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Principle of MFN in a Preferential Trade Era

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ABSTRACT

Ever since the emergence of International Trade, the global economy has focused on ensuring that trade between nations occurs in a fair and equitable manner. With the adoption of GATT and the eventual establishment of WTO, the same theme has continued. Principles of non-discrimination such as national treatment, most favoured nation and reciprocity are integral to the smooth functioning of international trade. But in the recent few decades we find countries shifting to a different practice in order to achieve their economic goals. The preferential trade era has opened new avenues for nations to achieve short term economic goals. They believe that bodies such as WTO have struggled recently to take into account the economic and developmental needs of all participating nation. According to them, the multilateral process is slow and does not cater to the needs of all. Such limitations of the current international trade regime have led the countries to move towards PTA's. This has created a spaghetti bowl of trade arrangements which are complex and are a convoluted mess.

Keywords: *Non-discrimination, MFN, Preferential Trade.*

I. INTRODUCTION

Ever since the Great Depression, major economic powers have consciously tried to ensure that a similar fate does not befall mankind in future. The Great Depression represents the results of protectionist measures first initiated by United States of America and later replicated by other nations such as Britain and France as a retaliatory measure. The fallout resulted in the creation of trade blocs globally.

Post-World War II years primarily focused on how to avoid such an economic collapse. Trade liberalization was the peak of the conversation. Subsequently, with the creation of GATT, the objectives of trade liberalization were seemingly achievable. One of the ways of achieving this goal was to incorporate principle of non-discrimination with GATT. One such principle was called MFN (Most Favoured Nation). Over the years, this principle became the cornerstone of the multi-lateral trading system². Political leaders from around the globe

¹ Author is an Assistant Professor of Law, School of Legal Studies, REVA University, India.

² Warren H. Maruyama, 46 Stan. J. Int'l L. 177 (2010), Preferential Trade Arrangements and the Erosion of the WTO's MFN Principle

concluded that the best way to organise international trade was to apply principle of MFN.³

Yet, nearly 50 years of sophisticated international trade has turned the principle of MFN into an exception instead of being the rule. There has been a discernible shift among nations to engage in creation of PTA's (Preferential Trade Agreements) such as NAFTA, EU, TPP & RCEP. Since the turn of the century, there have been a plethora of custom unions, common markets, regional & bilateral trade agreements reducing the value of MFN.⁴ The proponents of PTA have argued that due to the failure and frustrations with the international trade system as under WTO/GATT, governments tend to shift to much achievable trade goals through PTA's. Other arguments such as poverty alleviation, peace and stability are quoted routinely to defend the exponential rise of PTA's, but at the same time, there must be an acknowledgment towards the erosion of the MFN and other non-discriminatory principles.

Once, renowned economist, Jagdish Bhagwati had referred to PTA's as "spaghetti bowl", wherein the diversity of trade arrangements makes for a complex and convoluted mess.⁵ Such an exponential increase in the number of PTA's has raised an alarm among the supporters of multilateral trading systems. In this paper, we would understand the reason for the push towards a system of bilateral trading system and why it is a cause for worry.

II. ORIGINS OF PTA'S

Countries have always preferred expanding their territorial influence not only through military conquests, but also through trade. Arrangements such as colonial preferences, bilateral commercial treaties were the tools used to achieve such goals. By the late 19th century, there was a comprehensive movement towards protectionist trade instead of an open one. What can be termed as Great Depression 1.0 from 1873-1877, there was an increased pressure for domestic protection which weakened access to foreign markets. Subsequent developments such as the Unification of Italy & Germany (which put pressure on the Non-Discrimination system of European trade), Refusal of USA to join Europe's open trade system (instead negotiating their own BTAs) & the race amongst the great economic powers to establish & expand their sphere of influence (not just to carve out a market for export but also to secure national self-sufficiency of raw materials) pushed global trade into the realm of

³ The future of WTO, Addressing institutional challenges in the new millennium, Peter Sutherland (2010).

