assessments (see, for example, Schott 2000).

Note, however, that in current WTO negotiations the single undertaking now gives developing countries some leverage to push their own export interests – if US and EU officials do not address their priority demands, then they could simply prevent the Doha Round deal from closing. In a 180 degree reversal from the Uruguay Round precedent noted above, the single undertaking gives developing countries a stick in the closet; like most sticks, it is most valuable if threatened but not used.

### **3 Why has the Doha Round Proceeded so Slowly?**

In November 2001, WTO member countries agreed to launch a new round of global trade negotiations and christened it the Doha Development Agenda. This odd name was meant to distinguish the venture from the Uruguay Round and emphasize that developing country interests were to be given priority. Of course, all GATT/WTO rounds seek to advance development objectives, and all have granted exceptions to developing countries that ease or exempt them from the liberalization and rulemaking obligations in the package of agreements. But in light of the heavy load of new commitments undertaken by developing countries in the Uruguay Round, many countries argued that they deserved compensatory treatment in the next round...and thus interpreted the Doha mandate as an entitlement policy in which the negotiations were about concessions developed countries would make to developing countries – and not what developing countries needed to contribute to the

exercise to benefit both *themselves*, other developing countries, and the Organisation for Economic Cooperation and Development (OECD) world.<sup>2</sup>

Six years later, the Doha Round seems likely to underachieve, if it succeeds at all. Negotiators have traversed numerous crises and tolerated the tactical games that diplomats invariably play to cope with the boredom of Geneva winters. But they haven't done a lot of actual negotiating!

There are many reasons why the Doha Round has progressed so grudgingly. Some of the problems reside in the complex issues on the trade negotiating agenda, but the most difficult challenges transcend the responsibilities of trade ministers and emanate from the economic and political environment in which trade policy operates. This topic alone merits its own paper; instead, let me offer a few key reasons for the Doha doldrums.

First, and most important, the global economic and political environment has become increasingly unsettled over the course of the Doha Round due to both adjustment pressures emanating from globalization (including growing competition from China) and new security requirements that complicate and raise the cost of international commerce. Globalization pressures make policymakers more cautious about taking on additional adjustments via the Doha Round when they are already having a hard time coping with existing competition. However, they also recognize that they must adapt quickly to changing conditions in world markets or fall sharply behind in the global competition for market shares and investment resources, so protection is not a long-term option. On balance, this “globalization imperative” has made WTO members more risk averse to multilateral trade reform in the Doha Round (though some countries have pursued more targeted liberalization via RTAs).

Second, there is a sizeable gap in the ability of countries to participate actively in WTO deliberations. Resource constraints are real, and many developing countries allocate their representation to regional bodies that offer more immediate pay-offs in terms of unilateral trade preferences. Unfortunately, this leads to foot-dragging in the WTO. Furthermore, developing countries have been unsure whether they could take advantage of new trading opportunities in the Doha Round due to infrastructure and human capital constraints. These legitimate concerns underscore the need to follow through on trade facilitation reforms in the Doha Round and complementary commitments to “Aid for Trade” to strengthen economic infrastructure and administrative capabilities.<sup>3</sup> Trade and integration arrangements should also be part of the policy response and integrally linked with a country's development strategy (though not necessarily the main driver of that strategy).

Third, the foreign policy imperative to work together – which solidified global support to start the Doha Round two months after the tragic terrorist attacks of September 11, 2001 – has frayed amid frictions over US policy in Iraq, increasing competitive pressures from China, and renewed concerns about energy security and nuclear proliferation. The cooperative spirit of Doha, forged by the crisis of the moment, seems to be a fading memory. In

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2 For more discussion on this point, see the section titled “Misconstrued development round” in my invited column, “Unlocking the benefits of world trade”, *The Economist*, 1 November 2003, 65–67.

3 For an analysis of the benefits of trade facilitation for economic development, see Wilson / Mann / Otsuki (2003).

its place, trade officials offer a cacophony of diplomatic rhetoric known in Geneva as “the blame game.”

Fourth, success in the Doha Round is complicated by the legacy of previous GATT rounds. The GATT era substantially reduced border barriers to manufactured imports in both the United States and Europe. In the mercantilist calculus of the WTO, all that US and EU officials have left to “give” are reforms of restrictions that have survived eight previous negotiating rounds over the past 50 years. Obviously, such protection is deeply rooted in domestic politics and will be hard to dislodge. Some political observers question whether WTO members can offer sufficient inducements to get the transatlantic powers to liberalize, especially in agriculture.

