



School of Economics

Working Paper 2005-15

Regional Trade Agreements

Richard Pomfret

School of Economics
University of Adelaide University, 5005 Australia
ISSN 1444 8866

October 2005

REGIONAL TRADE AGREEMENTS

by

Richard Pomfret

School of Economics
University of Adelaide,
Adelaide SA 5005, Australia

<richard.pomfret@adelaide.edu.au>

To be published as a chapter in Michele Fratianni and Alan Rugman eds. *Regional Economic Integration* (Elsevier, forthcoming 2006).

Regional Trade Agreements

1. Introduction

Regional trade agreements have been a major and recurring feature of the global economy during the last half century. The evolution of thinking about such agreements has tracked the policy developments. The first wave of regionalism, led by the western European customs union which followed the 1957 Treaty of Rome, was analysed within the framework of Vinerian customs union theory. The second wave, which was characterized by agreements in the 1980s going beyond preferential tariff reduction towards deeper integration, was considered to be a “New Regionalism” requiring new tools. The third wave of bilateral agreements in the early 2000s continues many of the trends towards deeper integration, although it is in some respects hardly even regionalism.

This paper first briefly describes the three waves of regionalism. It then reviews customs union theory and the analysis of deep integration. In both of these approaches to regional trade agreements, the nation state is the basic unit of analysis. The fifth section goes into the question of the appropriate level of analysis for the global economy; are the roles of the nation state and of multilateral institutions evolving in the twenty-first century, and what scope will exist for the intermediate units formed by regional trade agreements? The final section draws some conclusions.

2. The Three Waves of Regionalism

Since the signing of the General Agreement on Tariffs and Trade (GATT) in 1947, three waves of regionalism have swept the world trading system. During the 1950s and 1960s the “rush to discrimination” was led by Western Europe, which founded the only substantial new customs union of the second half of the twentieth century and also established a complex network of preferential arrangements with other trade partners.¹ The European customs union was taken as a model by groups of

¹ The quotation is from Gardner Patterson (1966). The European Community’s preferential trading arrangements (PTAs) with non-members were in many respects a substitute for the missing common

developing countries in Africa, the Caribbean, Central America, and South America, but even the most promising of these arrangements, the East African Community and the Central American Common Market, collapsed during the 1970s.² The customs unions agreed among developing countries all failed because they were based on a regional form of import substitution which inevitably led to conflict, because each member wanted a regional market for its own inefficient industries but was unwilling to buy the expensive or poor quality import-substitutes being produced by their partners. The European customs union had similar strains, but for most goods (except farm products) the least-cost supplier within the union was globally competitive, and the political will for greater economic union outweighed perceived costs even for large net economic losers such as the United Kingdom, which joined in 1973.

A second wave of regionalism was initiated by the United States' departures from the GATT non-discrimination principle in the first half of the 1980s and peaked with the North American Free Trade Agreement (NAFTA) negotiations in the early 1990s, which coincided with the European Union's 1992 project for completing the internal EU market. Although NAFTA was signed and implemented, the EU completed its 1992 program and Australia and New Zealand deepened their free trade area into the Closer Economic Relations, the major trading nations reaffirmed their commitment to the non-discrimination principle with the successful conclusion of the 1986-94 Uruguay Round of multilateral trade negotiations and the establishment in 1995 of the World Trade Organization (WTO) as the successor to the GATT. As in the first wave, there was a demonstration effect as groups of developing countries worried about the need to establish and strengthen their own regional groupings. The geographical scope was wider than in the first wave as Latin American regional arrangements such as Mercosur and African customs union in various overlapping incarnations were joined by Asian regional organizations. The practical outcomes of these follower RTAs were, however, minimal for much the same reasons as in the

foreign policy (some were preludes to membership, others such as the Yaoundé/Lomé/Cotonou Conventions retained special relationships with former colonies and similar African, Caribbean and Pacific economies). These PTAs contributed to the US abandonment of the non-discrimination principle, when it signed its own PTAs with favoured clients in the Caribbean and Israel, and to poor countries' opposition to multilateral trade liberalization, which may erode their preferences' value, but in themselves they are not of great significance for the global trading system.

