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MULTILATERALISM VERSUS REGIONALISM IN WORLD TRADE

Introduction

For many economists the link is unambiguous and straightforward – increased trade and trade liberalisation both contribute to enhancing the developments prospects of a nation. For others, the link is less straightforward and far from proven¹. Bhagwati claims that we ended the twentieth century with a far firmer case for free trade than the one we inherited at the end of the Second World War². At the same time Irwin, while supporting the notion of free trade, acknowledges that the profession still very often lacks substantial empirical support for free trade proposition³. This paper assumes somewhat boldly that trade liberalisation in principle leads to higher welfare levels. Said that, it puts forward the key question: How should the world trade be liberalised?

The paper presents a brief synthesis of the discussion on the two modes of development of the world trade. Should the international trade develop through the broad multilateral agreements or should countries instead pursue the trade liberalisation in regional or trans-regional blocks? Are these two ways mutually contradicting or complementary? Is the current wave of regionalism going to lead to a division of the world into a number of competing inward-looking blocs or is it going to lead to a more open multilateral trading system?

Regional Trade Agreements – overview

Even dedicated defenders of free trade are divided with respect to their views on Regional Trade Agreements (RTAs) and their effects on global welfare. Some argue that RTAs are beneficent institutions that complement WTO objectives, others see them as serious impediments to the development of a fair and free trading

¹ B. Bora, *Book review*, World Trade Review 1:3, 2002, pp. 345-356.

² J. Bhagwati, *Free Trade Today*, Princeton and Oxford 2002.

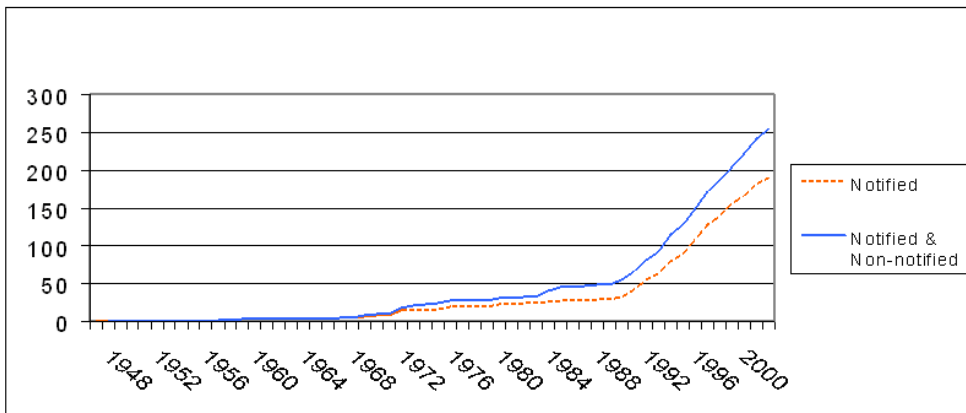
³ D.A. Irwin, *Free trade under fire*, Princeton and Oxford 2002, p. 67.

system. This lack of a consensus persists in spite of many theoretical and empirical contributions to the study of RTAs⁴.

RTAs are as diverse as they are numerous. While they fall generally into the categories of Custom Unions (CUs) and Free Trade Areas (FTAs) such agreements can look very distinctive in the context of different sets of countries, different stages of development, different trading patterns, and different levels of commitment to trade liberalisation⁵. FTAs have proliferated faster compared to CUs. North-South regional agreements are likely to be FTAs while South-South agreements are likely to be CUs⁶. It is worth noting here that some studies suggest that developing countries are likely to be better served by North-South than by South-South free trade agreements⁷.

The drive towards the conclusion of RTAs which gathered pace in the 1990s continues unabated (figure 1). All 149 WTO Members, with the exception of Mongolia, currently participate in or are actively negotiating RTAs.

Figure 1.
RTAs notified to the GATT/WTO (1948-2003)



Source: *The Changing Landscape of RTAs 2003*, World Trade Organisation, Geneva 2003.

Table 1 shows that more than a half of the world merchandise trade now occurs under the umbrella of preferential trade agreements. The Most Favoured Nation clause introduced by GATT seems to be becoming an exception rather than a fundamental rule of the global trading system.