Fifth, WTO members made a huge tactical mistake in requiring that progress on agriculture precede negotiations in other areas. The rationale was clear: farm reforms lagged in past rounds and needed to “catch up” in the Doha Round. In the event, focusing on agriculture effectively delayed negotiations across the entire Doha agenda. Progress on agriculture has been insufficient to spur worthwhile offers on manufactures and services; many of the big emerging-market countries that will enjoy the most growth over the next decade – China, Brazil, India, Indonesia, South Africa, and Thailand – remain wary, and justifiably so, that key US and EU farm reforms will be excluded or subject to lengthy deferment in the Doha Round negotiations. Because they believe the farm trade talks are “unbalanced” – demanding too much from them and too little from the United States and the European Union – they have held back in talks to liberalize trade in other areas. Yet without contributions by at least the middle-income developing countries on industrial products and services, officials in many OECD countries cannot garner political support for a deal to sharply reduce farm subsidies and border protection. Geneva officials say this is a “chicken and egg” problem. In fact, it is a lame excuse for not taking responsibility – which, in other words, means lack of political will.

Sixth, policymakers in the United States and Europe face growing resistance to new trade liberalization. US trade politics is dominated by China bashing; several bills have been introduced in Congress to respond and counter the undervaluation of the renminbi, including invoking WTO dispute settlement under GATT Article XV, and to impose antidumping and countervailing duties with more intensity against imports from China. In Europe, member states continue to grapple with the impact and adjustment pressures generated by enlargement, and with implementing the structural reforms of the Lisbon Agenda. Antidumping measures are being deployed with increasing frequency to blunt import growth from East Asia, particularly in the areas of textiles, apparel, and footwear. Investment policies are being contorted to develop national champions – and some member states seem to only want competition among national champions when it comes to the football pitch!

On both sides of the pond, China bashing has become allied with renewed calls for economic nationalism, the blood brother of trade protectionism. In the United States, public outcries doomed both the Chinese purchase of UNOCAL and Dubai Ports World’s planned investment in East Coast seaports. It’s not hard to see how the current clamor could turn into calls for national ownership of strategic assets, and in turn provide a political excuse to block reforms involving establishment in goods and services industries. Investments by sovereign wealth funds, especially those from the Middle East and East

Asia, could provoke nationalistic outbursts reminiscent of the Dubai Ports World saga of 2006 (see Graham / Marchick 2006). China already has faced this challenge in the energy sector. My fear is that other sectors will be classified as “strategic” and targeted for protection – including information technology and telecommunications as well as energy production and distribution.

Rampant *China bashing* in both the United States and Europe could provoke tit-for-tat trade retaliation, which in turn could disrupt the Doha Round. While existing WTO obligations constrain the use of traditional forms of trade protection like tariffs and quotas, the protectionist backlash could surface in more subtle ways such as clawing back of prior reform via new regulatory policies. We already have seen some examples in restrictions blocking trade in genetically modified foods and in security-related investment restrictions.

The above incomplete list entails formidable obstacles to reaching agreement in the Doha Round. A deal is still doable in 2008; the terms already are imbedded in the chairman’s drafts circulating in Geneva and can be extracted with a modicum of diplomatic skill. But the ambitious objectives of Doha 2001 will not be met – too much time has been wasted and too little *negotiation* pursued to expect major changes in current policies. However, the Doha Round can still be useful if it can lock in the incremental gains achieved to date and set the table for the early resumption of more substantive talks on a broader agenda (which I outline in the last section of this paper).

#### **4 Doha fallbacks**

If multilateral trade liberalization stalls, WTO members have two mutually-reinforcing options: unilateral liberalization and regional trade integration. Economists will tell you that unilateral liberalization is good and that unilateral liberalization combined with reciprocal reforms by one’s trading partners is even better. In fact, the combined approach has been deployed successfully for some time, as the results of prior GATT rounds and regional integration arrangements have been coupled with self-serving unilateral liberalization.<sup>4</sup>

But the unilateral reform engine may now be running on fumes. While average applied tariffs in developing countries have been cut well below the rates bound in the Uruguay Round, they still are in the 10 to 20 % range for many countries. There are good political economy reasons why liberalization seems to fade as applied rates decline. To cut the “muscle” of protection, government officials need a big political counterforce to the strong lobbies benefiting from subsidies or barriers to imports. Such a political coalition can only be put together with results from a big reciprocal negotiation involving concessions from foreign suppliers of value to domestic industry – thus the continuing interest in bilateral and regional trade talks.

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4 According to World Bank (2005), unilateral liberalization accounted for almost two-thirds of the average weighted tariff cuts implemented by developing countries over the period 1983–2003.