²The various RTAs mentioned in this chapter are described and analysed more fully in Pomfret (1997/2001).

first wave; each partner was unwilling to grant other partners non-trivial preferential access to its own protected markets.³

In the opening years of the twenty-first century, a third wave of RTAs has been gathering force, led by Asian countries, which had previously been the strongest bulwarks of non-discrimination. The emergence of Asian regionalism can be dated from the aftermath of the 1997 Asian Crisis, and was partly in reaction to dissatisfaction with the role of the Bretton Woods institutions. The earliest manifestations were in calls for an Asian Monetary Fund or even monetary union, although this led only to the 2000 Chiang Mai Initiative, which provided (limited) stand-by swap facilities for countries facing currency crises (Pomfret, 2005a). However, the collapse of the 1999 WTO meetings in Seattle and the diminishing significance of APEC led to calls for new approaches to trade liberalization in the Asia-Pacific region. Bilateral negotiations were begun in 1999/2000 by Japan with Singapore, South Korea, Canada and Mexico, by South Korea with Chile and New Zealand as well as with Japan, and by Singapore with New Zealand, Australia, the USA, Canada and other countries. In their embracing of bilateral agreements, the Asian countries were joined, especially under the G.W. Bush administration, by the USA, which started to negotiate bilateral trade pacts with friendly countries such as Jordan, Morocco and Australia. As is obvious from these examples, although the third wave is seen as a recrudescence of regionalism, many of the bilaterals are not regional.⁴ It is also not clear how novel the pattern is; bilateral agreements have long existed in areas such as double-taxation or investment treaties, without being labelled as a type of RTA.

Whether regional/bilateral agreements are becoming a major feature of the global trading system (as opposed to a major preoccupation of trade negotiators) is not obvious. It is sometimes asserted that, because the number of RTAs notified to the WTO reached an all-time high in the early 2000s, regionalism was more prevalent

³ The Asian RTAs were especially ineffective. The two largest economies in the South Asian Association for Regional Cooperation (SAARC), India and Pakistan, withheld MFN treatment from one another. The Economic Cooperation Organization (ECO) was in abeyance while Iran was at war with Iraq. Most empirical studies find minimal effects on trade for SAARC or ECO, and even for the Association of Southeast Asian Nations (ASEAN), which was the least moribund of the Asian RTAs.

⁴ When Thailand under Thaksin, for example, embarked on a policy of negotiating bilateral trade agreements, it began with Bahrain and Australia before moving on to the USA and Japan; this pattern is weakening Thailand's regional trading arrangements by eroding preferential treatment negotiated within ASEAN. South Korea's experimentation with bilaterals started with Chile and New Zealand, willing collocutors, but hardly regional neighbours and never likely to generate large bilateral trade flows.

than ever. Crawford and Fiorentino (2005) in the opening paragraph of their survey of RTAs state that “Between January 2004 and February 2005 alone, 43 RTAs have been notified to the WTO, making this the most prolific RTA period in recorded history”. Such counting is nonsense, because some arrangements are important but many are inconsequential. One reason for the rapid increase in the number of RTAs during the 1990s was the proliferation of bilateral and plurilateral free trade agreements among countries of the former Council for Mutual Economic Assistance; these were primarily a response to regional disintegration, rather than a trend towards regionalism in Central and Eastern Europe. On 1st. May 2004 when eight eastern European countries joined the EU, the web of bilateral trading arrangements among the accession countries and of preferential agreements between the accession countries and the EU became redundant, although with the incorporation of eight more countries into the EU customs union the degree of regionalism was increased. According to Crawford and Fiorentino (2005, n21) 65 RTAs notified to the WTO were abrogated on that date, so that by their own measure net RTA formation between January 2004 and February 2005 was minus 22, i.e. 2004 saw the biggest retreat from RTAs in recorded history.⁵