⁴ *Ibid.*

⁵ CFR's Jagdish Bhagwati Argues Against Preferential Trade Agreements in New Book; Recommends Completion of Multilateral Doha Round, COUNCIL ON FOREIGN RELATIONS (July 16, 2008), <http://www.cfr.org/world/cfrs-jagdish-bhagwati-argues-against-preferential-trade-agreements-new-book-recommends-completion-multilateral-doha-round/p16798>.

protectionism even more.⁶

Historically, giving such trade preference was the policy of choice in the era of 1930. Countries would readily agree to give special or specific market access to select countries.⁷ This is the era where countries were creating protectionist policies which led to massive trade distortion. To avoid a complete collapse, countries were beginning to enter into bilateral trade agreements.⁸

Following WWII, many international bodies were created to stabilise a bleak looking international economic situation. Bodies such as IMF, World Bank were created. United States of America was giving a major push for greater economic partnership with the world. In the words of FD Roosevelt in 1945 *“The purpose of the whole effort is to eliminate economic warfare, to make practical international cooperation effective on as many fronts as possible, and so to lay the economic basis for the secure and peaceful world we all desire.”* Similarly, discussions on a multilateral trade organisation gave birth to ITO (International Trade Organisation). But ITO did not see the light of the day due certain reservations which United States Congress had, which led to the Truman administration giving up on the push for its approval.⁹ Instead, GATT was given the approval to align international trade and its policies.¹⁰ GATT set out to create a complex set of rules and policies to prevent any use of trade barriers leading to policy distortion like in the few decades earlier. Within GATT there were policies of non-discrimination which were supposed to act as the cornerstone of entire framework and provided a forum for discussion among the nations to cooperatively reduce trade barriers. Included in GATT were provisions which contrasted with its position of non-discrimination. Article XXIV of GATT allowed the creation of custom unions, free trade agreement and internal agreements to mutually benefit the countries entering into such an agreement but at no point should increase the level of trade protection among other members. Among these were a few other limitations that parties entering such RTA's had to contend with such as:

- RTA's can only be entered into with developing countries,
- These agreements can only function to reduce trade barriers,¹¹

⁶ World Trade Report, 2011.

⁷ Preferential Trade Agreements and the WTO: Impetus or Impediment, Committee on International Trade, New York City Bar.

⁸ *Ibid.*

⁹ Understanding the WTO: Basics, The GATT years: from Havana to Marrakesh, http://www.wto.org/english/thewto_e/whatis_e/tif_e/fact4_e.htm

¹⁰ General Agreement on Tariffs and Trade, Oct. 30, 1947, 61 Stat. A3, 55 U.N.T.S. 187

¹¹ GATT 1994, at art. XXIV, 5.

- If tariffs are raised, compensation in line with Article 28 is to be paid,¹²
- All member nations must be notified of your intention to of entering into such an agreement so that an evaluation can be done to check if they violate any provisions of GATT.¹³

As trade among nations grew, so did exceptions to the principle of MFN. Special & Differential Treatment developed over time and Part IV of GATT was included in 1960s which provided more discriminatory measures for the advantage of developing countries. These measures did not require any reciprocal benefits to be provided.¹⁴ In 1971, a waiver was adopted to legitimize, temporarily, a “General System of Preferences” which later was made permeant by 1979 “Enabling Clause”. This was extended to least developed nations and confirmed the notion of non-reciprocity by developing countries in trade agreements.¹⁵ Due these measures in place, countries have found it easier to achieve their development goals. Countries preferred having faster and deeper rule making broader than WTO. These among many other reasons have led to the exponential rise in the number of FTA’s/RTA’s. But, why is the case such? Why are countries deviating from a well-established system lauded by economists worldwide, for years?

III. APPEAL OF PTA’S

What we must understand, before dwelling deep into this matter is that international welfare holds little weight in front of national welfare. Many people are willing to sacrifice their comfort for positions of influence and power.¹⁶

A. *Foreign Policy*

Every state long to gain a major foothold internationally. They aspire to become powerful nations and solidify their position relative to their compatriots. Countries want to see themselves improve in comparison with others rather than their former self. This is a common feeling among all developing nations. Over the years, what countries have found is that trade agreements strengthen ties among two nations. Countries not only open doors for trade, they also look for a deeper cooperation and partnership. Foreign policies are tailored to promote trade interests of a nation. Nations tend to become economically co-dependant,

¹² Id. at art. XXIV, 6.

¹³ Id at art. XXIV, 7.

