

## Regional Trade Agreements and the WTO

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*Abstract: While trade is growing fast, the multilateral trading system faces a number of internal difficulties linked to the size of its membership and the diversity of economic situations, trade interests, and previous commitments. But the multilateral trading system is also challenged by the outside rapid development of regional and bilateral free trade agreements. This raises serious challenges for the multilateral trading system. There has been a rapid growth in the number of regional trade agreements (RTAs) in recent years. It has raised the question as to whether RTAs pose a threat to the multilateral trading system. The trend in the growth of RTAs should express strong concerns about the negative effects of growing regionalism. We should tend to regard regionalism much more as a complement to multilateralism.*

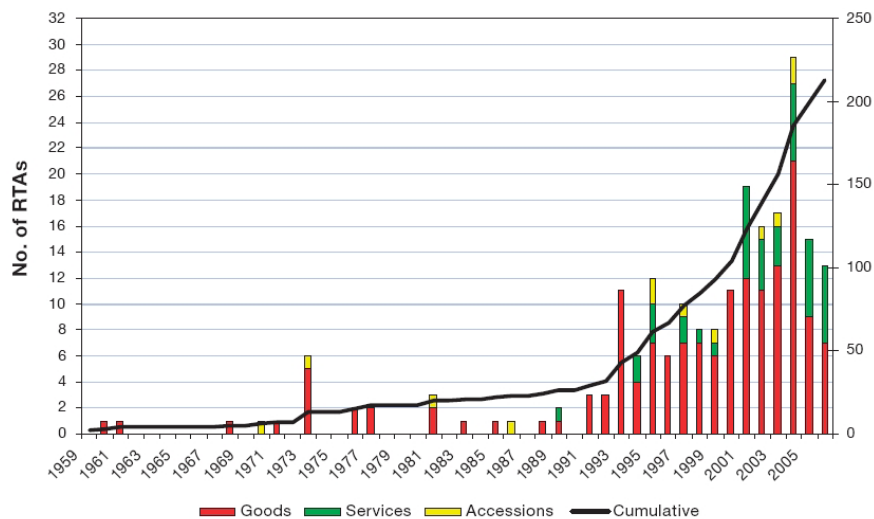
*Keywords: regionalism, multilateralism, RTAs, multilateral trade negotiations, WTO*

### 1 Introduction

International economic order is rapidly changing. Until the early 1990s, multilateralism was dominant and regional remained marginal. Today, however, regionalism is well acknowledged as one of the two pillars of international economic order, together with multilateralism. It will be thus important to explore the harmony between regionalism and multilateralism. The question is whether regionalism may be a faster way to reach multilateralism or, rather, hurt multilateral liberalization. Are regional integration arrangements “building blocks, or stumbling blocks,” in Jagdish Bhagwati’s phrase [17], or stepping stones toward multilateralism? Since the end of the Uruguay Round, the world trading system has experienced the emergence of a large group of regional blocs. Ranging from the NAFTA and the Mercosur to the APEC and the enlargements of the EU, regional blocs seem to become factors that have to be taken seriously in the future trading system.

## 2 Regional Trade Agreements in the World

One of the most striking development in the world trading system since the mid 1990s is a surge in Regional Trade Agreements (RTAs). “Regional Trade Agreements (RTAs) are a major and perhaps irreversible feature of the multilateral trading system” is the opening sentence of a Working Paper of Crawford and Fiorentino (2006) [11]. Initially WTO encouraged the growth of RTAs because it believed that regional integration initiatives can complement the multilateral trade regime. However, the high proliferation of RTAs in global trade and increased diversion of trade through this route is increasingly becoming a cause for concern for the multilateral trading system under WTO.



Source: Crawford, J.-A.-Fiorentino, R. V. [11]

Figure 1

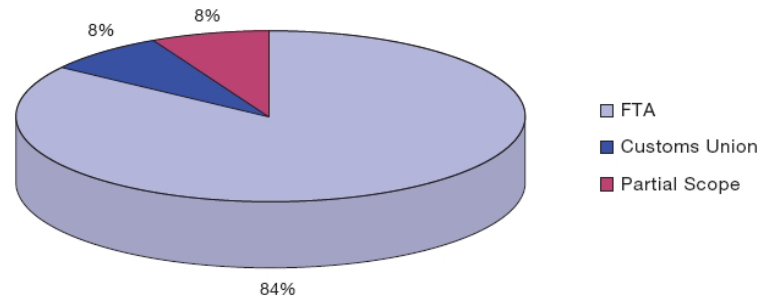
RTAs notified to the GATT/WTO (1948-2006), currently in force, by year of entry into force

### 2.1 The Nature of RTAs

Many countries which traditionally relied on the multilateral trade regime are increasingly joining regional agreements to promote trade.

