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Introduction

Book section (Published Version)

Original citation:
Originally published in Manger, M. S., *Investing in protection: the politics of preferential trade agreements between north and south.* Cambridge, UK : Cambridge University Press, 2009, pp. 1-26. ISBN 9780521765046

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Investing in Protection

The Politics of Preferential Trade Agreements between North and South

Mark S. Manger

Book DOI: http://dx.doi.org/10.1017/CBO9780511635311

Online ISBN: 9780511635311

Hardback ISBN: 9780521765046

Paperback ISBN: 9780521748704

Chapter

1 - Introduction pp. 1-26

Chapter DOI: http://dx.doi.org/10.1017/CBO9780511635311.002

Cambridge University Press

1 Introduction

In late September 2006, a short letter arrived at the Secretariat of the World Trade Organization in Geneva that formally announced the entry into force of the United States–Bahrain Free Trade Agreement, bringing the number of notified trade accords to 200. With every preferential trade agreement (PTA) – an arrangement that liberalizes trade between member states only – the principles of multilateralism and non-discrimination in international trade as embodied by the World Trade Organization (WTO) lose more relevance. When the letter was received, already more than half of global commerce was conducted under the rules of one PTA or another.

How different the world of international trade diplomacy looked only twelve years earlier. After almost eight years of negotiations, ministers of 109 countries shook hands in Marrakesh on April 15, 1994, on the occasion of the signature of the most ambitious multilateral trade agreement in history. The final deal brought agriculture into the domain of the General Agreement on Tariffs and Trade (GATT) and created the General Agreement on Trade in Services (GATS), a GATT counterpart for services, by then making up a third of global commerce. Most importantly, it established the World Trade Organization itself, a formal international institution with its own staff and seat in Geneva (Barton *et al.* 2006: 93).

The mood was euphoric. US Vice-President Al Gore, who had flown in to address the meeting, called the deal "truly momentous." Peter Sutherland, the Irish Director General of the General Agreement on Tariffs and Trade, said that he was tempted to dance a jig on the table to express his joy.[1] Multilateral liberalization appeared to be firmly established. During the 1980s and early 1990s, many developing countries had embraced an open trade policy and applied for GATT membership.

[1] This depiction of events draws on an article in the *New York Times*, April 16, 1994.

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They were joined by central and east European states that had emerged from communist rule. Even China was in negotiations for accession. Yet, today, multilateral trade negotiations under the auspices of the WTO seem to be little more than a sideshow. Since the early 1990s the world has seen an explosion of preferential trade agreements. Notably, the majority are North–South agreements that bring together economies of vastly different sizes and levels of development.

The rapid proliferation of North–South PTAs is striking since, compared with even minor tariff reductions on a multilateral basis, they do not create much trade. The commitments to lower barriers they embody are dwarfed by the unilateral steps taken by many emerging market countries. Thanks to successive GATT negotiation rounds, most-favored-nation (MFN) tariffs[2] are at historically low levels. Trade economists are divided over whether PTAs improve welfare (compare *inter alia* Freund 2000; McLaren 2002), but almost unanimously judge them a second-best solution to multilateral and unilateral liberalization.

But arguments against PTAs are not just theoretical. The multitude of agreements creates a patchwork of different rules that burden exporters with paperwork and bureaucracy, leading the chairman of Li & Fung, Hong Kong's largest trading company, to pronounce in the *Financial Times* that "multilateralism creates value, bilateralism destroys value."[3] If the complex rules are hard to follow for major trading firms, then they are simply too costly to comply with for most companies from developing countries. One study shows that only half of the imports into the European Union (EU) from least-developed countries make use of the full tariff preferences available. The other half is covered by MFN tariffs, since exporters would rather pay the higher duty than deal with the documentation requirements (Brenton 2003).

Especially for developed countries, individual PTAs with developing economies offer very limited export prospects. Even Mexico, a country with a population of over 100 million, registered annual vehicle sales of only 500,000 in 2005 – about the size of the auto market of Los Angeles. Many PTAs specifically exclude those goods in which developing countries have a comparative advantage. Conventional exports

[2] MFN tariffs are the duties countries charge on a non-discriminatory, unconditional basis. Art. 1 of the GATT requires its signatories to grant market access equal to "the most favored nation" unless, of course, they sign a preferential agreement.

[3] *Financial Times*, November 3, 2005.

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are an unlikely explanation for the popularity of North–South PTAs. Why, then, the sudden proliferation of these preferential trade agreements? Why do major economic powers sign agreements with partners that bring little market size and overall welfare benefits?

This book argues that foreign direct investment (FDI) by multinational firms and the attendant trade are key driving forces of North–South PTAs. FDI flowing from developed to developing countries changes the incentives for governments in both, motivating them to pursue bilateral and regional options because they satisfy the political demands of multinational firms. As these firms invest in developing countries to produce goods for developed markets, they call for the reduction of barriers at home and abroad because it facilitates vertical integration, or the specialization of production according to technological capacity and labor cost. Firms produce high-end goods in the North and low-end products that require cheaper labor in the South, and ship these goods to the other partner.

Yet many multinational firms no longer see the WTO as the best way to meet their trade liberalization needs. Unlike multilateral deals, preferential agreements for trade and investment offer a special benefit: They can be used to raise the barriers for competitors from non-member states. Without such barriers, North–South liberalization would attract "beachheads" of FDI from outsiders, turning the developing country into a back door to the market of the northern partner. To make North–South liberalization politically feasible, governments therefore erect new barriers as they tear down others.

Raising barriers requires the use of discriminatory tools. Since nearly all recent PTAs are free trade agreements (FTAs)[4] in which the members set their own external tariffs, they require rules to determine the origin of goods. In the absence of such rules, goods would simply be imported via the partner country with the lower tariffs. These rules of origin (ROOs) can be designed to the disadvantage of outsiders and to provide protection for insiders. A related mechanism is at work in the service sector, which attracts a large share of FDI. Market and regulatory structures penalize late entry and provide incentives for preferential liberalization.

[4] Throughout the book, I refer to preferential agreements in general as PTAs, and to FTAs only in specific cases where the legal text uses the term. This applies to the FTAs between Japan and Mexico, Chile and the United States, the EU and Japan, and Japan–Thailand and Japan–Malaysia.