The problems of simple counting are highlighted by examination of the twenty RTAs notified to the WTO in the first half of 2005 (Table 1). Six were bilaterals (Australia-Thailand, Japan-Mexico, and Panama-El Salvador) which were double-counted because they are under GATT Article XXIV and GATS Article V. Twelve were bilaterals involving pairs of eastern European countries (mostly among regions of former Yugoslavia, i.e. reflecting regional disintegration). The other two were an EFTA-Tunisia agreement and an Israel-Romania agreement.⁶ None of these twenty agreements can be expected to have a significant impact on world trade or even on the trade of the signatories. This is, of course, not to argue that no RTAs are important – the EU, NAFTA, Mercosur and some others obviously are – but it is to caution against simplistic claims of proliferating regionalism in world trade.⁷

⁵ The precise number may be disputed but the order of magnitude is clear. According to the World Bank (2005, 53), the number of RTAs fell from 285 to 229 as a result of the EU enlargement in 2004.

⁶ The European Free Trade Association (EFTA) consists of Iceland, Liechtenstein, Norway and Switzerland.

⁷ Much of the confusion about the number of RTAs derives from the WTO's website, which includes a dramatically rising but effectively meaningless chart of the cumulative number of RTAs registered with the WTO since 1948. Despite the statement in the accompanying text that “Not all RTAs notified in the last half century are still in force today”, no account is taken of abrogation or non-implementation and the visual impact is of rampant regionalism. The same chart appears as Chart 1 in the Discussion

In contrast, it is arguable that, despite the increased attention being paid to regional arrangements, the hold of multilateralism is stronger than ever as practically all trading nations have now acceded to the WTO, with lower trade barriers and stronger trade dispute settlement procedures than ever before. Perceptions of WTO enfeeblement reflect a tendency of news reporting to highlight conflict rather than accord. The end of the Multifiber Arrangement in December 2004 was a monumental step in global non-discriminatory trade liberalization which is surely good for global resource allocation and for people who wear clothes, but the press coverage in early 2005 highlighted negative effects on countries suffering from preference erosion (such as Bangladesh) and the impact on producers in powerful nations. Even as the USA and EU were negotiating safeguard measures against the surge of clothing imports from China, little mention was made of the fact that these were legal under China's WTO accession accord but limited in duration to 2008. Other striking examples of the increased rule of law in international trade since the creation of the WTO are the ability of small countries to win cases against major trading nations (and have the offending policies modified) and the willingness of the US Congress to amend US tax law (on FISCs) to comply with a WTO judgment.

3. The Economics of Preferential Trade Policies

Regional trading arrangements (RTAs) are often described by the five levels of integration set out by Bela Balassa (1961):

- preferential trading arrangement (PTA),
- free trade area (PTA with zero internal tariffs),
- customs union (FTA + common external trade policy),
- common market (CU + free movement of factors of production),
- economic union (CM + common economic policies).

The five categories are often treated as a sequencing pattern towards closer integration as well as a taxonomy of deeper and deeper integration.⁸ The defining feature of all

Paper (Crawford and Fiorentino, 2005) linked to the WTO webpage on the prevalence of RTAs; although the paper contains an official disclaimer, the authors are staff of the WTO Secretariat. The WTO has a duty of transparency when RTAs are notified but it should also provide reasoned commentary rather than scaremongering about the threat of regionalism.

⁸ A debate in East Asia, which has been particularly strong since the 1997 Asian Crisis, is whether the sequence can be reversed with monetary integration being used as a stimulus for trade integration

of these RTAs is that trade among members is treated differently to trade with non-members.