For developing countries, RTAs have become increasingly important, especially given the low expectations that the Doha Round can fulfill its development objectives. Given the lackluster pace of the WTO talks, and the ongoing challenges posed by globalization and competition from China and India, many developing countries have turned to RTAs to complement and often propel *domestic* economic reforms. If properly crafted, RTAs can contribute to economic growth by spurring competition in domestic markets and dampening inflation – which in turn helps create a more stable and attractive environment for investment. Indeed, competition for investment drives many of the RTAs to which developing countries participate. If a country maintains high levels of protection, costly regulations, or discriminatory standards, investors generally will opt to locate in other countries that have policies more conducive to production and investment.

Note that the access to trade preferences is generally not an important driver, particularly in North-South RTAs where industrial countries maintain only a few albeit significant border barriers to developing country exports. Preferential access is important for some products (e. g., agriculture; autos; apparel), but RTAs often limit or exempt those products from free trade commitments. Moreover, preferences are depreciating assets whose value declines as WTO negotiations and/or other RTAs are concluded.

## 5 Regionalism and the world trading system

Bilateral and regional trade arrangements have coexisted with the GATT/WTO since the launch of the postwar trading system. Indeed, one can argue that the US Reciprocal Trade Agreements Act of 1934 provided much of the grist for the deliberations at the Havana Conference that crafted the GATT as part of the broader coverage of the International Trade Organization. The original GATT contained exceptions for existing preference schemes like the British system of imperial preferences (dating back to the Ottawa Agreements of 1932) and special tariff arrangements between the United States and Cuba, and the United States and the Philippines, as well as the broad most-favored nation (MFN) exceptions for free trade areas and customs unions under GATT Article XXIV.<sup>5</sup>

Over much of the 60-year history of the GATT-WTO trading system, RTAs have been a sideshow in international trade relations, with the notable exception of the agglomeration of the European Union. Over the past two decades, however, there has been a sharp increase in bilateral and regional free trade agreements and customs unions, as well as new negotiations or proposed talks on what I call “super-regional pacts” – such as the Free Trade Area of the Americas, European Union and Mercado Común del Sur (MERCOSUR), and the Free Trade Area of the Asia Pacific among others. Some of these initiatives have foundered; others potentially pose negotiating alternatives, as well as complements, to the Doha Round.

Throughout the GATT/WTO era, the WTO Secretariat reports that 302 RTAs were notified under GATT Article XXIV and an additional 22 RTAs under the GATT’s “Enabling

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5 The original draft of the GATT covered only customs unions and did not mention FTAs, which were added during a substantial rewriting of these provisions at the Havana Conference in 1946–47. See GATT, *Analytical Index of the GATT: Guide to GATT Law and Practice*, 6th ed., Geneva, 1994, 785–788.

Clause”. Some RTAs become “inactive” or redundant as regional groupings expand; as a result, as of October 2007, only 194 RTAs were currently in force. The total number of RTAs in force is actually lower today than at its peak level in 2003. Moreover, there is substantial double-counting of RTAs because separate notifications are required under the GATS for pacts that cover both goods and services.<sup>6</sup>

Care should be taken in drawing general conclusions from this seemingly vast pool of agreements, for several reasons. First, the pacts differ widely in terms of content and participants; some are comprehensive like the Australia-New Zealand Closer Economic Relations Trade Agreement or the North American Free Trade Agreement (NAFTA), while the WTO Secretariat discretely labels others as “partial scope agreements.” The trade impacts and implications for the world trading system vary accordingly – so beware comparing acorns and oak trees! Second, many of the agreements are part of the agglomeration of the European Union over several decades or reflect efforts to reestablish trade ties that formerly existed in the socialist bloc among countries that have now returned to a market-oriented economic system. Third, some of the pacts notified to the WTO attempt to link together neighbors with small and fragmented economies; others offer valuable economic and political benefits for developing countries in partnerships with the United States, European Union, or Japan.

So is the so-called “FTA Frenzy” exaggerated? Not necessarily. The above totals underestimate activity: many pacts are not notified due to weak WTO notification requirements (especially for RTAs among developing countries); and there are a large number of initiatives under negotiation or under serious study, particularly in East and South Asia which has become the hot bed of regionalism in the 21st century.