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North–South PTAs thus trigger an endogenous dynamic unanticipated by earlier proponents of preferential trade agreements: other countries conclude defensive agreements with the host country out of fear of being shut out of markets and production locations. North–South PTAs are therefore not just a beauty contest among developing countries over who is the most open to foreign trade and hence to be rewarded trade agreements with rich partners, as the former US Trade Representative (USTR) Robert Zoellick suggested when he coined the term "competitive liberalization." It is a contest between major economic powers to gain access to emerging markets and important production locations, to impede such access for competitors, and to restore it when others have moved first.

This book offers a political economy account of the endogenous competition driving much of the proliferation of North–South PTAs. The approach assumes that governments decide their policies in response to pressures from organized societal groups. Although political variables may shape the decision to pursue PTAs, I emphasize the economic incentives that cause their proliferation, since even a PTA concluded for non-economic reasons is likely to have redistributive effects within and between countries. At the centre of the argument is a model of trade policy formation at the domestic and systemic level. Domestic sources of trade policy, in particular the interests of multinational firms, lead to policy outcomes at the international level. Since these interests not only influence the decisions to seek trade agreements, but also the design of PTAs, they have (at times unintended) consequences that reverberate abroad. Multinational firms in other countries in turn seek to influence the trade policy choices of their home government.

Through several case studies the following chapters explain how this process results in a spiraling model of more and more PTAs. The in-depth case studies cover the North American Free Trade Agreement (NAFTA) and the two defensive agreements with Mexico signed by Japan and the EU. I then apply the framework to several cases of North–South PTAs concluded in recent years: Japan's FTAs with Thailand and Malaysia, and the FTAs with Chile signed by the United States, the EU, and Japan.

Unequal partners: the proliferation of North–South PTAs

If trade liberalization is defined as the lowering of tariff barriers, the GATT should be considered a spectacular success. Negotiations have

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cut down manufactured goods tariffs on MFN basis from an average of over 50 percent to between 5 and 10 percent. Most manufactured imports into the industrialized countries face near-zero or no tariffs. In the light of this achievement, the sheer number of North–South PTAs signed in recent years is particularly striking. A closer look at the institutional features of the global trade regime and the character of recent PTAs shows that today's agreements coincide with profound changes in the world economy. Developing countries have reintegrated with the global economy, causing changes in the character of investment in these "emerging markets" and affecting the multilateral trade regime in turn. As such, this trend does not herald a return to the protectionist blocs of the 1930s. The scope of recent PTAs, covering new issues beyond trade in goods, their character as partnerships between countries of unequal levels of development, and their often "extra-regional" geography set them apart from past trade arrangements.

The experience of the interwar years, when retaliatory tariffs led to the creation of protectionist blocs, provided the initial impetus for the United States to support the creation of the GATT. Based on the constitutive norm of non-discrimination as expressed in MFN tariffs, Article XXIV of the GATT stipulates that regional integration measures have to conform to three standards. First, they should cover substantially all trade. Second, they should liberalize trade between the members within a reasonable time frame. Third, they must not raise the barriers against third parties above the initial MFN level at which tariffs are "bound" by GATT members. However, many developing counties apply much lower tariffs than their bound rates, leaving room for increases in tariff rates. Moreover, no similar clause exists with regard to non-tariff barriers such as rules of origin or the regulation of FDI. Although PTAs have to be "nested," or made compliant with the overarching GATT/WTO regime,[5] the weak disciplines of Article XXIV give states considerable freedom in creating discriminatory measures.

Because of the leeway given by the GATT, PTAs vary in their coverage of trade and in the inclusion of the flows of the factors capital and labor. A considerable number of agreements fall under the "enabling clause" of the GATT that allows developing countries to sign agreements among themselves with generous time frames for tariff reduction, often

[5] See Aggarwal (1998) and Aggarwal and Urata (2006) for an analysis of the "nesting" of multiple international regimes.

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resulting in little or no actual liberalization. Many recent PTAs have this declaratory character. Other agreements only reaffirm existing tariff-free trade between states that previously belonged to the same political entity, as in the 1992 FTA signed by Slovakia and the Czech Republic, or agreements between former Soviet republics. Finally, some agreements are superseded by later PTAs, while others are suspended for political reasons.[6]

Counting only the PTAs in force and joint GATS Article V (trade in services) and GATT Article XXIV (trade in goods) agreements such as NAFTA as a single institutional package, we arrive at a cumulative figure of about 170 PTAs in 2008. Taking a minimum difference of US$15,000 in per capita gross domestic product (GDP) in purchasing power parity terms as threshold to count a country as "developed," about 100 are "North–South PTAs" – here used as a shorthand, although some "Southern" countries such as Macedonia and Armenia (partners of the EU and Switzerland, respectively) would be better characterized as economies in transition. This figure is much smaller than is to be expected based on the number of countries involved, since the EU has a common external trade policy and the European Free Trade Area (EFTA) member states[7] usually negotiate agreements jointly. This study focuses on the growing subset of PTAs between pairs of countries that are highly unequal in their level of development and the size of their economies.

Figure 1.1 is a graph of the growth of these agreements over time. Until 1991, North–South PTAs were limited to a handful of agreements, mostly between the European Community and its close neighbors, such as the EC–Malta FTA of 1971. The turning point came in the early 1990s, when countries in Latin America and many former communist countries began to seek PTAs, and when the United States, the creator of the GATT regime and the biggest importer, turned to North–South agreements. By the mid-1990s, the trend was in full swing.

Notably, the number of North–North agreements has in fact decreased in recent years, as several central and east European countries have joined the EU (Pomfret 2007). North–South agreements as defined

[6] Whalley (2008) offers a thorough overview and warns against alarmist double-counting of PTAs.

[7] Iceland, Norway, Switzerland, and Liechtenstein.