¹⁴ Supra Note. 2

¹⁵ *Ibid.*

¹⁶ Brad Kloewer , The Spaghetti Bowl of Preferential Trade Agreements and the Declining Relevance of the WTO, Denver Journal of International Law & Policy, Volume 44, Number 3 48th Annual Sutton Colloquium, April 2020.

allow for better political cooperation. This expands their relationship into the realm of national security, political mechanization and lobbying for favourable matters at UN. There have been many instances where countries tend to prefer their trading comfort over the pervading geo-political complexities. Countries use this new found partnership to leverage better trade deals with powerful nation or avoid sanctions for unpopular behaviour. Countries in Europe who might want to trade with Iran otherwise fearing US retaliation tend to take a step back.¹⁷ Also, there have been repeated instances where countries which are military allies tend to trade more with each other especially in cases where countries have one major opposing alliance. The need for geo-political security generally gives a push to closer trading partnership in the garb of helping allies.¹⁸

Many diplomats since the post war era have believed that free trade, free minds and free markets were inseparable ideals.¹⁹ Cordell Hull (Secretary of State in the Roosevelt era) articulated this principle 80 years ago on February 6th 1938 wherein he stated that economic prosperity can be achieved globally if the world is at peace and this can only be achieved if there is a solid economic foundation which can be achieved through mutually beneficial trade.²⁰ Economist Thomas Schelling had written that investment, trade, management of enterprise, shipping and tourism is international relations.²¹

B. Deficiencies in WTO

There has been repeated criticism over WTO and its functioning. Some have gone so far as to question the fundamental structure of WTO. Among these, there has been one constant issue which scholars keep circling back to. With the increase in PTAs being signed by countries, WTO lacks any feature to support its growth or regulation.

Multi-lateral trade agreements have a very slow pace of negotiation.²² The Doha round of WTO which commenced in 2001 and formally ended in 2015. There are so many voices to be heard, their concerns taken into account which unduly stretches the negotiation. Unlike

¹⁷ Prince Michael of Liechtenstein, Economy and trade as a foreign policy tool, Emerging Europe, Opinion, <https://emerging-europe.com/voices/economy-and-trade-as-a-foreign-policy-tool/> (Last accessed on 3 Jul 2020, 11:15 AM).

¹⁸ Helen V. Milner, The political economy of International Trade, *Annu. Rev. Polit. Sci.* 1999. 2:91-114.

¹⁹ The Wise Men, Walter Isaacson and Evan Thomas, Simon and Schuster, 1986.

²⁰ Alan Wm. Wolff, Paradigm lost? US Trade Policy as an Instrument of Foreign Policy, News & Events, WTO, February 5th 2018, https://www.wto.org/english/news_e/news18_e/ddgra_09feb18_e.htm#fntext-3 (Last accessed on: 3 Jul 2020, 11:00 AM)

²¹ Michael B. Froman, The Strategic Logic of Trade, New Rules of the Road for the Global Market, Foreign Affairs, November/December 2014, <https://www.foreignaffairs.com/articles/americas/strategic-logic-trade>, (Last accessed on 3 Jul 2020, 11:24 AM).

²² ABC OF PREFERENTIAL TRADE AGREEMENTS: FREQUENTLY ASKED QUESTIONS, MONOGRAPHS ON GLOBALIZATION AND INDIA, MYTHS AND REALITIES, (CUTS Centre for International Trade 2009).

MTAs, PTAs are negotiated at a much rapid pace and since there less voices to be heard, issues are ironed out quickly as well.²³

The Dispute Settlement Body of WTO also lacks any assistance to PTAs. Any dispute which arises between the parties of a PTA can be brought to the DSB considering that it is only allowed to hear cases between states and PTAs are entered with private players as well. Due to this deficiency, parties to PTAs tend to look to alternatives such as ICJ, ICSID or NAFTA Tribunal.²⁴ Also, WTO is only allowed to pass prospective resolutions and not retrospective ones. These lacunas in WTO cause a major vacuum which breeds the idea for countries to look for an alternative to WTO. Moreover, the general distrust which developing nations have for such multilateral institutions also gives steam for such nations to pursue other alternatives to achieve their economic objectives. This distrust stems from the fact that economic & geo-political powerhouses repeatedly lobby such multilateral forums for their benefits. Structural inequalities are reflected and perpetuated through WTO. Such inequalities are not only in an abstract form but also at a concrete level through the policies and modus operandi of WTO.²⁵ Such actions don't benefit the developing nations in any way. They only end up serving the concerns of the affluent countries.²⁶

