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# **Walking and chewing gum at the same time: Australia's free trade area strategy\***

Christopher Findlay<sup>†</sup>

The pursuit of free trade area agreements (FTAs), according to some, does not impede the multilateral trade negotiations process. It is argued to the contrary in the present paper that the FTA approach does impede the multilateral one. Comments are offered on common approaches to the analysis of the impact of FTAs, on the reasons why, despite concerns evident in these comments, the FTA strategy has become so popular, and on ways out of a dilemma of FTA proliferation, or at least ways to avoid the risks associated with it.

## **1. Introduction**

... the argument put by some academics that we can't walk and chew gum at the same time and therefore should focus exclusively on the Doha multilateral negotiations rather than an FTA with the USA – or with Singapore, or Thailand, or in our prospective trade agreements with Japan and China – is nonsense – pure and simple.<sup>1</sup>

The Australian Trade Minister, Mark Vaile, has drawn an analogy between being able to walk and chew gum at the same time and the current Australian trade policy strategy which includes the pursuit of free trade area agreements (FTAs) alongside participation in the work of the World Trade Organisation (WTO). The quotation implies that it is possible to do both things at the same

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<sup>†</sup> Asia Pacific School of Economics and Management, The Australian National University, Canberra, Australia.

<sup>1</sup> Extract from a speech by The Hon. Mark Vaile, MP, Minister for Trade, Australia, delivered on his behalf by Senator Chris Ellison at the National Farmers Federation Annual Conference, Carnarvon, WA, May 23, 2002 [emphasis added in the original].

time, and that one does not impede the other. It is argued to the contrary in the present paper that the FTA approach does impede the multilateral one, and that there are other strategies to use in the new preferential trade policy game.

The Government's report on the Australia-Thailand FTA negotiations (DFAT 2002) illustrates the arguments now being made in favour of a greater focus on FTAs in our trade policy package. As the Minister noted in the same speech: 'no Australian government has pursued a more ambitious and diverse trade policy than has our government'.<sup>2</sup> FTAs, it is argued (and as stated in the executive summary of the Thailand report):

- bring significant economic benefits (indicated by the growth in trade and investment, and estimates of increases in welfare);
- provide a framework for cooperating on a wider range of issues than just liberalisation of trade in goods (e.g. they could include services, investment, e-commerce, standards and competition policy);
- are consistent with the parties' goals in the APEC process concerning free and open trade and investment by 2010 for a developed economy and;
- are consistent with efforts to secure trade reforms through the multilateral trade round launched at Doha.

Why bother with international agreements? The analysis and empirical work on the effects of liberalisation show that generally the greater part of the benefits of reform come from the actions of the economy which is the focus of that analysis. That is, the greater bulk of the benefits can be obtained from unilateral action. However, unilateral action is not easy because it imposes costs on some people who are able to mobilise political resistance, even though they may be relatively small in number.<sup>3</sup> Domestic interests from whom the policy-makers can draw support to offset the resistance of others to change can accelerate reform. Those forces in favour of reform are easier to mobilise in an environment where it is understood that other countries are also liberalising. Policy change in those other economies will create new market access opportunities. International

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<sup>2</sup> Findlay (2002) provides further information on negotiations in progress. Progress in signing agreements has been slower than originally expected. Comments are offered below on why that might be so.

<sup>3</sup> Unilateral action can also lead to adverse movements of import compared to export prices. See Yang *et al.* (2000) for a commentary on the implications of this in terms of trade effect for a concerted approach to unilateral reform.

cooperation can therefore be used to support the change in domestic policy.<sup>4</sup> It also provides a forum in which to bind policy to avoid backsliding at a later date.