Since the turn of the century, the major economies of the Asia-Pacific region have embarked on a series of negotiations of RTAs with key trading partners. The United States extended its Western Hemisphere-oriented FTA policy to East Asia/Oceania (signing pacts with Singapore, Australia, and Korea); China began negotiating with members of the Association of South East Asian Nations (ASEAN) soon after its accession to the WTO; and Japan and Korea entered into RTAs for the first time, adopting the multi-track approach to trade negotiations long followed by the United States. ASEAN members were willing partners in many of these ventures, even as they struggled to deepen economic integration within their own 10-nation group. In addition, smaller open economies such as Singapore, Mexico, and Chile aggressively pursued both regional and trans-Pacific partnerships and championed broader Asia-Pacific initiatives to revive momentum toward the goal of free trade and investment in the region proclaimed at the meeting of Asia Pacific Economic Cooperation (APEC) leaders in Bogor, Indonesia in November 1994.

As I wrote in 2004, regionalism can be a boon or the bane of the world trading system (Schott 2004, chapter 1). By design, RTAs are discriminatory and thus conflict with the WTO’s fundamental MFN principle. Whether RTAs are on balance trade-creating or trade-diverting, however, depends on the terms of the deal and the economic environment in which the pact is implemented.

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6 Since the WTO entered into force in 1995, about 35 % of the RTAs have had been notified under both GATT Article XXIV and GATS Article V.

There is a vast literature on the impact of RTAs on the multilateral trading system. For the purposes of this paper, I will boil the arguments down to what I regard as the most salient points. There are four main ways that RTAs can complement and reinforce the multilateral trading system: advancing trade liberalization, establishing useful precedents for WTO talks, locking in domestic reforms, and bolstering alliances among trading partners. Similarly, there are four main reasons why RTAs may undercut the multilateral system: trade and investment diversion, overlapping and conflicting trading rules, attention and resource diversion from WTO talks, and bad precedents for other trade accords. The following sections summarize these arguments.

## 6 RTAs as complements to the WTO

The most important benefit of RTAs is that they seek to reduce participating country trade barriers beyond the countries' current WTO commitments. If they are true to their name, RTAs will commit to eliminate barriers on "substantially all" trade between the partner countries (some are obviously less perfect in this regard than others). In contrast, WTO negotiators pursue incremental reforms in each trade round, leaving substantial barriers in place after the accords are fully implemented. The difference can be put simply: RTAs achieve deeper cuts in trade protection than WTO reforms but the RTA liberalization is accorded to only a few countries, while multilateral agreements are applied on an MFN basis to the entire WTO membership. Deeper cuts, but by fewer countries, and applied on a discriminatory basis. Advocates of RTAs argue that, on balance, the pacts are trade creating and spur positive welfare gains for participating countries as well as, over time, for third countries due to the stimulus to growth in the RTA region.

Second, RTAs often create commitments in areas beyond the scope of existing WTO obligations. These "WTO-plus" provisions can set useful precedents for future multilateral talks. Indeed, the US-Canada FTA provided useful precedents for the General Agreement on Trade in Services (GATS), and the US-Chile FTA may provide a template for a WTO e-commerce provision. More recent US FTAs with Peru and other countries include substantive obligations on labor and the environment – areas where the WTO footprint has been small but could well expand in the future (see concluding section).<sup>7</sup> In these and other WTO-plus areas, discriminatory application of RTA rules is possible. However, the demands of the marketplace and the costs of applying several different standards push for convergence towards a unified set of regulations.

In addition to setting precedents, RTAs provide a real world classroom to help educate trade negotiators. Negotiators learn by doing – it is hard to know the sticking points of a problem until one tries to negotiate a solution for it. Such education is invaluable for developing countries exposed to the rulemaking puzzles presented in talks on services, intellectual property, and other new issues on the WTO agenda.

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7 Pursuant to the May 10, 2007 "Bipartisan Agreement" between the Bush administration and the Congress, the US-Peru FTA, signed December 14, 2007, contains extensive provisions on labor that go well beyond those in prior US accords. The new labor template is already being emulated and augmented by the European Union in its free trade talks with Korea.

Third, RTAs “lock-in” domestic policy reform because they raise the cost of policy reversal, if the change violates the terms of the agreement and makes the country potentially liable to trade retaliation. In this regard, RTAs help buffer governments from protectionist demands that may be politically alluring but economically undesirable. In turn, uncertainty about the business and the regulatory environment is reduced, facilitating investment and development.

Fourth, RTAs strengthen relationships among partner countries and help build alliances for WTO reforms in areas of common interest. The launch of the Doha Round in 2001 succeeded in large measure due to the closer trade relations resulting from US and EU trade initiatives with Latin American and African countries.