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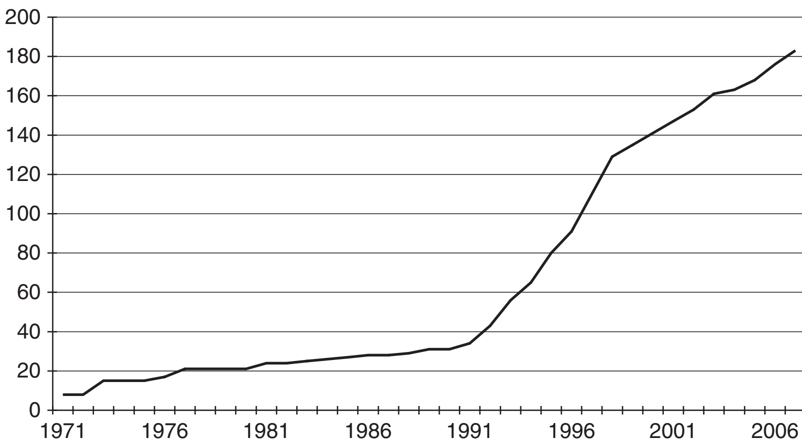

Figure 1.1 Growth of North–South PTAs, 1971–2007.
Source: WTO Secretariat; McGill Trade Agreements Database, http://ptas.mcgill.ca.

here are experiencing the fastest growth of all PTAs.[8] Almost all are classified as FTAs rather than as customs unions, the sole exception being the 1996 EU–Turkey agreement.

Advanced developing countries such as Chile, Mexico, or Thailand are preferred partners in today's agreements. Prior to liberalization in the developing world, commercial interests from the North were limited to resource extraction, "tariff-jumping" investment by multinational firms, or, in the case of many "developmental states," closely circumscribed domains of export-oriented production. Liberalization creates new opportunities and thus the incentives for interested parties in industrialized countries to lobby for agreements to secure preferential access.

In Latin America, unilateral liberalization represented the first step in overcoming the legacy of import-substitution industrialization.[9] During most of the 1950s–1980s, multinational firms produced outdated products, protected by high tariffs, for domestic sales in markets such as

[8] See also Fiorentino *et al.* (2006) for a slightly different classification that reaches a similar conclusion.
[9] Imports were to be substituted by domestic production, protected by high tariffs and quotas on imports. For a succinct description of these policies and their unintended effects, see Krueger (1995a), esp. chapter 1.

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Mexico, Brazil, and Argentina. Using various performance requirements, for example the sourcing of a percentage of inputs or mandatory export of a share of the production, governments attempted to harness the benefits of foreign capital (Caves 1996; Greenaway 1992). To compensate multinational firms for high tariffs and host country requirements, governments struck deals that sheltered investors from competition and offered economic rents (Evans 1979). While the provision of services remained in the hands of governments, the high tariffs and restrictions made exports and investment by smaller firms from developed countries infeasible. FDI sought markets, but under the specific conditions of the import-substitution policy of the host country. As Latin American countries began to liberalize in the late 1980s and early 1990s in search of foreign capital, they became attractive for a different kind of investment integrated with world markets.

Despite important differences from Latin American countries, Asian "developmental states" (Wade 1990) attracted similarly inward-oriented FDI. Multinational firms, in this case mostly from Japan, enjoyed exclusive market share arrangements for their products. While export-oriented investment caught the attention of many scholars, it was nearly always limited to a few industries – mostly computer parts and consumer electronics manufacturing in east and southeast Asia, especially in Taiwan, Singapore, and Malaysia. Following the 1997 Asian financial crisis, liberalization has reached this region as well.

As other sources of capital such as bank loans have dried up, countries in both regions have been forced to compete for investment. In this competition, governments see direct investment as preferable to volatile portfolio capital flows. Table 1.1 shows the growth in total net FDI inflows since 1987.[10] From a low base of less than 10 percent of global FDI, developing countries received a growing share of capital flows during the 1990s, with a peak of almost 36 percent in 1997. Although China's share of FDI to developing countries alone made up a third on average, other developing countries received massive inflows as well. The growing share flowing to developing countries drew on a steadily larger volume of global capital: measured in constant US dollars, foreign direct investment flows have grown more than sixfold since 1987.

[10] To facilitate comparison, all dollar figures throughout the book have been deflated to constant values using the US consumer price index with the year 2000 as base.

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Table 1.1. *Net global FDI inflows and country shares*

Year	Global FDI (US$ billion)	Country shares as a percentage: High-income countries	Developing world	Of which China
1987	178	90.3	8.1	1.8
1988	209	85.2	12.2	2.0
1989	248	86.6	11.9	1.7
1990	251	84.2	11.9	1.7
1991	186	73.7	22.1	2.8
1992	194	67.7	29.8	6.6
1993	249	66.4	30.3	12.5
1994	275	60.3	35.4	13.6
1995	357	64.5	31.7	10.9
1996	398	62.3	34.1	10.7
1997	491	59.6	35.9	9.4
1998	722	71.4	24.2	6.3
1999	1,119	79.5	16.2	3.5
2000	1,518	83.5	10.9	2.5
2001	779	72.5	21.7	5.5
2002	708	75.1	21.8	6.7
2003	608	69.7	25.0	7.3
2004	708	62.9	29.1	7.1
2005	929	66.4	27.5	7.5
2006	1160	65.8	27.2	5.8

Source: World Development Indicators Online 2008. All figures deflated to constant US$2,000.

Moreover, the raw figures obscure qualitative differences. While high-income countries still receive close to two-thirds of total direct investment, much of this FDI consists of the acquisition of existing firms. A larger proportion of FDI to developing countries is made up of "greenfield investment" that leads to the construction of new production facilities. As is repeatedly stressed in UNCTAD reports (e.g. 2004a), FDI is by now the most important source of foreign capital for developing countries.

In various ways these investment flows are linked to international agreements. For developing countries, combined free trade and investment agreements offer an institutional package that locks in unilateral

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liberalization and provides guarantees for investors beyond WTO commitments (Fernández and Portes 1998). These benefits resemble those promised by the growing number of bilateral investment treaties (BITs), another product of the competition for foreign capital (Elkins *et al.* 2006). In addition to these advantages, trade agreements with an industrialized partner, even with only modest tariff reductions, give a developing country an edge over competitors with similar factor endowments (Ethier 1998a, 1998b, 2001). Both benefits explain why developing countries seek bilateral agreements with developed countries.