Such preferential trading arrangements are permitted under the GATT/WTO rules, notably under Article XXIV on customs unions and free trade areas (and the parallel Article V of the General Agreement on Trade in Services) and under the Enabling Clause for special treatment for developing countries. They are, however, contrary to the spirit of the GATT, embodied in Article I which requires any GATT signatory to treat all other signatories equally, and Article XXIV contains stringent conditions which have seldom, if ever, been fully met in practice. There is also a paradox between the political economy forces encouraging politicians to embark on preferential trade policies and the economic forces working in favour of global adherence to the non-discrimination principle; despite dozens of plans for regional trading arrangements many failed to come to fruition, and among those RTAs that did begin to operate many failed to survive long or to exercise a significant influence on trade flows.⁹

The ambiguity in trade law captures the classic insight by Jacob Viner that any discriminatory trade policy, such as a customs union, is by its nature second-best. One distortion, the differential treatment between a member's domestic products and products from other member countries of the customs union, is removed and this permits a more efficient allocation of resources if imports from the partner replace domestic production or increase domestic consumption. At the same time, a new distortion is introduced between imports from member and non-member countries which were previously treated equally, and this can lead to inefficient diversion of trade from the least-cost global producer to a partner country which is less efficient but has an artificial price edge due to the preferential tariff. The trade creation and trade diversion effects of customs union accession work in opposite directions to leave the direction of change in welfare of the country joining a customs union, and of the world, theoretically ambiguous.

(Pomfret, 2005a).

⁹ Many regional agreements are intended to demonstrate special friendship. Especially at regional or bilateral summit meetings between autocratic leaders, who have few foreign policy instruments, a bilateral or plurilateral trade agreement is a popular outcome. This has been especially apparent in the former Soviet Union, where Presidents have announced a large number of RTAs, which have been allowed to lapse before they were implemented or were abandoned as political allegiances shifted (Pomfret, 2005c).

Thus, although a discriminatory tariff reduction, as in a customs union or free trade area, may be welfare-improving, the presumption is that, with competitive markets, removal of trade barriers on a non-discriminatory basis would be first-best (Johnson, 1965; Cooper and Massell, 1965). Politicians are often attracted to regional trading agreements for political reasons, but Viner's analysis explains why economic forces work against such arrangements in practice. The many RTAs involving developing countries broke down because each member might have liked trade to be diverted in favour of its own inefficient manufacturing enterprises, but did not want to bear the trade diversion costs of importing from its partners inefficient industries. If RTAs survived, then there was a suspicion that they involved some cost to third countries, eg. through terms of trade effects in favour of the union members, and this justifies the sceptical position vis-à-vis RTAs in the GATT.

A more positive attitude towards RTAs emerges if they are viewed as stepping stones to multilateral trade liberalization. Kemp and Wan (1976) showed that, if signatories of a preferential trading arrangement are required to ensure that no third country suffers a welfare loss, then there always exist welfare-improving PTAs and the process of forming such groupings will continue until all tariffs are zero. This proposition, however, requires members of a RTA to pay attention to the welfare of non-members and it ignores negotiating costs.

Although Balassa's taxonomy is sometimes seen as a sequence towards closer economic union, the decision to form an FTA or CU seems to be a choice rather than a sequence. An FTA is easier to negotiate, because it does not require agreement on a common external policy or on how to share tariff revenue.¹⁰ An FTA, however, suffers from the problem of trade deflection. Direct trade deflection, i.e. third-countries routing their supplies through the low-tariff member country as a point of entry into the FTA even when the final destination is a high-tariff member, can be averted by setting rules of origin (RoOs). If the low-tariff country has a substantial domestic production, then RoOs may not prevent indirect trade deflection, whereby the external imports go the low-tariff country while that country's own producers export to the high tariff (and therefore high-price) member country. The outcome is a race to the bottom, because the low-tariff country collects all of the FTA's tariff

¹⁰ A CU may require agreement on revenue sharing because the collection of customs duties under the common external tariff is not equitably distributed across countries, eg. in the EU Rotterdam's significance as a port means that many imports to northern Europe enter through the Netherlands even if their final destination is, for example, Germany.

revenue while the high-tariff country does not even obtain the intended protection for its producers.¹¹ Thus, true FTAs are rare, although the term has been hijacked and applied to RTAs which are not CUs.