## **7 Drawbacks of FTAs**

Part of the perceived advantage of an RTA is receiving preferential access into a partner country; such preferences are particularly notable in North-South RTAs because MFN trade barriers generally are highest in sectors of export importance to developing countries (e. g. textiles, clothing and agriculture). It is also one of the major drawbacks: granting preferences to some developing countries discriminates against the trade of others, resulting in costly trade (and investment) diversion. The NAFTA caused substantial trade and investment diversion in the textiles and clothing sectors from the Caribbean Basin countries as a result of the preferential treatment accorded Mexican industry. The US African Growth and Opportunity Act (AGOA) now is having a similar adverse effect on non-beneficiaries in Africa and elsewhere. In essence, whether via RTAs or unilateral preference schemes, industrial countries rob Peter to pay Paul.

Problems with trade diversion are obvious in theory but less evident in practice. Often, the growth impetus from RTA reforms yields net trade creation over time. Indeed, that is the robust conclusion for the world’s most prominent RTA, the European Union. Analysis of the trade consequences of a RTA – for both partner countries and nonsignatories – can only be fully considered after the main reforms have been implemented and the dynamic effects of those policy changes have fed through each economy.

Is there evidence of net trade creation or diversion for RTAs? The results of several studies are summarized below. We find strong evidence of net trade creation from RTAs and very limited instances of trade and investment diversion. Using a gravity model of trade and a 30-year data set containing 46 RTAs, DeRosa (2007) found that most RTAs are predominantly trade creating. Some RTAs in the study were found to be trade diverting, but for the most part these RTAs were minor. The major RTAs (i.e., NAFTA, the European Union, Mercosur, and the ASEAN) show no signs of trade diversion in the study, providing clear evidence against one of the main RTA critiques and in favor of a commonly cited RTA benefit.

Evidence against the trade diversion argument is not so clear cut in another recent gravity model analysis. In Hufbauer / Schott (2007), a gravity model analysis similar to the one in DeRosa (2007) is carried out with an expanded and updated data set. This analysis provides useful insight into the nature of trade diversion by considering agriculture and manufacturing trade flows separately from total trade. For manufacturing and total trade, the



results are similar to those reported by DeRosa; only a few agreements indicate trade diversion. The results for agricultural trade are far different; most of the RTA groupings show significant trade diversion in agricultural trade, including major RTAs like the European Union, the European Free Trade Association (EFTA), and NAFTA.<sup>8</sup> Most likely, these results are a product of the high MFN barriers in agriculture. As theory and intuition suggest, the larger the differential between MFN and preferential barriers, the greater the chance for diversion. The results in Hufbauer / Schott (2007), while limited by sector, do lend credence, at the very least, to the argument that multilateral liberalization is necessary in tandem with RTAs in order to blunt potential trade diversion.

In addition, Hufbauer and Schott extend their gravity model analysis to foreign direct investment, and report only limited investment diversion. The EFTA, the European Union's FTAs, Mercosur, and the South Asia Free Trade Agreement (SAFTA) are all found to lower the amount of investment from members to non-members, corroborating an anti-RTA argument. However, the story is not entirely negative. The results also show that several agreements brought investment from non-members into member countries. The US and Mexican portion of NAFTA, for example, stoked investment from non-members into member countries by 29 %, most likely due to European and Asian investments in Mexico in order to gain access to the lucrative North American market.<sup>9</sup>

The second major problem with RTAs is that they can create a web of overlapping and inconsistent trade rules (artfully described by Jagdish Bhagwati as a "spaghetti bowl") that complicates global sourcing and raises transactions costs.<sup>10</sup> RTA critics specifically take issue with rules of origin provisions, which can be particularly distorting. Origin rules are blatantly discriminatory, but their overall impact on business is unclear. For origin rules, like most aspects of RTAs, the problems are more pronounced in those sectors with high MFN protection. Conversely, if MFN barriers are low the protectionist effects of origin rules diminish, since importers can simply ignore the RTA rules and abide by MFN rules (as sometimes occurs in US-Canada trade). Moreover, as MFN trade barriers go down, the value of these rules of origin (reflected in the "margin of preference") diminishes significantly.

Empirical research is needed to determine how big a problem the "spaghetti bowl" really is. Recent work at the Inter-American Development Bank bears mention. Estevadeordal / Harris / Suominen (2007) look at 58 RTAs with varying rules of origin. In this study, the authors categorize the RTAs in order to understand their divergence from one another. They find that there are distinct origin rule "families" or similar styles that usually follow continental boundaries. The families do create some convergence regionally, but there is still wide divergence worldwide on specific products. According to the study, on average, only about one third of all agreements will have identical rules of origin on a given product. This corroborates the spaghetti bowl story; however, no attempts to quantify the overall dollar impact of the spaghetti bowl have been made. The authors argue that while di-

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8 In Hufbauer / Schott (2007) some RTAs are grouped together (e. g. Chilean, Mexican, Australian, and Singaporean FTAs are identified with the same dummy variable).

