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## Efficiency smothered by a preferential patchwork

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Pity computer manufacturers from Taiwan, beef farmers from Australia and carmakers from Japan. Thanks to the recent trade deal between South Korea and the US, they may well become the latest victims of a phenomenon increasingly worrying businesses and trade ministers: "trade diversion". As bilateral trade deals proliferate across the world, export markets may increasingly reward not the more efficient producer but the more privileged one.

Though referred to by exultant signatories as "free trade agreements" (FTAs), accords such as the South Korea-US pact and similar deals currently being pursued by the European Union, are viewed by many economists as doing more to tangle trade than to free it. Their worries are compounded by glacial progress in the multilateral so-called "Doha round" of trade talks.

Competitiveness, of course, is affected by many things, including some often more important than tariffs, such as changes in exchange rates and economic productivity. But for some producers, the effects of trade diversion are stark. Australian beef farmers, for example, face losing some of the big market share they gained in South Korea after Seoul restricted American imports due to fears of BSE. Australia, which is free of the disease, leapt in to fill the gap: its beef exports to Korea soared from A\$230m (US\$190m, GBP95m, 140m) in 2003 to A\$826m in 2006.

American farmers have demanded in the FTA that South Korea restart imports of US beef. "There is fear that this will enable the US, via FTA provisions, adversely to affect Australia's market share," says Tim Harcourt, chief economist of Austrade, the government export promotion agency.

Beef prices in Australia dropped rapidly just before the US-South Korea deal was signed, anticipating reduced demand. American farmers argue that Korea's rules were protectionist and that the FTA merely ensures fair implementation of universal standards, not preferential treatment. But they will also have Korea's 40 per cent tariff on beef removed over 15 years, an artificial advantage over the Australians, who will continue to be taxed.

Australia also exports A\$300m of car engines to Korea, which face tariffs of 8 per cent that will be abolished for US companies.

In the same way, Japanese and Taiwanese companies will now face tougher competition from tariff-free Korean exports to the US. While many Japanese car companies manufacture vehicles in the US itself, Japan still exports some higher-value models such as the Lexus. Korean carmakers, who are targeting the upper end of the \$30,000-\$50,000 range in the US market, claim that their Japanese counterparts have a 3 per cent cost advantage over them an edge that will be almost wiped out by the abolition of the 2.5 per cent US auto tariff for Korean imports.

Meanwhile Taiwan, economically very similar to South Korea with high-end telecoms and electronics exporters, will also struggle against Korean competition in the US. On a recent trip to Washington Lee Ying-yuan, the Taiwanese labour minister, told reporters: "South Korea's exports will enjoy duty-free treatment and that will have a very significant impact on Taiwan ...Our competition is cut-throat and profits are almost down to the margin."

Jeffrey Schott, senior fellow at the Peterson Institute think-tank in Washington, says: "The composition of exports from Taiwan to the US is changing all the time, not least because of the rise of China. But if you are asking whether there will be trade discrimination as a result of this deal, the answer is yes."

The affected countries have renewed talk about bilateral deals of their own with the US and South Korea to redress the advantage. For the US, this vindicates its strategy of "competitive liberalisation" that a patchwork of bilateral deals can be sewn together into a smooth quilt of free trade. "This should be a spur to other countries," Karan Bhatia, deputy US trade representative for south and east Asia, told the Financial Times. "This FTA is going to result in a great deal more efficiency ...leading in due course to more liberalisation in the east Asia region."

He adds that even when concessions benefit only American companies as with South Korea's promise to allow US-headquartered legal and accounting firms to set up in South Korea it still means opening up a protected market.

Bang on cue, Peter Mandelson, EU trade commissioner, will next week visit South Korea, where he will explore a bilateral agreement with the EU. The EU is also targeting deals with India and the Association of South-East Asian Nations (Asean).

The EU's strategy, too, is under fire. Patrick Messerlin, a trade economist at the Sciences-Politique university in Paris, says there are broadly two kinds of bilateral trade deal: those between relatively open economies, which can act as building blocks to more general liberalisation; and those between countries with generally high tariffs and restricted services markets, which tend to distort trade by giving privileges to inefficient companies. The EU's agreements, he says, will tend to be of the second type.

The European Commission rejects Prof Messerlin's contention, saying the EU market is relatively open "There won't be inefficient Indian producers with a big advantage in Europe," as one official puts it and that its deals are a complement to multilateral liberalisation rather than a substitute.

Still, countries following the US and EU say unhelpful precedents have been set. Australia, which has a bilateral deal with the US, is pushing for one with South Korea but complains that the carve-out of rice from the US-South Korea deal establishes the practice of excluding agricultural sectors wholesale. The EU, with its own protectionist farmers, is likely to accept even more exclusions.

Moreover, not all economies in the region will have the clout to sign matching deals to level the playing field. None has a market the size of the US or EU to dangle as a prize in front of South Korea. And on the US side, few are big enough to attract the kind of American export lobbying required to get the South Korea deal signed, if not yet agreed by Congress. And Taiwan, for one, will find it harder to sign a US FTA, given the political heat Washington would take from China for dealing separately with Taipei.

In a global trading system, there is no such thing as a discrete bilateral trade deal. Each one will affect another country. But some of those excluded, while making their unhappiness known, may not have the power to do much about it.