Less obvious is why these developed countries should take up the offer. Most developing countries are negligible export markets. In terms of national income, Mexico offered US firms barely 6 percent additional market size when NAFTA entered into force.[11] Foreign direct investment, however, creates powerful incentives for multinational firms to offer political support for PTAs beyond what the potential for conventional exports would lead us to expect.

Following the reintegration of many developing countries into the world economy, they attract manufacturing FDI to serve as export platforms to (mostly) developed-country markets. Sometimes, labor-intensive stages of production are moved to developing countries. At other times, multinational firms relocate the manufacturing of mass-market goods to low-cost countries, but keep the production of key components and high-end products at home. In addition, manufacturing FDI entails exports of machinery (capital goods) and inputs such as parts (intermediate goods) to the FDI host. One of the most important purposes of PTAs is to liberalize the trade in goods generated by FDI – much more so than the regulation of FDI in manufacturing itself or the reduction of tariffs on other exports.

Manufacturing FDI also creates a market for related services, for example insurance of exports or financing of direct investment. Moreover, since most developing countries have only recently begun to open their financial and telecommunications service markets, FDI in services represents a considerable share of the capital flows to emerging markets. Provisions for FDI in PTAs therefore apply in large measure to these flows.

[11] In concrete numbers, a GDP of merely US$466 billion compared with US GDP of US$7.7 trillion, adjusted for purchasing-power parity.

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Perspectives on preferential trade agreements

Earlier theoretical traditions in International Relations explained PTAs as a symptom of hegemonic decline and the inability of the United States to keep the multilateral trade regime open and non-discriminatory. Neoliberalism conceived of trade agreements as one cooperation problem among many, arguing that greater numbers of states engaged in negotiations make it more difficult to come to an agreement. PTAs can therefore be seen as the inevitable by-product as many countries join the WTO, mounting transaction costs make negotiations more difficult, and governments look for alternative venues for trade liberalization.

These interpretations still have purchase today. Mansfield and Reinhardt (2003) show that the growth of WTO membership, the recurrent negotiation rounds, and, in particular, the participation in trade disputes motivate states to seek PTAs as an insurance policy: should WTO rounds fail or end up deadlocked, states secure export markets. Likewise, PTAs can serve as coalition-building strategy to increase bargaining power or to "obtain countervailing market access" (Mansfield and Reinhardt 2003: 830) for countries that lose in WTO disputes. Moreover, the growth in the sheer number of PTAs will lead states to pursue such deals, as institutional templates become available and competitors use them to secure outlets for their exports.

Yet although PTAs improve market access, the gains are often circumscribed. Usually, both parties reserve the right to use the WTO as an avenue for settling claims, even if the PTA contains elaborate dispute settlement mechanisms. PTAs with the United States in particular do not offer protection from US trade remedy laws. While a stalled multilateral negotiating round leads countries to a search for alternative venues for trade deals, it cannot be the only factor at work. The number of North–South PTAs exploded *after* the last WTO round, while earlier waves of PTAs reached their peak during GATT negotiations as countries sought to gain leverage, as Mansfield and Reinhardt show.

System-level explanations also offer only limited insight into the cross-regional variation in the spread of preferential trade agreements: PTAs have spread quickly in the Western hemisphere, but have only recently arrived in Asia (Ravenhill 2003), reigniting scholarly interest in turn (Aggarwal and Urata 2006; Dent 2006; Pempel 2006). The peculiar pattern of how PTAs have spread across the globe and the recent surge in North–South agreements invite a search for additional causal factors.

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As Haggard (1997) has argued, the foremost reason for the impasse at the WTO table is the convergence or divergence of state interests, in particular over the seemingly intractable issue of agricultural liberalization. Katada *et al.* (in press) submit that major economic powers often prefer to deal bilaterally with a weaker partner because they can control the negotiating agenda to favor their internationally oriented businesses while protecting declining sectors. While this argument sheds light on some of the benefits of bilateral deals for developed countries, it cannot explain why states rarely chose this route until the early 1990s. Why do the interests of states converge on preferential rather than multilateral liberalization? Why has this convergence manifested itself so strongly in recent years?

Despite a multitude of studies, we have few answers to these questions. Economists have focused on the effects of PTAs on national and world aggregate welfare from a Pareto-optimality perspective. Most economists agree that multilateral liberalization is preferable to bilateral agreements. Just how preferable depends on the Pareto criterion: PTAs could still be desirable as long as they make some countries better and none worse off. The classic formulations by Viner (1950), Lipsey (1957), and Meade (1955) argued that PTAs can be welfare enhancing if more trade is created than diverted away from more efficient countries outside the arrangement. Kemp and Wan (1976) raised the prospect that PTAs can be constructed in a way that makes at least one member better off, but does not affect outsiders. Later contributions found that welfare effects tend to be ambiguous (Panagariya 1999, 2000).

With the second wave of regional trade agreements in the 1980s, the focus shifted from these "static" considerations to "dynamic issues": are PTAs "stumbling blocks" or "building blocks" (Bhagwati 1991) towards global free trade? Krishna (1998) argues that trade diversion reduces the incentives for parties to a bilateral agreement to reduce trade multilaterally. Levy (1997) even contends that bilateral PTAs can make multilateral liberalization politically unviable, while McLaren (2002) warns that PTAs can induce member countries to make relation-specific investments that inhibit future multilateral liberalization. Much of the criticism depends on how much trade is actually being created by PTAs, with recent studies suggesting a much stronger positive effect (Baier and Bergstrand 2007; Magee 2008). These benefits also help to explain the motivation for "natural" – that is, geographically close – partners to form PTAs. Yet it is doubtful how relevant these findings are for today's

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agreements between distant partners. The most prominent study of PTA formation motivated by welfare gains (Baier and Bergstrand 2004) relies on a dyadic dataset that ranges only until 1996, with almost 60 percent of the PTA formation outcomes driven by two political entities, the EU and EFTA.