9 In the FDI gravity model analysis in Hufbauer / Schott (2007), NAFTA is divided into its three parts: a US-Canada FTA, a US-Mexico FTA, and a Canada-Mexico FTA.

10 See Bhagwati / Panagariya (1996).

vergence is prevalent, the regional similarities provide opportunities for coordination that could begin to mitigate the spaghetti bowl effects.<sup>11</sup>

Third, RTAs can divert attention away from multilateral negotiations for several reasons. First, countries have limited resources to engage in trade negotiations, and RTAs clearly limit time that can be spent negotiating multilateral reforms. This problem is particularly acute for developing countries, which usually have only a few officials for all trade negotiations. But it can also affect developed countries, whose budgets can be inadequate to meet the extensive demands of a proactive, multifaceted trade agenda (see Ambassador Robert Zoellick's letter appended to GAO 2004). Second, some developing countries become less interested in WTO talks after concluding preferential deals with their key trading partners because they want to preserve their preference margins in partner countries from erosion due to MFN trade liberalization in WTO negotiations. Third, RTA critics fear that trade diversion caused by RTAs may indirectly cause disengagement from multilateral talks. Trade diversion increases the cost of nonparticipation, inciting third countries to attempt to join RTAs or create their own (Baldwin 1993). This concept, dubbed "domino regionalism" by Richard Baldwin, could fragment the trading system into blocs or spur competitive liberalization that complements and reinforces multilateral reforms (Bergsten 1996).

Is this actually the case? Some analysts have claimed that Mexico is less interested in the Free Trade Area of the Americas (FTAA) because of the NAFTA and does not want other countries to share its access to the United States. However, that argument does not seem to hold. Mexico has pursued FTAs throughout the world precisely because it knows that the United States will continue to expand its own roster of preferential partners and that those pacts will dilute the value of Mexico's preferences in the US market anyway. Rather than hunkering down within NAFTA, Mexico has fully participated in WTO and FTAA negotiations, and has negotiated a network of FTAs to enhance its status as a destination for foreign direct investment to serve other markets within the hemisphere.

Fourth, RTA critics argue that some accords can set bad precedents for multilateral trade. Due to economic and political asymmetries in North-South RTAs, developed country partners can push for the inclusion of origin rules or intellectual property protection that developing countries may find burdensome to implement and enforce. Others argue that RTAs cover subjects that are better dealt with outside the trade arena, such as labor and environment. Of course, many believe that coverage of these areas is crucial – for both substantive reasons and to bolster domestic political support for the pact in industrial countries.

In sum, RTAs can be, on balance, trade creating or diverting, can build support for or divert attention from multilateral negotiations, can enhance or dilute (or both) negotiating resources, and can foster good and bad precedents for other trade initiatives. The overall

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11 In this regard, the countries of the Andean region and members of the Central American Common Market are now seeking to harmonize the trade regulations embodied in their respective neighborhood accords and FTAs with the United States. If successful, that negotiation could spark renewed interest in some type of broader hemispheric trade pact to substitute for the moribund process seeking a Free Trade Area of the Americas.

outcome depends on how pacts are crafted, the commitment of the partner countries to the WTO system, and how much progress is made in parallel WTO talks.

As I concluded in Schott (2004), RTAs can contribute to and strengthen the multilateral trading system “*if their coverage is comprehensive, if origin rules are kept to a minimum, and if the members are committed to work together to advance MFN trade reforms in the WTO.*” However, if the Doha Round goes into hibernation or collapses, then the downside risks of RTAs may dominate and erode the vitality (and perhaps the viability) of multilateral initiatives. This “cost of failure” is not well appreciated among WTO ambassadors, who have not yet had a trade round fail in their lifetime.

## **8 Does regionalism enhance developing country power in the WTO?**

In 1947, the GATT was signed by 23 countries. Today, the WTO has more than 150 members. For the past six decades, decisions have been taken by consensus. Very few matters are subject to a vote, where each member – large or small – has the same weight. The consensus rule is likely to continue, even though the WTO decisionmaking process has become cumbersome as the number of issues on the WTO agenda and the number of participants have proliferated. As a result, “consensus building” has become more important for both developed and developing countries in order to produce WTO agreements.