The remarks below challenge the expectation that the FTA track assists the multilateral system in this process. Comments are offered on common approaches to the analysis of the impact of FTAs, on the reasons why, despite concerns evident in these comments, the FTA strategy has become so popular, and on ways out of the dilemma of FTA proliferation, or at least ways to avoid the risks associated with it.<sup>5</sup>

## 2. Analysis of FTAs

A common approach to the analysis of FTAs is to apply general equilibrium modelling to capture the economic effects. As Robinson and Thierfelder (2002) report, generally these methods find that trade creation exceeds diversion, and that welfare of the members improves.<sup>6</sup> Furthermore, they find that welfare improves for old members when new members are added, suggesting an incentive to expand membership.

As Robinson and Thierfelder (2002) also point out, it is possible to find larger benefits in the modelling work by taking into account imperfect competition, economies of scale, and investment flows. Krueger (1999) reports larger benefits from more recent studies that are based on models whose specifications permit the identification of more of the dynamic gains. An example of this approach is the work by Davis *et al.* (2000). They simulate the effects of a free trade area involving the members of the ASEAN Free Trade Area (AFTA) and the Australia-New Zealand Closer Economic Relations Trade Agreement (CER), using the APG-cubed model (18 countries and 6 sectors). They allow for allocative efficiency effects, terms of trade changes and capital accumulation for goods and services, as well as

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<sup>4</sup> Cooperation need not take place in the rules-based system of the WTO. The APEC process is based on a concerted approach to unilateral action.

<sup>5</sup> There is a vast amount of literature on regional trading arrangements. See Lloyd (1996) for a discussion of types of regional arrangements and Panagariya (2000) for a review of the literature on preferential arrangements.

<sup>6</sup> Vousden (1990), section 10.2 provides a thorough discussion of the welfare effects of preferential arrangements on member economies, including a review of the traditional notions of trade creation and diversion. For more recent reviews of this literature, see Robinson and Thierfelder (2002), who provide a review of theoretical results before offering an excellent summary of the empirical work, and also Panagariya (2000). Care should be taken in modelling the impact of the APEC process, because its liberalisation is not preferential, but often assessments of its impact are lined up against NAFTA or AFTA which are preferential. See Yang *et al.* (2000) for a clear treatment of the APEC process.

endogenous productivity effects. Davis *et al.* (2000) find positive effects of a joint AFTA-CER FTA (of an extra \$US25.6b GDP in net present value terms in AFTA and \$US22.5b for CER).<sup>7</sup> These gains are nearly three times as great as the results of an earlier study which excluded services liberalisation and these productivity effects.

Adding in the dynamic effects certainly adds to the estimates of the size of the gains. But has the analysis so far captured all of the relevant dynamic effects? Two additional effects of FTAs which affect their contribution to wider ranging liberalisation and therefore larger welfare gains, include those on the political economy of domestic reform and on the reactions of trading partners.

A further concern is that some acknowledged complexities of FTAs have, so far, not been analysed in any depth. These include the problems associated with excluded sectors, the use of a series of small group arrangements, the presence of regional or global supply networks, and the risks of partial reform in the presence of foreign direct investment.

## 2.1 Political economy dynamics

The creation of preferential arrangements creates new interest groups that gain rents from their special position in foreign markets. Import demand from the member economy is diverted to them, increasing their producer surplus. Members of these groups might also capture rents from a privileged position in a foreign market for services. What incentive do they then have to give up part of these gains by admitting new members? The community as a whole may be better off by expansion of membership but what drives policy?

Private interests have a considerable role to play in determining policy and it is the management of private interests which is the core issue in the present paper. FTAs create new interest groups that resist further change. These groups are created among export interests who previously were relied upon to drive domestic policy change under the multilateral process. The export interests who, if given the alternative of a multilateral solution would have taken policy 'all the way', are fractured.<sup>8</sup> The additional gains they reap from taking the extra step to global free trade are small relative to the costs of the domestic political activity required. The ability to organise the coalition in favour of global free trade is weakened. The FTA strategy is therefore

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<sup>7</sup>The real consumption gain allowing for the ability to shift spending through time is one per cent by 2005 for AFTA as a whole and 0.6 per cent for CER.