To understand the motivation behind North–South PTAs, we need to focus on the two different forces that tend to influence the foreign economic policy of individual states: reactions to policies of other countries and to domestic political demands. Government policy often reflects the interests of strong and well-organized societal groups (Grossman and Helpman 1994), although mediated by the domestic institutions that offer or restrict access to governments (Mansfield and Busch 1995; Nelson 1988).

Since multinational firms are responsible for most international trade, their interests are an obvious starting point for the analysis. In Milner's framework, governments balance producer and consumer interests. Public officials therefore seek the support of industrial sectors, some of which will be in favor of liberalization. Firms support regional liberalization because it allows the mutual reduction of tariff barriers by "trading scale economies across industries" (Milner 1997: 91), in effect balancing costs and benefits between exporters in the two partner countries.

Along similar lines, Busch and Milner (1994: 270) put the growing importance of exports and intra-industry trade at the centre of their explanation of firm preferences. Producers that can achieve economies of scale in home markets are more competitive globally, leading them to demand regional trade agreements. This demand will be most pronounced when firms are competitive in terms of technology and management but lack the sizable home market to achieve the optimum efficiency. Milner cites the example of Canadian firms that supported NAFTA. Chase (2005) develops this approach further by showing that support for regional trade agreements since the end of World War I corresponded closely to the economies of scale that important industries achieved depending on their level of technology.[12]

[12] But see Thompson (1994), who argues that Canadian firms were particularly opposed to further liberalization. Since Canada and the United States had signed an FTA before NAFTA was proposed, Canada's initial interest in NAFTA was limited to the protection of the gains made in the CUSFTA (Cameron and Tomlin 2000: 63–64).

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However, adding market size through North–South PTAs may not be the key to achieving economies of scale. Most developing country markets are too small to move firms down the cost curve towards greater efficiency. The drive to achieve greater economies of scale offers a convincing account of PTAs between developed countries or the political support for a large common market like that of the European Union, but without a commensurate explosion in returns to scale, it does not explain the exponential growth of North–South PTAs in recent years.

In a series of papers, Chase (2003, 2004) seeks to address this problem, arguing that multinational corporations lobby for regional agreements with developing countries because of the growth in offshore processing. Many of these firms, however, face a legacy of sunk investments originally made under protectionist host country policies. They therefore press for barriers to non-members to provide breathing room while they restructure.

Temporary relief is one aspect of non-tariff barriers, but not the most important. A growing literature demonstrates how rules of origin and other barriers have become a strategic policy instrument that firms try to manipulate to their advantage (Duttagupta and Panagariya 2003; Krishna 1998; Krishna and Krueger 1995; Suominen 2004). When a host country still retains high MFN tariffs – typical of many developing countries – rules of origin and tariffs interact to raise the costs for non-member firms. If member firms mainly source inputs from within the FTA, then ROOs are a costless device for insiders to extend protectionism to the host country and to gain the political support of intermediate goods producers. ROOs therefore either divert trade to producers in the PTA while inducing producers from non-members to relocate production into the PTA, or they create additional costs for outsiders.

The discriminatory aspect of PTAs, I argue, is one of the greatest attractions for multinational firms. The account in this book expands on political economy models that predict that preferential agreements are most likely to be formed when they divert trade, because the gains to exporters then outweigh the costs to import-competing industries (Grossman and Helpman 1995; Panagariya and Findlay 1996). The unintended consequence of such trade diversion is the reaction by other countries. Excluded parties can counter PTAs in two possible ways: they can either form PTAs among themselves, or they can attempt to join an existing agreement to prevent trade diversion. Baldwin (1996) calls this the "domino effect of regional trade agreements."

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Although the domino theory appears to be an apt description of the progressive expansion of the EC/EU, it faces a fundamental challenge: only in the rarest of instances have PTAs been shown to divert trade, and even these findings are sensitive to econometric specifications (Magee 2008). Even NAFTA, with its unusually restrictive rules of origin, has not had measurable negative effects on trade with non-members (Aussilloux and Pajot 2002; Krueger 1999). In fact, when a developing country signs a PTA, in most cases its trade with members and non-members alike increases significantly. North–South PTAs often coincide with other economic reforms in developing countries and should in principle boost growth by attracting foreign investment. Moreover, "beachhead" FDI from outsiders in one country in order to serve the markets of the parties to the agreement will increase trade as its complement. As a result, many PTAs appear to have the counterintuitive effect of creating trade with the outside world. Neither the diversion of trade in finished goods based on comparative advantage, economies of scale, or stalled multilateral negotiations at the WTO seem to account fully for the recent explosion of North–South PTAs. Changing the focus to foreign direct investment explains this outcome.

Firms, states, and their investment in protection: an overview of the argument

North–South PTAs offer a variety of advantages to firms, depending on the sector in which investment takes place. In many service industries the first firm to enter a developing country market opened through a PTA enjoys advantages over later entrants. In manufacturing, PTAs allow firms to lower the cost of an internationally fragmented production while preventing competitors from non-member countries from obtaining the same benefits. These benefits are less evident at an aggregate economic level, but are clearly visible at the level of individual firms.[13]

In services, the structure of many markets confers important first-mover advantages. Many service industries are textbook examples of

[13] Since within PTAs FDI flows primarily from North to South, the following refers to the developed country as the "home" country, the developing economy as the "host."

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oligopolies or natural monopolies, in which efficient production requires a dominant market share. First-movers with enough capital can buy up existing assets – such as telecommunications networks or branches in retail banking – and attain a commanding position. These firms will be able to offer their products at a lower cost than later entrants because with a larger market share first-movers produce on a greater, more efficient scale. Competitors would have to make significant investments before reaching profitability. Preferential liberalization therefore threatens to shut out competitors. Because the first-mover advantage is the result of market structures rather than the reduction of barriers, this applies even if host country laws on FDI are subsequently made non-discriminatory – that is, if liberalization is multilateralized later. In addition, first-mover firms may attempt to influence important regulations in a way that raises rivals' cost of market entry. As emerging market countries move towards the liberalization of services, the overhaul or, in some cases, initial creation of regulatory regimes becomes necessary, e.g. in the provision of financial services and the protection of investor and intellectual property rights. With the primary exporters of these services located in developed countries, this process creates an interest in influencing the regulation to adapt models used in the home country, thus lowering the barrier to entry for their providers and raising them for others (Wunsch-Vincent 2003).[14] In manufacturing, liberalization creates the opportunity to use the advantages of specific locations in the production of goods. Capital-intensive production takes place in developed countries that offer access to high technology and research and design facilities and personnel. Labor-intensive stages of production are outsourced to the developing world. This vertical fragmentation of production leads to an increase in intra-industry trade, or trade in the same industry in differentiated goods. Unlike intra-industry trade between developed countries, however, the traded goods are differentiated by "quality": developing countries are more likely to export low-cost goods, while developed countries export high-cost, high-quality goods. For example, while many car manufacturers produce their upscale vehicles in their home country, entry-level cars are produced in less developed countries. A typical case is the German car

[14] See also Mattli and Büthe (2003) for the importance of international standards and regulations in providing advantages to some firms over others.