In the Doha Round, developing countries have played prominent roles in the substantive negotiations. In large measure, this activity reflects the size and increasing global engagement of emerging economies like China, Brazil, and India. These three countries account for a larger share of global gross domestic product (GDP) than Japan; their combined output in 2006 was roughly equal to one-third of the US GDP.<sup>12</sup> Bigger markets mean countries have more “chips” on the negotiating table. That’s an important reason why membership in the ad hoc steering groups for WTO negotiations shifted over the past two decades from the “Quad” (United States, European Union, Canada, Japan) to the “G-4” (United States, European Union, Brazil, and India) – though neither iteration has been particularly effective.

Can RTAs enhance the role of developing countries in WTO negotiations? Let me offer a two-handed economist’s short answer to this political science inquiry.

On the one hand, to the extent that RTAs spur productivity and welfare gains in the member economies, those countries will likely have a bigger stake in world trade and in WTO talks. Regional associations among developing countries also can enhance their capacity to participate in WTO negotiations, if members are willing to pool resources and share information (a good example is the Caribbean Regional Negotiating Machinery).

On the other hand, RTAs among developing countries do not necessarily add “weight” to their members’ influence in WTO matters. It depends whether the country accepts “re-

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12 To be sure, some smaller developing countries have been active on single issue or sectoral talks (e. g., West African cotton exporting nations), but have limited ability to exercise their implicit blocking power – unless they are willing to bring the entire multilateral process to a halt.

sponsibility” and contributes commensurate to its economic standing in the trading system. Brazil has no more leverage as a member of Mercosur than it did in the Tokyo Round when it negotiated independently. In contrast, Brazil has more leverage in the Doha Round due to its commercial diplomacy and its leadership of the G-20 developing country caucus, formed in the run-up to the Cancún WTO ministerial in September 2003 to promote substantial liberalization of agricultural protection and deep cuts in US and European farm subsidies.

## **9 Reinforcing the multilateral trading system: What needs to be done?**

The problems of the Doha Round and the proliferation of regionalism confront WTO members with a central challenge: how to make the multilateral trading system more relevant and more effective in addressing obstacles to the free flow of goods, services, and capital, and in promoting sustainable development.<sup>13</sup> Like its members, the WTO as an institution must respond to globalization pressures and adapt its work to fit changing conditions in world markets. This will require changes in the way the WTO works and with whom it works. In this concluding section, I outline three broad and inter-related challenges facing the WTO: “Multilateralize Multilateralism”; “Multilateralize Regionalism”; and “Modernize Multilateralism.”

### **I. Multilateralize Multilateralism**

The fundamental obligations of the WTO are most-favored nation treatment (MFN) and national treatment embodied in GATT Articles I and III. However, there are a vast number of exceptions that take the WTO far away from the ideal of a universal system with a single set of rules.

The exceptions can be classified in five main categories: import remedies (antidumping and countervailing duties; general import and balance of payments safeguards); regulatory exceptions (including general exceptions in Article XX and national security controls in Article XXI); RTAs and plurilateral agreements (of which the government procurement agreement is the most notable); developing country preferences (embodied in Part IV of the GATT and in “special and differential” preferences for developing countries included in all WTO accords); and in carve-outs negotiated in the national schedules of each WTO member country. Taken together, it is hard to say that “multilateral” = “MFN”!!

That said, WTO members would do well to fill many of the holes in the MFN gaps cited above. The broad exceptions in Article XX and XXI deserve priority attention because security and environmental problems pose new challenges to the WTO system.

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13 This challenge is discussed in the context of African regionalism by Draper / Qobo (2007).

## II. Multilateralize Regionalism

As noted in earlier sections of this paper, RTAs will continue to proliferate regardless of the outcome of the Doha Round. The challenge is to make the design and implementation of RTAs more WTO-friendly (see, for example, Baldwin / Thornton 2008). The vast literature on this subject offers a multitude of proposals; most are theoretically sound but flawed in terms of political economy considerations – in other words, they are easier to discuss than to negotiate and legislate.

In terms of design, policymakers often extol the merits of “open regionalism”, though there is no consensus regarding the practical application of this concept. Some equate open regionalism with unconditional MFN; others envisage a reciprocity requirement (e. g., extending the benefits to non-member countries on the same conditions as the charter members when those countries are ready to accept the RTA obligations). In this way, current members cannot forestall the dilution of RTA preferences as the membership expands, and the RTA thus does not become a substitute for multilateral initiatives (and indeed will eventually approximate a global accord). The problem is that legislative bodies that ratify RTAs seldom like to issue “blank checks” for free access to their markets. That is why accession clauses, if included in RTAs, are seldom invoked.