⁴ *Reflections on Regionalism for the WTO*, Carnegie Endowment for International Peace, Princeton 1996.

⁵ *Reflections on Regionalism for the WTO*, op.cit.

⁶ M. Schiff, *Multilateral Trade Liberalization, Political Disintegration, and the Choice of Free Trade Agreements versus Customs Unions*, World Bank Policy Research Working Paper No. 2350, May 23, 2000, p. ii.

⁷ A.J. Venables, *Regional Integration Agreements: a force for convergence or divergence?*, Annual Bank Conference on Development Economics, Paris, June 1999.

Table 1.
 Preferential trade share of intra-RTAs trade in merchandise imports of major regions

	2000	2005 (estimation)
Western Europe	64,7	67
Transition economies	61,6	61,6
North America (incl. Mexico)	41,4	51,6
Africa	37,2	43,6
Middle East	19,2	38,1
Latin America (excl. Mexico)	18,3	63,6
Asia	5,6	16,2
WORLD	43,2	51,2

Source: *World Trade Report 2003*, World Trade Organisation, Geneva 2003.

Table 2 offers a synthetic collection of arguments for and against the creation of RTAs as means of trade liberalisation.

Table 2.
 Pros and cons of Regionalism – a synthesis

Pros	Cons
<ul style="list-style-type: none"> • intensifies trade (creation effect) • open regionalism (open membership, consistency with GATT XXIV, member countries free to liberalise further unilaterally) • deep regionalism • regionalism as a step towards universality of MFN 	<ul style="list-style-type: none"> • discriminates (diversion effect) • 'spaghetti bowl' effect • lower motivation to negotiate multilaterally • may be less favourable for developing countries • by nature contradicts the MFN clause

Motivation for entering into RTAs

The economics

Economic analysis offers several reasons why governments might opt for preferential liberalisation. The first one is the theory of the “**second-best**”. In a world where policy-imposed barriers to trade exist, and it is impossible to remove them across-the-board, it may still make sense in terms of national and global well-being to reduce these barriers on a selective basis. If some countries are unwilling to liberalise while others wish to do so, for example, liberalisation via regional agreement might be more beneficial to the world than *status quo*⁸.

⁸ *World Trade Report 2003*, World Trade Organisation, Geneva 2003.

A second reason for governments to seek discriminatory liberalisation is that they may be able to reap gains from trade in product areas where they cannot compete internationally. In other words, regional trade agreements could serve the purpose of shutting out third-party competition from more efficient suppliers.

RTAs can also be used by some countries as a vehicle for promoting deeper integration of their economies than is presently available through the WTO, particularly for issues which are not fully dealt with multilaterally, such as investments, competition, trade in services, environment and labour standards (so called '**deep regionalism**'). Particularly regarding trade in services, preferential access may confer long term advantages in a market and may enable a supplier to steal an irreversible march on the competition. Smaller countries particularly would see RTAs as a defensive necessity, while even larger economies may turn to RTAs to avoid being 'left out in the cold'. Membership in RTAs can provide a means of securing Foreign Direct Investment (FDI), particularly for a country with low labour costs which has preferential access to a larger, more developed market⁹. The phrase '**domino regionalism**' has been coined to capture this kind of motivation, explaining to a degree the explosion of membership in regional arrangements.

In addition to that, participation in regional agreements may also be valued for its '**signalling**' properties. If a country can demonstrate to potential traders and investors that it is committed to opening its markets, and that the commitment will not be easy to reverse this could also be a reason for engagement¹⁰.

The politics

Political considerations are also reported to be key to the decision to foster regional trading arrangements. Governments seek to consolidate peace and increase regional security with their RTA partners, or to increase their bargaining power in multilateral negotiations by securing commitment first on a regional basis, or as a means to demonstrate good governance and to prevent backsliding on political and economic reforms. They may also be used by larger countries to forge new geopolitical alliances and cement diplomatic ties, thus ensuring or rewarding political support by providing increased discriminatory access to a larger market. Increasingly, the choice of RTA partners appears to be based on political and security concerns, thus potentially undermining or diluting the economic rationale which might be used in support of participation in RTAs¹¹.