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manufacturing company Volkswagen that assembles most of its high-end models in Germany, but produces its entry-level Polo and Golf models in the Czech Republic and Brazil.

Moreover, such investment implies an enormous increase in trade in intermediate goods: parts production often takes place in specialized factories to achieve efficient production scales. The same parts are then shipped to different locations. Fragmented production thus creates a demand for tariff reduction in home and host countries. While transport costs are less and less important, not every country is equally attractive as a location of production. Proximity to developed country markets, as well as other factors such as available primary materials, turn access to these locations into competitive advantages.

The decisions firms make in a globalizing world explain their interest in the reduction of barriers to trade and investment in general, but not the popularity of preferential agreements. Unilateral or multilateral liberalization could lower tariff barriers between developed and developing countries, allowing trade and investment to produce efficiency gains without a multitude of different rules. Politics, however, opens the door to preferential treatment. While a North–South PTA allows firms to produce abroad where costs are lower, it also exposes the home market to foreign competition; nothing would prevent firms from third countries from investing in the developing partner country and using it as an export base. Firms and labor in the North will therefore try to minimize the threat of entry of competitors. When two countries with very different wage levels liberalize bilateral trade, firms and workers in manufacturing industries will often try to raise the barriers for outsiders.

In this situation, non-tariff barriers such as ROOs, an essential part of all preferential agreements, can be structured to increase the cost of production for firms from non-member countries. Despite earlier liberalization, developing country tariffs are still higher than the MFN tariffs of developed countries. Sufficiently strict rules of origin in an FTA interact with the remaining tariff to extend protection: firms from within the PTA can produce in the host country, and import intermediate goods from and reexport goods to the home market without costly tariffs. By contrast, firms from non-member countries can only import parts from home at a high price – if they exceed the rule of origin, they pay the initial tariff on the intermediate good, and often the MFN tariff on exports to the developed country as well. The barriers against

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outsiders created by a PTA therefore benefit both firms and workers in the partner countries.

Theoretically, firms would be induced to switch to suppliers from within the FTA, the classic case of trade diversion. However, firms often cannot easily change suppliers with whom they have long-standing relationships. Principal suppliers within the FTA may have close ties to the competition. Assuming that they do not choose to exit and surrender the FTA market to their competitors, how do non-member firms react?

Since they cannot influence the ROOs in the first PTA, non-member firms have to tackle the second part of the protectionist policy: the MFN tariff of the host country. Without tariffs, rules of origin lose much of their force. The obvious reaction is to lobby the host government to lower its duties. But unless negotiated within the framework of a PTA, the rules of the GATT prescribe that MFN tariffs can only be lowered for imports from *all* member countries. There is little that foreign firms can offer to motivate a developing country to do so since the political costs for the host country governments would normally be too high, unless they can convince their home governments to strike a deal with the host country. To retain their competitiveness, non-member firms therefore seek recourse with their home governments. The defensive reaction of these non-member firms is an unintended consequence of the first PTA – they likewise call for a PTA with the same developing country. Since intermediate and capital goods exporters in non-member countries are hurt by the same ROOs and tariffs, they become allies in this undertaking. Likewise, excluded service firms that witness preferential liberalization will try to level the playing field. Even though firms from non-member countries may not have been interested in a PTA with the host country originally, they will now come to support it to prevent exclusion from an important host of FDI. In response, their home governments also negotiate PTAs with the host country – the dominos fall, causing an endogenous proliferation of bilateral trade agreements driven by FDI in developing countries.

This account also helps to explain the variation in the spread of PTAs across the globe. Developing countries in the Americas were the first to liberalize their economies and to attract FDI in manufacturing and services. The important trade and investment links and the discriminatory measures of PTAs almost immediately triggered defensive PTAs. The cumulative effect of these agreements eventually reached more

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distant countries in Europe and Asia.[15] When the Asian financial crisis forced liberalization on several developing countries in the region, the endogenous dynamic came into full force again.

In sum, two factors emerge as the driving forces behind North–South PTAs: concentrated interests in FDI-exporting countries have a strong incentive to lobby for preferential agreements because they confer specific advantages over competitors. To be politically attractive, these agreements must have a discriminatory effect on trade and investment with non-members. This effect manifests itself mainly for firms from other countries that are disadvantaged in their ability to use developing countries as export platforms, or that are excluded from services markets. These firms push their home governments for defensive agreements[16] to remain competitive.

Methodology

If this study's central claim of an endogenous proliferation of PTAs holds, then its explanation presents a challenge for standard comparative methods. While comparative analysis has developed a nuanced set of approaches for different problems (George and Bennett 2005; King *et al.* 1994), it ultimately rests on two assumptions: that the cases are completely independent and, if several cases are affected by the same common external force, that this factor is truly exogenous. Usually the analyst pairs cases according some variation of Mill's (1843) "method of difference" to identify the variable(s) that are responsible for variation in outcomes while other factors are held constant, even if they are common influences such as having been part of the same colonial empire. Such research designs have demanding requirements for "unit homogeneity" (King *et al.* 1994: 91–94). More recent studies of the effects of globalization (e.g. Tiberghien 2007) have assumed that an external force affects all cases equally, so that domestic institutions and interests explain the

[15] See also Dent (2006: 49–50) for how Asian PTAs mimic extra-regional models. The effect is also partly captured in the empirical work of Mansfield and Reinhardt (2003): countries are more likely to sign PTAs with geographically proximate countries and important trade partners, especially when these countries are signing preferential agreements.