Rules of origin have been a central focus of RTA reformers, since these provisions not only complicate global trade but also dilute the scope of liberalization in RTAs by making some types of transactions ineligible for trade preferences. In terms of design, the best approach to origin rules is to avoid industry-specific provisions and to minimize domestic content requirements. Cumulating origin rules across RTAs makes clear economic sense, but runs afoul of the political lobbies that insisted on the restrictive origin rules in the first place, and thus will likely fail when big trading powers are involved.

All these proposals are second best: if one wants to reduce the distortions caused by rules of origin, the best solution is to cut MFN tariffs and thus reduce the margin of preference for RTA members. A variant of that approach would be for WTO obligations to require that RTA members harmonize and lower the MFN tariffs (say over a 10-year period) down to the level of the lowest rate applied by any of the RTA members, so that there is a complementarity in the regional and multilateral reform efforts. Note, however, that negotiators faced rigid opposition in both the Uruguay Round and the Doha Round to proposals that would increase the substantive requirements for RTAs under GATT Article XXIV. The economist’s potion is castor oil to politicians!

As a practical matter, WTO members may find the most immediate payoff is improving transparency of RTAs. Indeed, the Doha Round already has made some progress in this area. In December 2006, the WTO General Council approved a new “Transparency Mechanism for Regional Trade Agreements” that is being implemented on a provisional basis pending completion of the Doha negotiations. The main objective of this accord is to get countries to notify the WTO when they are negotiating RTAs and then supplement that notice with details about the pact once it is signed. In that regard, the new mechanism requires that RTA members notify “changes affecting the implementation of an RTA” as soon as possible after they

occur, and submit a final report on the completion of the implementation of the pact. These submissions will alert WTO members when RTA preferences, or RTA provisions such as rules of origin, are modified, and afford members the opportunity for additional consultations on the RTA.

### III. Modernize Multilateralism

Like generals, trade negotiators often fight the last war. Such myopia is clearly evident in the Doha Round and cause of much of its distress. Going forward, the WTO agenda will have to better address changing conditions in world markets, including the growing concerns about global warming, and address more directly the critiques in both developed and developing countries against the WTO and its evil twin, “GATTzilla”!

Modernizing the WTO will require a healthy dose of institutional reform. Key areas that should be addressed include the decision-making process (which should maintain the WTO’s consensus rule but revamp the process of consensus *building* as suggested in Schott / Watal (2000); reform of the dispute settlement procedures in anticipation of an increased caseload on “gray area” legal issues; surveillance (already begun with the provisional application of new RTA transparency rules); and the role of parliamentary and nongovernmental organizations (in response to the sometimes confused debate about the WTO’s “democratic deficit”).

Going forward, the WTO also will have to adapt its substantive agenda to the new demands of globalization and the political imperatives of sustaining coalitions in support of multilateral initiatives. WTO rules on taxes and subsidies need to be recast to meet the new challenges of global warming and to respond to demands that the definition of subsidy (and thus the scope of permitted countervailing measures against distorting or prohibited subsidies) be made infinitely elastic to cover concerns about currency manipulation, regulatory abuse or neglect, and labor market practices. In addition, WTO members will have to address trade and security linkages before pre-shipment inspection and visa requirements become major obstacles to international flows of goods, services, and people. The WTO needs to establish overarching disciplines before national or regional initiatives begin to establish de facto norms. To be sure, this will create tension between those seeking “policy coherence” versus those resisting “agenda overload.”

Because many of these subjects require negotiation into areas beyond the expertise and competencies of trade officials, the WTO will have to collaborate more effectively with other international economic organizations. The biggest challenge will be working with the International Monetary Fund (IMF) and World Bank on interrelated trade, finance, exchange rate, and development issues (particularly the nascent “Aid for Trade” programs). National governments and international organizations have long tried and failed to develop coherent policies that cover these cross-cutting issues – though they have issued a large number of hortatory declarations. Also daunting will be the task of balancing trade and environmental objectives, now that the latter has grown to climatic proportions, since it is not clear what body would be

the obvious interlocutor on the environmental side.<sup>14</sup> And, despite the ideological objections and practical concerns of developing countries, the trade and labor issue will have to be joined, building on the constructive principles on labor rights and conditions of work developed over the past decade or two in the International Labor Organization.

In other words, the trading system in the 21st century must be re-engineered. The WTO's legal architects effectively sought to restore the structural integrity of the International Trade Organization that emerged from the Havana Conference of 1946–47. Their plan was flawed...not because it wasn't ambitious but because it was not ambitious enough.

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14 Esty (1994) anticipated this need in his prescient study and proposed the creation of a Global Environmental Organization.

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