<sup>8</sup>Some of the theoretical literature which captures these effects is reviewed in Findlay (2002), in particular, see papers by Krishna (1998); McLaren (1999); and Andriamananjara (2002).

undermining the effectiveness of a key constituency on which the multilateral strategy was built.

## 2.2 Reactions by others

The assessment of the FTA route usually considers each agreement one at a time. There is little consideration of how other trading partners might react. Yet evidence is also available that even small group arrangements create at least some trade diverting effects and terms of trade effects. Trade diversion, which also affects the terms of trade of those economies, will have an effect on their welfare.<sup>9</sup> It is not only the actual but also the expected effects that matter for strategy. Wide ranging use of FTAs by one economy will lead to a reaction by others. At the least, this may involve some action to express their concern, but also to negotiate their own agreements in order to compensate for the actual or anticipated effects of the adoption of this strategy by their trading partners. Therefore, the second round effect is that a single initiative by one economy contributes to a series of such initiatives. Some people would say that this outcome is exactly what is sought. But will serial preferentialism build into global free trade?

## 2.3 Excluded sectors

The assessments of an FTA generally assume it will be implemented without exception. The effects on trade are derived, for example, from modelling results which assume all tariffs are removed on the trade between members. More recent work also attempts to include the effects of removing all impediments to trade and investment in services.<sup>10</sup>

However, each member of a potential FTA has one or more sensitive sectors about which it is concerned. They are likely to be sectors which are already relatively highly protected (e.g. agriculture in northeast Asian economies and the USA, or textiles and clothing in Australia). There is a risk that trade barriers in these sectors will be excluded, because cutting those barriers will be resisted by the private interests who lose from that cut in protection. The size of the gains from reform in the context of an FTA,

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<sup>9</sup> See for example the GTAP results in Centre for International Economics (2001).

<sup>10</sup> Some of the modelling work tries to take into account the possibility that not all sectors will be covered. But given the nature of the models and the degree of aggregation involved, this is done by assuming impediments are removed on trade between members to a degree less than 100 per cent. However, the tariff cuts actually implemented are not uniform. It is more likely that some tariffs will be cut and others not, so the degree of dispersion in rates of protection could increase, thus reducing the benefits of the policy change.

especially a bilateral one, may not be sufficient to mobilise the domestic political support required to offset this resistance. In other words, motivating reform in this setting, while it might appear easier because there are fewer international parties involved, is actually harder because the flow and concentration of domestic benefits may not yield the political support required to deal with the sensitive sectors.<sup>11</sup>

The consequence is that if an agreement is ever signed, some sectors will be excluded. Furthermore, the package of exclusions is likely to vary between FTAs, because each has a different membership and each group has a different set of sensitive sectors. The assumption, often implicit, is that the FTA route leads to free trade because the different agreements can be aggregated. That is, preferences in trade are distributed more and more widely until eventually the whole world is included. It is not clear, however, in the presence of exclusions that this processing of 'bolting together' of the agreements will be feasible.<sup>12</sup>

## 2.4 Series of small group arrangements

In this environment, the likely scenario is a series of small agreements.<sup>13</sup> The resistance to taking in new members to an existing agreement and building a larger one are real. However, there are some countries who will be attractive members of preferential arrangements (large countries in particular) and these economies can emerge as hubs in a series of agreements. Snape (1996a) explains that there is an incentive to create tailor-made agreements to deal with products regarded as 'difficult' by the hub country. He also notes that small countries have incentives to join, especially as more and more countries sign up with the hub. The hub-and-spoke system can 'spread like a rash'

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<sup>11</sup> Dealing with agricultural subsidies in the USA is an example of a policy reform which is expected to require participation of a wider set of interests in the process of change. In commentary on the prospects for a free trade agreement between Australia and the USA. Mr Vaile has been quoted as saying that 'the issue of agricultural subsidies was only ever going to be dealt with through the WTO's Doha round of talks' (in Sid Marrs and Rodney Dalton, 'US paves way for free trade', *The Australian*, Monday, July 29, 2002, p. 4).