[16] Use of the terms "offensive" and "defensive" in relation to agreements seems to have been coined by officials at Japan's Ministry of the Economy, Trade, and Industry (METI).

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variation in outcomes. The cases in this book, by contrast, are assumed to be interdependent. The model proposed is dynamic in the sense that the conclusion of one PTA will trigger several others. How can a model like this be tested without resorting to circular reasoning?

As argued by Büthe (2002: 485), modeling sequences of events offers a solution: Sequence "allows us to have causal feedback loops from the *explanandum* at one point in time to the explanatory variables at a *later* point in time only" (emphasis in original). Accordingly, I develop a model that predicts a sequence of decisions and feedback effects. Differences in the cases will therefore manifest in *variation over time* in the outcomes dependent on the strength of the causal factors.

To test this model I develop individual analytic narratives for each case study, emphasizing process-tracing (George and Bennett 2005: 211–81) to identify the constraints and variables that matter to the actors in their decision-making. In developing these accounts, the model provides the cast of actors, their interests and strategies (McKeown 1999). I begin by outlining two ideal types of North–South PTAs, an "offensive" type of agreement in which outsiders are discriminated against, and a "defensive" type that counters these effects. I then develop a model that establishes causal relations. My cases are dyads of countries with different factor endowments in which foreign direct investment flows predominantly in one direction. The independent variables are the political demands made by firms and other actors such as labor unions in the capital-exporting countries, while the actual institutional outcomes (trade and investment liberalization in preferential trade agreements) form the dependent variables. One of the most important sources of variation in outcomes is the strength of trade and investment links and resultant political demands within a particular dyad compared with other dyads involving the same host country. Consider the (not entirely) hypothetical example of South Africa as a host country for FDI. The strongest trade and investment links exist between the EU and South Africa, followed by the United States and Japan. The FTA between the EU and the South Africa affects more US firms than Japanese competitors, so that *ceteris paribus*, we are more likely to see a political reaction in US trade policy than in Japan.

The case studies are based on qualitative data collected through the analysis of interest group publications, documented lobbying activity such as congressional hearings, and over seventy interviews with decision-makers in government and the private sector. Given different

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political systems, such data cannot be truly "symmetric" (King *et al.* 1994: 48) in the sense that a uniform method of collecting information is used in all cases: lobbying in Japan leaves no visible paper trail, while evidence of comparable activities in the United States is often publicly available. These problems preclude a cross-sectional quantitative analysis of the effect of lobbying. Detailed process-tracing is the only feasible technique for testing hypotheses in this situation. To isolate the competition between major developed countries from those characterizing the bilateral relationship with the developing country, I focus on cases in which the trade policy of the latter remained constant.

The first case study focuses on NAFTA, the "original" and, in terms of trade and investment flows, still the most important North–South agreement. Since most of its clauses have been in effect for over a decade, it is possible to analyze outcomes among members as well as longer-term reactions among non-members to this offensive move. The North American deal also provided the institutional template for a variety of other agreements.

I then compare two defensive agreements: the EU–Mexico FTA as a response to NAFTA, and the Japan–Mexico FTA as countermove to both prior agreements. In particular the case of the EU–Mexico "Association Agreement" and the time lag to the conclusion of the Japan–Mexico "Economic Partnership Agreement" strengthen the argument: given the stronger investment interests, the EU moved faster to counter the effects of NAFTA. The European initiative in turn spurred Japan on to pursue its own FTA with Mexico. Mexico's policy remained consistent throughout the negotiations of all three agreements: it proposed each of them, but then negotiated defensively for all of them with the exception of specific agricultural exports.

In a third step I include cases in which the competitive dynamic is restricted to only one sector: services in the case of the FTAs of the United States and the European Union with Chile, and manufacturing in the cases of the Japanese FTAs with Thailand and Malaysia. The cases also changed the roles of key actors. In Chile, the United States and the European Union competed neck and neck after the United States' initial objective of Chile's accession to NAFTA had failed. Again, Chile's trade policy remained consistent in all the cases studied here: Chile sought FTAs with all major trade partners.

Finally, in the cases of the Japanese FTAs with Thailand and Malaysia, I focus on differences in the bilateral trade and investment

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relationship with the partner countries to bring the differing political coalitions into relief. Malaysia had fewer export interests regarding Japan compared with Thailand, leading to a quick conclusion of the negotiations with the former compared with the protracted bargaining with Thailand. These cases provide evidence that North–South agreements are unlikely to liberalize trade beyond the narrow interests of multinational firms with investment in the partner countries and their suppliers. It is noteworthy that the Japanese agreements with the ASEAN countries have likewise triggered defensive countermoves by the United States and the EU.

Caveats, limitations, and contributions

As with most political agreements, it is impossible to identify a single variable as decisive for the conclusion of an individual PTA. This applies to both the theoretical and the empirical dimensions of this study. In the case of NAFTA, concerns about the stability of the southern neighbor and the resulting flows of immigrants into the United States played a role in motivating the free trade agreement. The agreements with Chile also had an important function for the United States and the EU by setting high standards for the protection of intellectual property rights, reflecting the rule-making function of PTAs as described by Katada *et al.* (in press). Japan's trade agreements undoubtedly have a strategic diplomacy aspect, especially since China has started to negotiate trade agreements with important providers of natural resources and food products in southeast Asia and the Pacific.

On a theoretical level, the explanation put forth in this work does not endeavor to capture all the forces at work in the current proliferation of preferential trade agreements. PTAs can also be used to express political support when strategic interests are at stake, as in the case of the United States–Jordan FTA and the follow-up initiative to establish a regional free trade zone in the Middle East. Likewise, in cases of PTAs between countries of very similar levels of development, other considerations, such as achieving economies of scale, will be of central importance. As a final limitation, this study does not attempt to provide a generalized explanation of the policy choices of the developing country partner. A theoretical appraisal has been put forth by Shadlen (2005), while Cameron (1997), Grugel and Hout (1999), Pastor and Wise (1994) and Haggard (1995) offer individual country studies in Latin America

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and southeast Asia. My focuses is specifically on the convergence of interests between North and South that favors the narrow kind of liberalization evident in recent PTAs.