Regional Trade Agreements (RTAs) are defined as groupings of countries which are formed with the objective of reducing barriers to trade between member countries. Contrary to what the name suggests, these groupings or unions may be concluded between countries not necessarily belonging to the same geographical region. Depending upon their level of integration, RTAs can be broadly divided

into five categories: Preferential Trade Agreements (PTAs), Free Trade Agreements (FTAs), Customs Unions (CUs), Common Markets and Economic Unions.



Source: Crawford, J.A.–Fiorentino, R. V. [11]

Figure 2

Notified RTAs in force, as of December 2006, by type of agreement

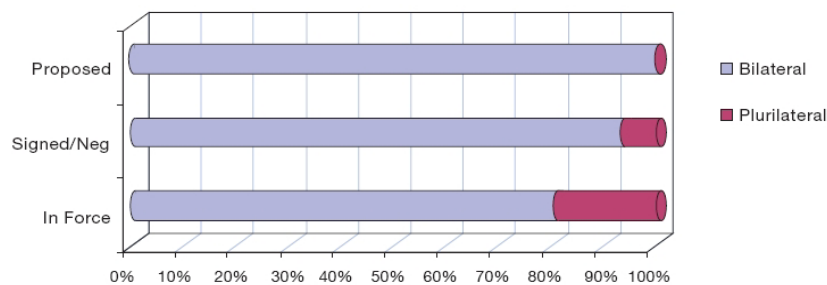


Figure 3

RTAs' configuration, as of December 2006 Source [11]

The main reason for WTO member's preference of bilateral FTAs<sup>1</sup> before multilateral FTAs or CUs is probably the mere fact that bilateral FTAs are easier to conclude than multilateral FTAs and certainly a lot easier than a CU. Apart

<sup>1</sup> A PTA is a union in which member countries impose lower trade barriers on goods produced within the union, with some flexibility for each member country on the extent of the reduction. A Free Trade Area (FTA) is a special case of PTA where member countries completely abolish trade barriers (both tariff barriers and non-tariff barriers) for goods within the member countries. It should be clarified here that in most cases, countries do not abolish trade barriers completely even within Free Trade Areas. Most agreements tend to exclude sensitive sectors. A Customs Union (CU) provides deeper integration than an FTA because, unlike FTAs where member countries are free to maintain their individual level of tariff barriers for goods imported from non-member countries, in a CU, member countries also apply a common external tariff on a good imported from outside countries.

from this there are two types of regional agreements which provide “deep integration”.<sup>2</sup> Among the Regional Trade Agreements, a large majority of the agreements are PTAs or FTAs. In contrast, there are only a handful of Customs Unions, Common Markets and Economic Unions worldwide. The new generation of RTAs, especially those comprising developed countries, includes more regional rules on investment, competition and standards; as well as provisions on environment and labour. Most of these new agreements also include preferential regulatory frameworks for mutual services trade.

### **3 Why are Countries Going for Regional Trade Agreements?**

These explanations can be divided into three broad categories. First is the traditional explanation of welfare effects through trade liberalization and the consequent gains from trade at a regional level. Viner, [14] introduced the concepts of “trade creation” and “trade diversion” and showed that the net effect of trade liberalization on a regional basis is not unambiguously positive. He pointed out that RTAs can lead to trade creation if RTA members switch from inefficient domestic producers and import more from efficient producers from other members of the RTA. In this case, efficiency gains arise from both production efficiency and consumption efficiency. Trade creation and trade diversion have opposite welfare implications and the net effect will depend upon which of these two effects dominate. Krugman (1991) [11] is of the opinion that the beneficial effect of a regional trade agreement will depend on whether there is enough “inherent regionalism” in the transport costs between the member countries of the RTA.

According to Bhagwati,[17] trade diversion is more likely to dominate trade creation in most situations. When trade is multilateral, i.e. when countries import from and export to union members as well as outside countries, trade diversion is inevitable.

There is an emerging consensus among economists that frustration with the multilateral trading system is one of the prime reasons behind the current growth of regionalism. Krugman suggests that countries find regionalism an easier alternative because large number of participants in multilateral trade negotiations

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<sup>2</sup> The first is called Common Markets, where member countries attempt to harmonize some institutional arrangements and commercial and financial laws and regulations among themselves. A common market also entails free movements of factors of production, i.e. removal of controls on free movement of labour and capital. The final ‘deep integration’ level is the ‘Economic Union’ where countries implement common economic policies and regulations and adopt a single currency.