Vested interests within national bureaucracies could also drive RTA formation. Once the bureaucratic machinery has been set up to negotiate regionally, there is a natural temptation for those involved to seek to perpetuate their functions by creating conditions for the negotiation of successive agreements. With regional agreements becoming so omnipresent, the default question asked seems increasingly to be why a regional agreement does not exist with a trading partner, rather than

⁹ *The Changing Landscape of RTAs*, World Trade Organisation, Geneva 2003.

¹⁰ *World Trade Report 2003*, op.cit.

¹¹ *The Changing Landscape of RTAs*, op.cit.

why such an agreement should exist. There is ample evidence to suggest that the negotiation and administration of multiple agreements strains the institutional capacity of even the largest countries and may dampen enthusiasm for liberalisation at the multilateral level. Finally, RTAs tend to create vested interests (mostly of national producers) determined to avoid the dilution of preferential margins¹².

Chosen issues and concepts relating to RTAs

Trade creation and trade diversion

The way economic theorists have viewed discriminatory trade blocs has changed over time. At the time of the formation of the GATT in 1948, RTAs were viewed as a step towards free global trade. Provided new RTAs did not raise trade barriers vis-a-vis the rest of the world, they resulted in an overall lowering of trade barriers in the world economy and this was regarded as benign. GATT Article XXIV is based on this view. Viner (1950) changed this perception dramatically¹³. In static analysis his seminal concepts of **trade creation** and **trade diversion** remain central today¹⁴. Viner noted that since RTAs liberalise trade preferentially, on one hand, they “create” new trade between union members while, on the other, they “divert” trade from low-cost outside suppliers to high-cost within-union suppliers. The former effect arises from a union partner undermining another union member's less efficient industry and is beneficial. The latter effect arises from a union member displacing a more efficient outside supplier by taking advantage of the tariff preference it enjoys in a partner country. This effect is harmful. Unions which are primarily trade creating are beneficial and those that are primarily trade diverting are harmful to member countries taken together and to the world as a whole¹⁵.

‘Spaghetti bowl’

In FTAs as opposed to CUs, member countries fear that imports from outside countries destined to a high-tariff member may enter through a low-tariff member. Or more subtly, entrepreneurs in the low-tariff country may import a product in almost finished form, add a small value to it and export it to the high tariff country free of duty. To avoid this trade deflection, FTA agreements usually include the **rules of origin** according to which products receive the duty-free status only if a pre-specified proportion of value added in the product originates within the union. As a result, for a given product, there are several different tariff rates depending on what origin is assigned to it. The problem of the proliferation of RTAs is

¹² *The Changing Landscape of RTAs*, op.cit.

¹³ D. MacLaren, *The case for free trade and the role of RTAs. Seminar on Regional Trade Agreements and the WTO*, Geneva 2003.

¹⁴ J. Viner, *The Custom Unions Issues*, New York 1950.

¹⁵ A. Panagariya, *The Regionalism Debate An Overview*, World Economy, June 1999, pp. 477-511.

often described in terms of the ‘**spaghetti bowl**’¹⁶ phenomenon, whereby several preferential trade agreements have different rules of origin and tariffs that make it very difficult to identify ‘who is whose’. The complexity has led to the problem that RTAs tried to avoid: increasing protectionism and transaction costs.

Open regionalism

In the policy debate, advocates of the current wave of RTAs defend it on the ground that it represents “**open regionalism**” in contrast to closed, import-substituting regionalism of 1950s and 1960s. One of the definitions offers three criteria for open regionalism: (i) open membership with positive encouragement to non-members to join, (ii) consistency with GATT Article XXIV, and (iii) freedom to member countries liberalise further unilaterally or with non-members on a reciprocal basis¹⁷.