4. The “New Regionalism” and Deep Integration

A novel feature of RTAs of the 1980s such as the Australia-New Zealand Closer Economic Relations, the US Canada Free Trade Agreement, or the EU enlargements, was that they involved countries with fairly low tariffs. Vinerian trade creation or trade diversion was likely to have small welfare implications, which raises the question of why were such RTAs formed. Supporters of the deeper EU, NAFTA or the CER argued that these were new forms of regionalism going into areas where the Vinerian analysis was inapplicable, such as increasing-returns industries, policy harmonization, or service activities.¹²

Most economies have policies to limit the creation or abuse of monopoly power. They differ in name (anti-trust, restrictive practices, anti-monopoly, competition policy, etc), and also differ in content and application. Content varies primarily due to differing views on the appropriate trade-off between permitting efficient realization of economies of scale and limiting the market power which large enterprises are likely to have. Lax implementation may reflect “capture” of the regulators by the people they are supposed to be regulating or lack of resources devoted to the regulatory authority. The issue for regional integration was illustrated when the EU was moving towards deeper integration in the 1980s. Members with tougher competition policies felt that firms from countries with laxer competition policies had a competitive edge, because monopoly profits at home could cover their fixed costs, enabling them to have lower marginal costs and hence be able to price more aggressively in other EU markets. This could initiate a race to the bottom, but

¹¹ Many authors (e.g. Crawford and Fiorentino, 2005, 17) state that RoOs can prevent trade deflection, but that is only true as a general statement if trade deflection is defined to include only direct trade deflection. Where tariffs are low, intra-FTA transport costs are high or products are differentiated (as in, for example, EFTA), then indirect trade deflection is less likely, although when it does occur there will be a deadweight welfare loss due to augmented transport costs. For analysis of trade deflection, see Pomfret (1997/2001, 185-8).

¹² The term deeper integration to capture regional agreements in these new areas was popularized by Robert Lawrence (1996).

that would allow undesirable abuse of monopoly power across the EU internal market, so the preferred solution was to negotiate a common competition policy.

Policy harmonization applies to many other areas. Non-tariff barriers hamper regional integration, and in many cases are used by producers to segment markets in order to enjoy local monopoly power. Major steps in creating the EU internal market involved establishing principles of mutual recognition and disallowing minor variations in safety, health or environment standards, although this has led to tedious case-by-case judgments. The landmark Cassis de Dijon case, in which a German law requiring liqueurs to have a minimum 32% alcohol content was found to have no public health justification, established that goods could not be redefined when they entered another EU country. Similarly, the German *Reinheitsgebot*, which set standards for beer purity, was declared an inadmissible non-tariff barrier. The specificity of judgments is, however, reflected in a case brought against a Danish law on reusable beer and soft drinks bottles, which non-Danish beer producers argued was a restriction on the free internal market, but which the EU allowed to continue as a justifiable environmental protection measure.

As border measures such as tariffs and non-tariff barriers to trade diminish, the significance of other trade costs becomes more apparent (Anderson and van Wincoop, 2004). If the behind-the-border costs vary from country to country, then the trade playing field is not flat. Foreigners will find greater difficulty in penetrating the market of a country which has poorly developed infrastructure, financial sector and other support services. This concept of unfairness has been most often voiced by the USA, which sees its home market as easier to supply than other countries' markets, and hence US exporters and import-competing producers are at a competitive disadvantage. Similar market opening pressures became a feature of the EU's market deepening, especially with respect to financial services after the last national-level capital controls were removed in the early 1990s. The third wave bilateral trade agreements often include measures of financial sector liberalization, especially when pushed by the USA or Singapore whose home financial sectors are relatively efficient.