reduces the cost of non-cooperation and creates rigidity in the system. Also according to him, modern trade barriers are much more complicated to negotiate in a multilateral forum and most countries find it easier to deal with these issues on bilateral or regional level. Baldwin [14] in his “domino theory of regionalism” describes similar motivation for joining regional groupings. He believes that regionalism did not occur because countries have lost faith in GATT or because USA has adopted regionalism. There is another big debate in the current international trade literature about whether regionalism can help or hinder the multilateral trading system. There are opposing views among economists about the role of regionalism in the current global trade system. Krugman is of the opinion that regional trade blocs are welfare improving in nature and are unlikely to have any negative impact on the multilateral trade system. Baldwin [14] does not see regionalism as a threat to the multilateral trading system. According to him, because trade is “already quite free in major trading nations, few regional liberalizations are capable of creating anti-liberalization forces”. Therefore, he concludes that most regional trade agreements will weaken the opponents of trade liberalization and hence will promote and foster multilateral trade liberalization.

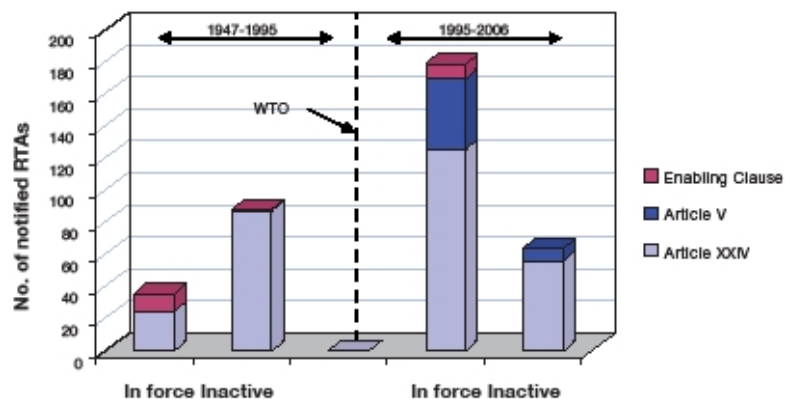
But the dominant view among mainstream economists suggests that regionalism is harmful for the multilateral trading system. For example Bhagwati and Krueger [18] think that preferential trade agreements are essentially discriminatory in nature and they view the drift towards PTAs as a serious threat to the multilateral trading system. Increased regionalism is dangerous because it not only leads to inter block trade wars and domination of small countries by bigger partners in the regional blocks but also because it reduces the enthusiasm for participation in the multilateral trade regime. They worry that RTAs divert attention from the multilateral trading system. They argue that most preferential agreements lead to trade discrimination and thereby harm the multilateral trading system. Bhagwati also argues that the growing number of PTAs may lead to a complex system of regulatory structures. This phenomenon, known also as the “spaghetti-bowl” problem, may lead to complexity and lack of transparency in the global trading system.

## 4 WTO and RTAs

As well known, the WTO was set up to liberalize international trade on the principle of non-discrimination and to eliminate trade barriers through multilateral negotiations. It has contributed to expanding world trade and is expected to do more if the current DDA multilateral negotiations are completed ever. Some 421 RTAs have been notified to the GATT/WTO up to December 2008. If we take into account RTAs which are in force but have not been notified, those signed but not yet in force, those currently being negotiated, and those in the proposal stage,

we arrive at a figure far more than 400 RTAs. They are scheduled to be implemented by 2010. Of these RTAs free trade agreements and partial scope agreements account for over 90% of the turnover while CUs account for less than 10%.

Regional trade agreements represent an important exception to the WTO's principle of nondiscrimination. According to the WTO rules, countries within a RTA can trade among themselves using preferential tariffs and easier market access conditions than what is applicable to other WTO member countries. As a result, WTO member countries that are not a part of the RTA lose out in these markets. As increasing amount of global trade is being diverted through this route, there is a certain amount apprehension about the role of regional trade agreements in WTO. In general Article I (GATT, 1947) forbids any preferential trading arrangements (the „Most Favoured Nation” principle). An exception to this is that Regional Trade Agreements are permitted, so long as they take the form of customs unions or free trade areas satisfying the conditions of Article XXIV, essentially that „substantially all trade” is fully liberalised, and that there is no overall increase in external protection.



Source: Crawford, J.-A.-Fiorentino, [11]

Figure 4  
RTAs notified to the GATT (pre 1995) and WTO (post 1995)

„Article XXIV being an exception to the MFN principle allows discrimination instead of combating it. The formation of an FTA or CU is regulated under Article XXIV GATT 1994, which provides for more beneficial treatment between members to a RTA than that afforded by the schedule of concessions negotiated under the WTO Article XXIV, consequently, provides for an exception from the MFN-Principle.” [21] The MFN exception stated in Article XXIV may at first sight seem illogical, since the only way to be excused from applying non MFN consistent and discriminatory trade preferences is to completely discriminate, (MFN denies all discriminatory preferences meanwhile the MFN exception in

Article XXIV allows discriminatory preferences if they are completely discriminatory against the non RTA members). Other exception are General Agreement on Trade in Services (GATS) Article V, The Enabling Clause<sup>3</sup> and the Generalized System of Preferences (GSP).