Renato Ruggeiro, the former Director-General of the WTO, went a step further in defining open regionalism. He contrasted two interpretations of open regionalism. The first interpretation stops at consistency with Article XXIV of GATT and the understanding on its interpretation incorporated in the Uruguay Round agreements on Trade in Goods. In the second interpretation, “(...) *the gradual elimination of internal barriers to trade within a regional grouping will be implemented at more or less the same rate and on the same timetable as the lowering of barriers towards non-members. This would mean that regional liberalisation would in practice as well as in law be generally consistent with the MFN principle*”¹⁸.

Some critics find the idea of adherence to the MFN principle to be incompatible with regionalism. They make a point noting that if regional liberalisation is to be extended on the same time table to non-member countries on an MFN basis, it would be multilateral and not regional. If that is the case, one may ask then: why would any group initiate it on a regional basis in the first place? Moreover, the conventional view that Article XXIV of GATT ensures that trade block formation facilitates free trade is challenged by some scholars who claim that Article XXIV itself undermines the multilateral liberalisation process¹⁹.

¹⁶ C.L. Freund, *Spaghetti Regionalism*, International Finance Discussion Papers, No. 680, September 2000, Board of Governors of the Federal Reserve System.

¹⁷ A. Panagariya, op.cit.

¹⁸ R. Ruggeiro, *The Road Ahead: International Trade Policy in the Era of the WTO*, Fourth Annual Sylvia Ostry Lecture, Ottawa, 28 May 1996. WTO Press/49, Geneva, 29 May 1996.

¹⁹ B. Zissimos, D. Vines, *Is the WTO's Article XXIV a Free Trade Barrier?*, Centre for the Study of Globalisation and Regionalisation Working Paper No. 49/00, University of Warwick, February 2000, p. 1.

Conclusions

Due to their discriminatory nature, RTAs can be seen as welfare reducing for the excluded countries, for the world as a whole, and even for the member countries as they divert resources away from their most efficient uses²⁰. One perspective is that RTA's are a dangerous development in the world trading system and a distraction from the goal of multilateral trade liberalization²¹. On the other hand, it can be argued that RTA's benefit multilateral trade liberalisation by lowering transaction costs, creating larger markets²² and putting pressure on the countries to open up²³.

In the meantime, on the theoretical front, at least two major gaps remain with respect to the theory of preferential trading. Theory remains almost non-existent on the relationship among regional, multilateral and unilateral liberalisation in trade in services. Issues such as why regional arrangement might be a superior instrument of bringing foreign investment than multilateral liberalisation have yet to be addressed²⁴.

While both sides of the debate make valid points, a third, rather non-dogmatic approach should be considered. Such an approach admits that RTA's are neither good nor bad, but that the effect of RTA's on the global economy depends on the motives and ways of forming it as well as how it evolves over time²⁵.

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²⁰ S. Andriamananjara, *On the Size And Number of Regional Integration Arrangements: a Political Economy Model*, World Bank Policy Research Working Paper No. 2117, May 1999, p. 1.

²¹ J. Bhagwati, *The World Trading System at Risk*, Princeton, New Jersey: Princeton University Press, 1991.

²² R. Blackhurst, D. Henderson, *Regional integration agreements, world integration, and the GATT*, in: K. Anderson, R. Blackhurst (eds.), *Regional Integration and the Global Trading System*, London: Harvester Wheatsheaf, 1993.

²³ C.F. Bergsten, *American politics, global trade*, The Economist, 27 September 1997, pp. 23-26.

²⁴ A. Panagariya, *EU Preferential Trade Policies and Developing Countries*, World Economy Vol. 25, No.10, November 2002, pp. 1415-1432.

²⁵ S. Sheffield, *Agriculture, GATT, and Regional Trade, Agreements*, in: *Regional Trade Agreements and U.S. Agriculture*, United States Department of Agriculture, November 1998, p. 91.

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Abstract

The paper presents a synthesis of the discussion on the two modes of development of the world trade. The following questions are asked: Should the international trade develop through the broad multilateral agreements or should countries instead pursue the trade liberalisation in preferential blocks? Are these two ways mutually contradicting or complementary? The paper proposes a pragmatic approach which admits that each RTA and its effect on global welfare should be examined individually taking into account the motives and ways of forming it as well as how it evolves over time.