A disadvantage of the second and third wave RTAs is that their increased complexity means that interest groups, who are well-informed about a particular sector, may become involved in design of the agreement and may shape the RTA to their own, but not necessarily the national, benefit. In the Vinerian analysis trade diversion is often more politically acceptable than trade creation because the losers

from trade diversion (domestic taxpayers and non-preferred foreign suppliers) have little impact on the policymaking process, whereas the costs from trade creation are born by domestic producer interests, who are typically better organized and more powerful in shaping policy. Thus, there is a potential trade-diverting bias in CU or FTA design, which is one justification for the GATT/WTO requirement that an FTA or CU should cover virtually all trade so that countries cannot customize RTAs to include only sectors where trade diversion is more likely.¹³ With deeper integration the exclusions may be less transparent. In NAFTA, the RoOs have been used especially for textiles and apparel and for automobiles to favour trade diversion. More broadly, the very detailed RoOs in NAFTA serve to manage trade, often to the benefit of specific US firms, while as a tax on intermediate inputs the RoOs' global impact is presumed to be negative (Krueger, 1999).¹⁴ The extension to service sectors in deep integration arrangements almost inevitably increases the opportunity for rent-seeking, because most service providers are governed by regulations which may be desirable but which also offer the opportunity to erect discriminatory barriers to trade.¹⁵

Despite the novel features of the third wave of regionalism, the thrust of the analysis of the first two waves remains valid. Even in the new areas, multilateral non-discriminatory trade liberalization is usually the best approach not only from a cosmopolitan global perspective, but also often for the net economic welfare of the participants in potential regional arrangements.¹⁶ The lack of transparency and the selective coverage of second- and third-wave RTAs make it more likely, given the political economy of trade policy, that trade-creating opportunities will be passed over because they hurt domestic producers while trade diversion will be permitted. Such selectivity might facilitate reaching agreement on a RTA, but, as happened with most of the first wave RTAs, it will undermine the sustainability of the new bilaterals.

¹³ Despite the restriction in GATT Article XXIV, European producers managed for several decades to ensure through the use of non-tariff measures that the preference margins were especially high on agriculture, textiles and clothing, cars and steel - all sectors where trade diversion was likely to exceed trade creation.

¹⁴ The 900+ pages required to document the North American Free Trade Agreement illustrate the earlier point that many RTAs described as FTAs do not fit the formal definition of a free trade area, which would require a very simple agreement to abolish tariffs on internal trade. This applies to all of the so-called free trade areas in Table 1.

¹⁵ Messerlin (2005) cites the example of the high-level French lobbying to exclude bailiffs, notaries and barristers to the Supreme Courts from the EU Directive on Services.

¹⁶ This chapter does not address monetary integration, but a similar generalization about the economic benefits of a single money applies, subject to caveats about the optimal administration of monetary policy; see Pomfret (2005b).

5. Rethinking the Level of Analysis

Deep integration, or the final level in Balassa's taxonomy (economic union), poses an analytical problem. At what stage does an RTA become a nation state? We no longer think of the German, Italian, Canadian or Australian customs unions as RTAs, because the CU element was subsumed in nation-state formation. Today, the EU is not a nation state, but in some international organizations it has a single voice (eg. the WTO); at what point should the EU be treated as a single unit in the global economy?

What determines the size of nations? Alesina, Spoloare and Wacziarg (2000) argue that the number of nations is endogenous to the state of the global economy. The optimal size of a nation depends upon the marginal benefits of size (eg. ability to provide public goods such as national security which are characterized by scale economies) and the marginal costs of size (eg. increased difficulty in reaching agreement on national policies). One of the benefits of size is a larger domestic market, but this is less important in a global economy characterized by low barriers to international trade.¹⁷ Other things equal, in a more open global economy the optimal size of a nation is smaller and there will be more nations. As evidence in support of the hypothesis that the global trade regime matters, Alesina, Spoloare and Wacziarg contrast the 1920s and 1930s, when trade barriers were high and there was no increase in the number of nations, with the GATT/WTO era, when substantial decline in average tariffs was accompanied by an increase in the number of nations from about seventy to over two hundred.