<sup>12</sup> Freund (2000) presents a model in which uncooperative bilateralism does lead to free trade but she also acknowledges the costs associated with this route in a setting with more than one product.

<sup>13</sup> This discussion summarises part of Findlay (2002). Another issue in the development of a series of FTAs is the design of rules of origin which are required for specific products or services to which the terms of the agreement apply (because each member manages their trade relations with non-members independently, imports would flow into the group through the lowest tariff member without this rule). Krueger (1995) explains how the rules of origin can be manipulated.

(p. 61), in a process similar to the domino effect examined by Baldwin (1997) in his analysis of incentives for membership of preferential arrangements.<sup>14</sup> The spoke countries may or may not have arrangements with each other.<sup>15</sup>

Hub countries benefit in a number of ways (Wonnacott 1996). Foreign investors prefer to locate there to get access not only to hub markets, but to those of the spoke countries. Also, a firm based in the hub is more likely to be able to obtain inputs at low or zero tariffs than firms based in one of the spokes because it can source from the hub and any one of the spokes.<sup>16</sup>

Some developing economies in East Asia are concerned that, especially after access to the WTO, China is now even more competitive as a destination for foreign direct investment. One solution proposed is to negotiate an FTA with China. But attempts by other developing economies in East Asia to establish FTAs with China may lead to China becoming the hub in a series of such agreements, leaving the developing countries at best no better off in terms of competition for foreign direct investment. However, a constraint on this process is the unwillingness of other countries in the region to see China emerge as a hub in this manner.

## 2.5 Supply networks

Supply networks for manufactured products are complex and unstable. Japan was once a major buyer of Australian raw wool, but now imports little raw wool from Australia. Instead, Japan imports textile and clothing products from other countries where Australian wool is processed. The various stages of processing might take in a number of different locations. At various stages, a product might even move back and forth between the same locations, neither of which is Japan. Will a bilateral FTA between Australia and Japan facilitate access to the Japanese market for Australian wool? The

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<sup>14</sup> Some modelling work has been completed on this scenario and the results of this work are summarised by Robinson and Thierfelder (2002) who note that in consideration of the expansion of NAFTA 'the USA and Mexico each prefers to be the sole hub, adding "spokes" through bilateral agreements with new countries, but without full expansion of the agreement. It is the worst outcome for either the USA or Mexico to be just a spoke while the other country is the hub – they gain more from expansion of the membership (although, particularly for the USA, the numbers are small).'

<sup>15</sup> International air transport provides a simple one-sector illustration of this process by showing how the hub-and-spoke approach pursued by the USA puts spoke countries at a disadvantage. See Findlay (1997).

<sup>16</sup> Wonnacott (1996) explains how the result might be an inefficient pattern of investment that remains even if the hub-and-spoke system evolves into an FTA to which all the spokes belong.

major trade policy issue in the Japanese market now is the impediments due to tariffs on imports from third countries and not those which a bilateral agreement might cover.

The Australian wool industry will benefit from having the value adding processes located in the most efficient locations. Those locations shift as comparative advantage alters alongside economic growth. The possibilities change as technology changes and creates new break points in the value adding chain. The trade policy environment that supports this process is one which is not discriminatory and which lets newcomer suppliers take over market share from established producers as competitiveness shifts.<sup>17</sup> The same sort of process occurs in other manufacturing activities, for example, electronics and automobiles.<sup>18</sup> It also occurs in services – banks for example who set up in foreign services markets might want to locate their back-office functions in a third country. An airline might have one call centre for its whole network. The world of commerce does not work in the way that the FTA architecture presupposes.