The book offers three specific contributions. First, it breaks new ground by explicitly theorizing and tracing the competitive dynamic between North–South PTAs. The argument helps to resolve two long-standing puzzles in international political economy by explaining the regional variation in preferential trade agreements and the sudden surge in their popularity since the mid-1990s.

Second, the study underscores the importance of the political interests in developed countries that emerge with foreign direct investment and vertical trade integration. It shows that multinational firms exercise a profound influence on the character of North–South trade agreements that often results in special interest politics running counter to the spirit of free trade. Prominent critics of preferential deals such as Jagdish Bhagwati and Anne Krueger (Bhagwati and Krueger 1995) have issued early warnings of such an outcome based on grounds of principle. This study shows that the convergence of interests between developed and developing countries on flows of foreign direct investment from North to South only exacerbates the issues these scholars have highlighted.

Finally, it presents evidence against the case that preferential trade agreements can provide support for multilateral liberalization at the level of the WTO: given the political temptation to create non-tariff barriers to make North–South agreements feasible, these deals will satisfy multinational firms, a key constituency that previously offered the necessary counterweight to protectionist forces in the WTO. But liberalization is likely going to be limited to the goods these firms want to trade. The onerous rules and regulations typical of North–South PTAs will prevent many smaller firms from developed economies and most exporters from developing countries from realizing the gains of liberalization.

In addition to the agreements analyzed here, the account can be applied to a growing number of cases. Because of the weight given to the interests of services firms, US PTAs with South and Central American countries are likely to disadvantage firms from the EU. European negotiating positions vis-à-vis the Andean Community and the four Central American countries have been accordingly influenced by considerations of equal access for FDI. This also holds for Canadian initiatives, often in the tailwind of US PTAs. Although these two

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countries' PTAs with Colombia have important security dimensions, they also affect the relative position of European firms. Japanese PTAs with southeast Asian countries, as well as the EU's Mediterranean agreements, have in turn stimulated various bilateral initiatives of the United States, including agreements with Morocco, South Africa, and the ASEAN countries. Moreover, with some qualifications the argument can be extended to cover initiatives between developing countries where foreign direct investment flows predominantly in one direction, such as South Korea–Mexico and South Korea–Chile. As more advanced developing country firms from Brazil, China, and India invest in other developing countries, these new FDI home countries will likewise be pulled into a global competition.

The organization of the book

The study is organized as follows. Chapter 2 establishes the theoretical argument for when and why preferential trade agreements between developed and developing countries become viable, and why they trigger a round of countermoves towards bilateral agreements. The explanation is developed based on a simplified model of two countries exporting FDI and one seeking to attract it, building on theories of vertical integration of production across country borders.

Chapter 3 focuses on NAFTA as the first case study. Under pressure from multinational manufacturing and service industries, the United States begins to target individual states for market opening, while promoting the same issues in the WTO from the mid-1980s on. Bilateral investment treaties and service negotiations form the templates that ultimately lead to the respective chapters in NAFTA, which in turn becomes the model for future FTAs. The chapter takes stock of the lobbying efforts of various industries before and during the negotiations, relating them to the selectively protectionist outcome and tracing to the demands of firms the emergence of NAFTA's strict rules of origin.

Chapter 4 shows that following the conclusion of NAFTA, European manufacturers and service providers began to lobby their governments to seek solutions against the discriminatory arrangement. Given the strong interest of European service providers, in particular the Spanish financial sector, the EU moved quickly to the conclusion of an intermediate "framework agreement," followed by a fully fledged FTA. Lobbying takes place around the Directorate General for Trade of the

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European Commission and the Article 133 Committee (coordinating member states' interests and Community trade policy), in which Spanish interests clashed with protectionist forces from France. In the manufacturing sector, German automotive firms, in particular Volkswagen, emerged as key supporters of a bilateral agreement with Mexico.

Chapter 5 focuses on the Japanese reaction to NAFTA. Since investment by Japanese firms was concentrated in the manufacturing of electronics and automobiles, the discriminatory effect of NAFTA was limited to a smaller number of companies, many of them located in Mexican export processing zones (EPZs). Japanese electronics and automotive firms first unsuccessfully exhausted all possibilities of liberalization between Mexico and Japan. The eventual conclusion of the EU–Mexico agreement convinced policymakers in the trade and foreign affairs bureaucracy to move towards a policy of free trade agreements.

Chapter 6 traces the competitive dynamic between firms from the United States and the EU in the negotiations for a free trade agreement with Chile. Although investment in Chile is mostly limited to the service sector, the competitive dynamic was sufficient to motivate the United States and the EU to seek FTAs to secure equal access. Due to the lack of fast-track authority, the United States was unable to conclude an agreement with Chile before the EU. As a result of the EU move, intense lobbying in the United States drove the rapid conclusion of an agreement with evidently defensive aspects.

Chapter 7 focuses on two cases in which manufacturing industries dominated the negotiations. In the Japanese FTA negotiations with Thailand and Malaysia, the automobile industries and electronics industries played central roles, supported by a variety of intermediate goods producers. For the first time, Japanese firms are producing goods in southeast Asia not for exports to the US market, but for reimport to Japan. In both agreements, the vertical integration of trade strongly shapes the pattern of liberalization, leading to rapid tariff reductions on some goods and blanket exclusions for others, mostly "sensitive" agricultural products. Mirroring the agreements in Latin America, both the United States and the EU react by announcing negotiations with Malaysia and Thailand.

Chapter 8 summarizes and concludes that preferential trade agreements between North and South are first and foremost the product of the greater importance of foreign direct investment. The resulting

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pattern of liberalization that privileges the interests of multinational firms has implications for how PTAs will impact the multilateral trade regime. While the current proliferation of PTAs does not herald the reemergence of protectionist blocs, it threatens to undermine the support of important industries for multilateral negotiations, because their demands are met in bilateral and regional arrangements. At the same time it creates a patchwork of competing rules that mainly benefit the concentrated interests of a few multinational firms but offer less effective liberalization for smaller firms or those from developing countries.

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