## 5 Regionalism or Multilateralism

There is an increased attention being paid to regional arrangements. The threat to the multilateral trading system does not appear to be as large as is often reported. The debate about whether RTAs are "building blocks or stumbling blocks" for global free trade, which was so virulent in the 1990s, faded because, whatever the answer to the question, in practice RTAs have made so little difference either way. The impact on the global trading regime of the hundreds of RTAs notified to the GATT/WTO as being in contravention of the MFN principle has been trivial compared to the establishment of multilateral trade law based on the nondiscrimination principle. The dissemination of regionalism can contract and distort non-discriminatory multilateralism. Countries are too diverse in their developments. Negotiations under the framework of WTO take too much time as well. Regionalism is then an alternative to consider, at least, for countries geographically close to each other, especially for countries with close economic exchanges and interests.

## 6 Has the WTO Promoted Successful RTAs?

**Rose (2004)** [4] found that the WTO does not promote trade across a variety of gravity models. He published a "puzzling result." After an extensive empirical search, Rose found no difference in trade patterns between GATT/WTO members and non-members.

**Grant and Parmeter** [9] are of the opinion that the WTO has not been as effective as one might have expected, given the recent proliferation of RTAs in the last decade. The GATT/WTO has not promoted successful RTAs.

In section one (Generic RTA Effects) they estimated the effects of RTAs.

In section two (GATT/WTO Membership) they tested the effectiveness of the WTO allowing for separate RTA effects with respect to: both countries are GATT/WTO members (both-in);

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<sup>3</sup> Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries

one trading partner is a GATT/WTO member (one-in); and neither country is a GATT/WTO member (none-in).

In section three (Notified and Non-Notified RTAs), they allowed for separate effects of notified and non-notified regional trade agreements, the latter of which represents RTAs that have never been notified to the WTO and therefore is not subject to the provisions of Article XXIV.

In the final section (GATT/WTO Membership & RTA Notification Status) they combined GATT/WTO membership with notified and non-notified RTAs.

RTAs involving country pairs that are not party to the GATT/WTO (none-in) have been remarkably successful compared to RTAs that include one or both countries in the GATT/WTO. Two non-GATT/WTO members traded 183 percent more with each other in an RTA compared to just 86 percent when both RTA members were party to the GATT/WTO (both-in).

Non-notified RTAs that include at least one GATT/WTO member traded 141 percent more with each other compared to just 80 percent more trade under notified RTAs that include at least one GATT/WTO member.

Two non-GATT/WTO members of a non-notified RTA traded 216 more with each other compared to 166 percent between two non-GATT/WTO members in a notified RTA.

**Herz and Wagner** [10] found in their analysis a significant positive effect of WTO membership on bilateral trade: membership in regional trade agreements or currency unions substantially increase bilateral trade flows as well. By contrast, they found that the Generalized System of Preferences does not foster trade in general, rather the opposite. This might be due to the opportunistic behavior of industrial countries that grant GSP schemes as long as the concerned products are relatively unimportant, but restrict them as soon as they become relevant.

Recently many studies have used gravity equations<sup>4</sup> in order to estimate the effect of RTAs on trade flows between partners. These studies report very different estimates, since they differ greatly in data sets, sample sizes, and independent variables used in the analysis.

## Conclusion

The completion of the Uruguay Round of Multilateral Trade Negotiations coincided with the development of a worldwide trend towards increased regionalism, as witnessed by the conclusion of NAFTA, the emerging process of regional integration in Latin America and the launching of APEC. While this new

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<sup>4</sup> The gravity model is adapted from Newton's Law of Gravity, and in essence states that the attraction of goods between countries depends positively on their economic masses, and negatively on the distance between them.



trend has caused some observers to evoke the prospect of a world economy increasingly divided among rival “trade blocs”, recent studies suggest that regional trade agreements may complement rather than threaten the multilateral trade system. At a theoretical level, economists are divided over the desirability of regional trade agreement in a multilateral trade regime. There is still no consensus about this issue. However, regionalism, with its advantages and drawbacks, is a reality of the current global trade regime. [12] The wave of regionalism is likely to intensify in near future. If a very high proportion of global trade gets diverted through the regional route, WTO is bound to lose some of its relevance in the global trading system.

However, in the current state of distorted multilateralism, regionalism has turned out to be one of the more viable alternatives for developing countries to expand their market access. In this context, South-South RTAs are particularly useful as they allow developing countries to expand their market. Also, it is always possible that if the world is divided in a few mega trade blocks, then the weakest countries will be marginalized.

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