## 2.6 Partial reform and foreign direct investment

The impact of FTAs on the domestic political economy of trade policy reform has been stressed in the present paper. Foreign direct investment introduces some new actors into that arena. Foreign firms (as well as domestic firms) make investment decisions on the expectation that commitments to free trade areas will be completed and become important actors in the decision-making process about further changes in policy. In addition, in some cases the foreign investors capture rents available from their privileged position. This is possible in manufacturing, but is also a special problem in the service sector. For example, negotiation of an FTA gives a foreign investor first mover advantages into a protected (and most likely imperfectly competitive) market in the services sector. Their arrival adds to the level of competition in the market place, which is a benefit often claimed for an FTA; but it also transfers rents offshore and the national economic welfare is reduced. Partial reform actually leads to an outcome in which the initiator is worse off.

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<sup>17</sup> Robinson and Thierfelder (2002) stress the contribution of two-way trade to trade creation as a result of the introduction of a preferential agreement. They refer to fine degrees of specialisation that emerge in production processes for manufactured products. This phenomenon is certainly apparent, but does not occur simply between pairs of countries.

<sup>18</sup> The extent of value added may also be relatively small, and so small that a firm does not qualify for the conditions of the rule of origin to give it preferential access to another member's market. These rules may refer to 40 per cent or 50 per cent value added as a condition.

### 3. Why so popular?

It is not clear that the creation of a series of FTAs will lead to free trade. Such agreements may be difficult to aggregate because their architecture may be different and because of resistance from groups whose interests shifted at the time of their creation.

Why has this route become so popular? It is not only Australia which is active in this area but also others who traditionally have not pursued this strategy, such as Japan and Korea. Economies who have formerly placed a greater weight on the benefits among their members, the core group (e.g. those in ASEAN), are now also seeking agreements with other economies not previously regarded as part of the core group.

Reasons for this interest often remarked upon include the failures to make progress in the multilateral process, especially after the Seattle WTO Ministerial meeting. There may be other more fundamental reasons. One is the emergence of a new set of protectionist forces for the following reasons. Preferential access to imperfectly competitive markets is attractive because of the rents to which the entrant has access. Exchanges of access to each other's markets for the same product will lead to gains for the businesses involved in terms of market access and profits. This form of rent seeking could be an important driver of this policy strategy. This effect is likely to be relatively important in the now more open markets for services, or at least markets where the potential for trade via establishment of other modes of supply of services is now recognised but where impediments remain (e.g. in telecommunications). Private interests are dominant in this explanation of the popularity of preferentialism.

Public interest, or the perception of it, might also be driving policy. It might appear to be a rational response for a small country to initiate a series of preferential trade agreements when 'everyone else' is either doing so or expected to do so. As Trade Minister Vaile said in the same speech quoted earlier 'the message is that we can go backwards by standing still – if others are negotiating FTAs and we simply watch'. For some larger countries, the motivation may also be to become the hub in a network of such agreements.<sup>19</sup>

The benefits of a closer relationship in all its dimensions with the other party are also ascribed to an FTA. A more intense trading relationship, higher levels of interaction, more information flows, and deeper institutional

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<sup>19</sup> Another concern is that FTAs will divert resources from other activities, including the multilateral process. The Minister points out that extra officers have been appointed to the area in his department that manages these negotiations. However, those resources still incur opportunity costs. Garnaut (2001) also stresses the opportunity cost of time in discussion with counterparts in other governments.

linkages all lead to less risk of misunderstanding or conflict on economic or other issues. Perhaps there is also a hope for preferential treatment in some circumstances, for example, in the application of contingent protection, a connection that has been made in the discussion of the effects of an FTA between Australia and the USA. But what is the impact of the agreement with one party on other economies? If the argument is presented in the manner that preference leads to security, then an agreement implies a choice has been made. It will be interpreted as such by other economies and their interpretation increases risks in relationships with those economies. There is no free lunch.