C. Labour & Environment

Issues such as public morals, health & environment protection are not covered under WTO. Article XX of WTO acknowledges non-economic state objects but it does not take into account these aspects. There has been consistent criticism laid on WTO for its lack of green outlook and policies.²⁷ WTO can benefit from taking a cue from PTAs. The US-Peru Trade Promotion Agreement is one such instance. They created comprehensive protocols for environment protection directly taken into trade context and enforces environmental laws through a series of rules and mechanisms including a dispute settlement body.²⁸

Similarly, WTO standards do not even apply to labour standards which is incomprehensible considering the importance it holds in creating and assessing comparative advantage.²⁹ This

²³ Duncan Green, Doha round has run its course but new trade realities demand solutions, THE GUARDIAN (May 4, 2011), <http://www.guardian.co.uk/global-development/povertymatters/2011/may/04/doha-trade-realities-demand-solutions> (Last accessed on 1 Jul 2020 08:52 AM).

²⁴ Supra Note 14.

²⁵ Tan, Kok-Chor, *Justice without Borders: Cosmopolitanism, Nationalism, and Patriotism* (Contemporary Political Theory). Cambridge: Cambridge University Press, 2004.

²⁶ Jeffrey D Sachs, "The IMF and The Asian Flu," *American Prospect* 9/37: 16–21, 1998.

²⁷ Micheal W Wienstien & Steve Charnovitz, *The Greening of the WTO*, 80 *Foreign Aff.* 147 (2001).

²⁸ Thomas Werge, *Environmental Standards under the Peru FTA: A Template for the WTO*, 23 *Geo. Int'l Envtl. L. Rev.* 71 (2010-2011).

²⁹ World Trade Organization, *Briefing Note, Trade and Labour Standards: Subject of Intense Debate.*, http://www.wto.org/english/thewto-e/minist-e/min99_e/english/about-e/181ab-e.htm (Last accessed on 1 Jul 2020 08:52 AM).

topic has been subject to intense debate where one side (Europe & USA) believe rights such as to bargain collectively, freedom of association, elimination of discrimination & abuse are matters of consideration in WTO, whereas developing nations and a few developed nations believe these considerations can't legitimately be discussed in WTO. The rationale for this is that they are a smokescreen to undermine the comparative advantage that most nations enjoy in low-waged countries. They tend to argue that considerations for labour standards is an underhanded way for protectionism in developed countries. Better working conditions and improved labour standards are achieved through better economic growth which would be put at harm if labour standards are enforced in WTO since any violation of these norms would open such countries to sanctions leading to poverty and delay improvements in labour standards.³⁰

D. Trade Policy

Trade policies since the turn of the century tend to have a beggar thy neighbour policy effect where the protectionist measures of one country may be detrimental to others. Such measures work unilaterally, but in today's multilateral world, they seem to have a counterproductive effect. What must be taken into account is that we live in a highly globalised world and the policies of one country, especially trade policy can have cross border effects or international externalities.³¹ The two major effect associated with this are terms of trade effect and production relocation effect.

Countries that have great market power cannot resist the temptation of acting in a unilateral way. They tend to flex their economic power to drive trade into a non-cooperative realm. But since every country has the ambition of becoming an economic powerhouse and raise their national income through trade, such actions prove to have no value.³² Multiple countries taking such action tend to reduce trade volumes and contract aggregate welfare.³³ Such problems associated with trade are referred to as Terms of Trade Effect.

Similarly, trade policy of countries focuses on expanding their production which in turn leads to a change in the relative prices of the commodities. This methodology of production expansion again does not prove to work on a multilateral scale. The effort that each country puts in to expand production cancels out their efforts. Such measures of production expansion

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³⁰ *Ibid.*

³¹ World Trade Report, 2011.

³² Johnson, H. (1953), "Optimum tariffs and retaliation", *Review of Economic Studies* 21(2): 142-153.