#### **4. The ways out**

The options for resolving the FTA dilemma are, broadly, to agree to cooperate to constrain their use and to find efficient alternatives for delivering the contributions to liberalisation which small group cooperation offers.<sup>20</sup>

One solution is to reinstate the primacy of the role of the multilateral process, most importantly because of the manner in which it produces reductions in protection. A second reason is its capacity to constrain the FTA process. The multilateral process has rules which could do so although those rules need more work, not only for goods but even more importantly for services.<sup>21</sup>

Another solution is to look at other options which are more efficient for dealing with new issues in which the multilateral process might have no current coverage, or in which its progress might be slower and which attract attention in FTA negotiations. Drysdale *et al.* (1998) make the case for new types of agreements where explicit cooperation between two or more economies is required to remove impediments to trade and investment. For example, those associated with people movement, product standards, competition policy and consumer protection. These agreements could also

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<sup>20</sup> See Garnaut (2001) for a discussion of options of these types in the context of a negotiation with the USA.

<sup>21</sup> Crawford and Laird (2001) review the WTO rules on regional arrangements and the difficulty in their application. Snape (1996b) suggests ways in which they might be tightened including the full liberalisation of trade, at least in all products if not also in all productive factors; no raising of external barriers to trade and investment on or after formation, a willingness and capacity to negotiate the reduction of barriers; openness to new members on conditions similar to those faced by existing members; and homogeneous rules of origin and dispute settlement procedures. Results of Andriamananjara (2002) also point to the value of a commitment to lower m.f.n. tariff rates alongside the establishment of a preferential agreement and this too has been suggested as a rule to be added to the list. On issues in the application of the WTO rules on regional arrangements to services, see Stephenson (2000).

include a commitment to liberalise certain sectors of mutual interest, but to do so on a most favoured nation (m.f.n.) basis.

The risk lies in the formation of new blocs on the basis of these genuinely new-age agreements.<sup>22</sup> It is important to establish a constitutional rule on the terms of access for new members at the foundation stage of these arrangements. Also, prospective but not foundation members should be consulted on the constitution of the club, which should be directed at moving to existing international benchmarks on these issues, not to a new set of benchmarks. These issues are also at the heart of the APEC work program, which provides a forum for the design and execution of the so-called open club approach. Furthermore, APEC provides a forum in which coalitions can be built to work on WTO rules with respect with FTAs.

## 5. Conclusion

Can we 'walk and chew gum' (pursue the Doha Development Agenda and also write FTAs) at the same time? The options are not independent as there are important interactions between them. The framework used in the present paper for the discussion of this question was the value of international commitments as a way of mobilising support for domestic reform. The use of the preferential arrangements is a weak form of international commitment. Their use produces a series of agreements, perhaps in a hub and spoke formation, which are difficult to add together to make real free trade but which add to the costs of doing business. Furthermore, it can undermine higher level cooperation in the multilateral process.

Australia, however, is now faced with an FTA game in progress. It might appear to be rational for a country which is small in terms of world trade to join the game. The dilemma is that the FTA process can lead to the outcomes just described.

Options for breaking out of the dilemma in which we and our trading partners now find ourselves require new forms of cooperation. The options include looking for more sophisticated forms of agreement for dealing with impediments to trade and investment where explicit cooperation within a group is required, and reinstating the primacy of the multilateral system, including working on its rules on regional agreements. Australia may be a small country in terms of global trading, but it has an interest in the establishing the rules of the system, and it has the track record to make an effective contribution (e.g. demonstrated through its experience in the Cairns group, and through the leadership it has shown in APEC).

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<sup>22</sup> These agreements have been called Trade and Investment Facilitation Agreements (TIFAs). For an example of an argument for a TIFA, see de Brouwer and Warren (2001).

We might also say that, given that the game is now being played, we will talk to anyone who wants to speak with us about an FTA and that we have no preferences on the sequence of arrangements. But prospective partners should be aware that by 2010 we are committed to removing whatever trade and investment impediments remain and doing so on an m.f.n. basis. If we are not prepared to do make that statement, then we should return our focus to the multilateral system.

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