³³ Bagwell, K. and Staiger, R. W. (1999b), "Regionalism and multilateral tariff cooperation", in Piggott, J. and Woodland, A. (eds), *International Trade Policy and the Pacific Rim*, New York: St Martin's Press: 157-185.

are referred to as Production Relocation Effect.³⁴

Most countries to overcome these international externalities tend to sign PTAs. By doing so countries are able to encourage cooperative trade expansion. There have been many reports which direct this debate to the fact that these externalities can be overcome in a more efficient manner if they are considered at a multilateral level where simple rules allow for a comprehensive discussion³⁵ of tariff reduction and reciprocal market access.³⁶ But as discussed earlier, in the drive of countries to become a major player in the global economy, multilateral forums for discussion like WTO tend to yield no result. In the meantime, countries cannot put a hold on their dreams and ambitions. Therefore, to overcome these externalities, they form PTAs to bolster their economy.

IV. CONTEMPORARY RELEVANCE OF WTO

There may be many reasons why one might say that WTO has been replaced by PTAs, but even now, many academicians and trade analysts say that the uniformity in rules, transparency and enforceability provided by WTO cannot be replicated by a PTA run system. The simplicity of rules and balancing of power relations in international trade keeps WTO relevant even in these times, because if not for this, then we are only left with the politics of leverage.³⁷ In this section we shall be discussing the factors that still make WTO relevant in these times.

A. Transparency in operations

Among the multiple reasons why WTO is still preferred by nations, one of them is their transparency in operations. There are serious pitfalls in having information gaps and communication lapses in a trade policy or deal. WTO members benefit from having information/reports compiled by WTO.³⁸ In the absence of such a system, each member would then have to analyse every country's trade policy individually. This can be troublesome for nation's which have a substantial interest in global trade. In the case of small nations, such information becomes even more valuable since they lack the necessary skill or

³⁴ Venables, A. J. (1987), "Trade and trade policy with differentiated products: a Chamberlinian-Ricardian model", *Economic Journal* 97(387):700-717.

³⁵ Ossa, R. (2010), "A "new trade" theory of GATT/WTO negotiation", NBER Working Papers Cambridge MA. National Bureau of Economic Research (NBER) Working Paper No. 16388

³⁶ Bagwell, K. and Staiger, R. W. (2002), *The Economics of the World Trading System*, Cambridge MA: The MIT Press. MIT Press Books

³⁷ Silke Trommer, *The WTO in an Era of Preferential Trade Agreements: Thick and Thin Institutions in Global Trade Governance*, *World Trade Review* (2017), 16: 3, 501–526

³⁸ *Ibid.*

resources that are required to analyse such PTAs or trade policies.³⁹ Such reviews are vital to the larger survival of global trade since they increase the level of trade information shared among all member nations.⁴⁰ Trade policy reviews do not work in isolation of politics. Nations regularly insist on compliance to internationally recognised trade policies, share the correct information or fill information gaps which help redress issues related to dispute. This helps in consolidating trade regime and overcoming information asymmetries among members⁴¹.

What is to be understood is that in an era where trade treaties look increasingly like spaghetti bowls, the role played by Trade Policy Reviewer's is more important, especially for smaller nations which do not possess adequate resources to effectively analyse trade deals.

B. Uniformity

One thing which a multilateral trading system like the WTO offers is uniformity. Unlike PTAs, a WTO led regime seeks to unify international trade under one single regime. Right from being a forum for negotiations to dispute settlement, it offers equality in treatment. With the multi-layered nature of PTAs, the global idea of international trade & economy has taken a significant step back since it so vastly varies from what the WTO offers and regulates.

PTA regime is vastly different in complexity, scope and purpose. It is increasingly difficult to generalise or make inferences between such agreements. The way one country such as India negotiates with USA would be different from how it would negotiate with Sri Lanka or Bangladesh. Such variances in negotiations allow room for geo-political influences to play a major role which can lead to unfair trade terms being agreed to. It would not be a leap of faith to assume that such negotiations would serve the interests of powerful nations more than the smaller nations. Trade terms would be carved out for the benefit of the wealthy nations instead of providing a level playing field. These influences run contrary to the principles of equality and non-discrimination as enshrined under WTO. Bargaining power of every country right from a large to a small nation are respected in WTO.

C. Incoherence

There is little or no evidence beyond the EU to suggest that trade blocs work on a large scale. But even the EU is not insulated from internal powers struggles and circles of influence.

³⁹ Chaisse, J. and D. Chakraborty (2014), 'Implementing WTO Rules through Negotiations and Sanctions: The Role of Trade Policy Review Mechanism and Dispute Settlement System', *Journal of International Law*, 28: 153–185.

⁴⁰ Keesing, D. (1998), *Improving Trade Policy Reviews in the World Trade Organization*, Washington, DC: Institute for International Economics.

⁴¹ *Supra* Note 36.

Power asymmetries cause major detriment to the global trade regime. If a model much like the EU is to be replicated, it is not going to be easy. The sheer volume of issues (agriculture, IPR, etc) which would have to be discussed and sorted would only lead to an unnecessary delay, prolonging the negotiation. Also, it goes without saying that such discussions don't just bring trade issues to the table but also geo-political tensions.

D. Distribution of resources

Simultaneous negotiations require vast amount of resources to be dedicated to each trade discussion. Also, after a certain point, it becomes a complicated task to manage your domestic interests while maintaining a balance of market access and preferential treatment (if any) being offered at multiple negotiating tables. It would require an immensely dedicated set of people to continue the task with the same vigour as they started with. It goes without saying, that such simultaneous negotiations would detract from the efficient achievement of trade policy interests.

E. Dispute Settlement

One of the defining characteristics of WTO is its Dispute Settlement Body. In the 1980s, one of the major demands made by the leading nations of WTO was to create a robust dispute settlement body which would offer fair, reasonable and equal opportunity to hear trade disputes. DSB provide institutional and procedural support to all members which is one of the most essential characteristics of the body. Apart from the obvious stability and certainty in provides in regulation, DSB is also immune from power asymmetries. PTAs thin institutionalism does not provide the same Rule of law character which is so essential in trade disputes. To a large extent, it undermines it.

One might argue that most of the PTAs modelled on WTO DSB do not provide the adequate support to conduct day-to-day activities essential for such courts to undertake. Due to such lack of institutional support, access to dispute settlement and continuity of proceedings then cannot be guaranteed.

In such terms, thin institutionalism & fragmentation risk jeopardizing the rule-based character of global trade governance architecture. Capacity asymmetries, systemic exclusion of trading nations and trading topics alongside the resource constrained adjudication hamper the effectiveness, accessibility and reliability of legal recourse in the international trade under a PTA regime.

F. Multilateral Rules

One of the fundamental advantages of WTO is that it is a forum where the principle of ‘one vote, one member’ applies. Under this principle, nothing is agreed until everything is agreed. This links all the issues which are being discussed and gives a grand bargaining power. Under such a regime, inclusive discussion is nurtured. Smaller nations have as much say as the bigger nations. PTA negotiations do not facilitate effective participation of smaller nations. Smaller nations and small traders are at the risk of being excluded. The WTO not only nurtures collective bargaining but also aids smaller nations in trade related technical negotiations.

Fragmentation of trade rules would segregate nations into US rules or EU rules. This would also provide an incentive for firms to base their business which would provide them mutual benefit or regulatory convergence. This would defeat the purpose of creating an international economy.

V. CONCLUSION

In such uncertain times, what the world wants is stability and certainty. Even with the obvious benefits of PTA's, it becomes hard to establish that such a regime would be more beneficial to the global economy. WTO led regime provides that level of uniformity which is warranted currently.

Establishing world trade through PTA's is rather short-sighted. Countries would be able to derive benefits but to ensure sustained and long-term growth, WTO is an essential conduit. There are many flaws in the system, let's have no doubt about it, but at this point, it is about choosing the one system which would benefit nations in the long run. Transparency and dialogue are the two cornerstone of any trade arrangement which can not be achieved at the same level in PTA's than through WTO and its non-discriminatory principles.

We must be careful to ensure that we do not fall into the lure of PTAs too much. Also, keeping in mind the recent pandemic, it must be a priority to preserve multilateralism. While harmful trade rhetoric is being exchanged among nations, it is important to initiate a priority driven approach to improve the current multilateral trade system to incorporate the needs of the many.