Others view the proliferation of small states as part of a challenge to the primacy of the nation state in the global economic system. During the 1960s and 1970s the major economies realized that they had to accept limits on their monetary policy independence if they wanted to have efficient global capital markets and exchange rate stability. This trade-off has played out in other areas where the demands of an efficient global economy imply restrictions on national policy autonomy. Rodrik (2000), in a review of the global economy over the period 2000-

¹⁷ Alesina and Spoloare (2005) analyse the relationship between the benefits of size in the provision of national security and the likelihood of war, arguing that a better defined global security regime encourages country break-up (ie. an increase in the number of nations) but also leads to numerous local conflicts.

2009, foresees the rise of global federalism as the most important trend, driven by the need to reconcile the pressure for global policies with democratic control.

A more general view of this process is captured by the term “subsidiarity”, i.e. each policy should be dealt with at the lowest efficient level of decision-making. Some policies are more efficiently determined at a local level, eg. refuse disposal or zoning laws, while others are best done at a global level, eg. world trade law or the law of the sea, and the rest are best done at a variety of intermediate levels (regional, national, provincial, etc.). This process is most advanced in the EU, where national governments have simultaneously ceded some policy autonomy to the EU and some policy autonomy to sub-national regions such as Scotland, Catalonia, or Brittany. In general, the move from a centralized state to forms of fiscal federalism is positively related to the level of per capita income (Arzaghi and Henderson, 2005).

A positive building block argument for regional agreements is that they can be testing grounds for international policies in new areas, although turning a policy designed by a few countries into a global institution may arouse fears of it being moulded to the designers’ interests.¹⁸ An alternative building block argument is to recognize that regional agreement in a controversial new area may be easier than global agreement; the EU’s harmonization of competition policy illustrated the difficulty of reaching agreement even among countries with fairly similar economic structures.

Although RTAs focussing on non-tariff issues may become a feature of the global economy in future, it is important to emphasise that the process is at an embryonic stage. The empirical evidence in favour of the use of the nation state as the basic unit in international economics is strong. Even in the highly integrated North American market, Canadian trade exhibits a surprisingly large home-country bias. This was highlighted by John McCallum (1995), who found a large border effect in a gravity model analysis of trade among Canadian provinces and US states, and by Charles Engel and John Rogers (1996) who found a large border effect in analysing price variation across nine Canadian and fourteen US cities; in both studies distance matters, whether in determining trade flows or price arbitrage, but there is a huge discontinuity when the national border is crossed, even when it is an open border

¹⁸ The ill-fated multilateral investment agreement designed by the OECD is perhaps an example. The low and middle-income countries were never likely to accept a global regime on foreign investment designed by the rich countries which were the home of most transnational corporations.

between two economies with low trade barriers and to some degree similar cultures. McCallum graphically compared the volume of trade between Ontario and British Columbia with that between Ontario and California; although the Californian economy is much larger than that of BC and roughly equidistant from Ontario, Ontario trades much more with BC. The magnitude of McCallum's border effect has been questioned by Anderson and van Wincoop (2003), who also argue that a border effect is far more significant for the large country (the USA) than for the smaller country (Canada), but the presence of a US-Canada border effect seems incontrovertible.

Market forces may override a border effect even in the absence of a formal RTA. In North America, close relations between San Diego and Tijuana and other border pairs pre-dated NAFTA, and there is also a Great Lakes industrial region in which southern Ontario is more closely linked to south-east Michigan than to other parts of Canada (in contrast to McCallum's continent-wide finding). In East Asia, Sijori (Singapore-Johor-Riau) and the Pearl River Delta have been identified as sub-regional economic zones, which incorporate parts of neighbouring countries. In both these cases the process of regional integration involves parts of some countries, not the entire nation, and it is market-driven rather than a result of formal agreements.¹⁹

6. Conclusions

The theory and practice of RTAs has evolved considerably over the last half century. Viner's analysis remains relevant to any discriminatory arrangement, including RTAs, which is based on preferential tariffs or, with modifications depending on the specific measure, to non-tariff barriers imposed on a preferential basis. Attempts to form seriously discriminating RTAs have foundered in Latin America and Africa, and failed to get off the ground in Asia, largely because policy makers did not want to bear the trade diversion costs of importing from inefficient producers in partner countries. The most salient RTAs in the current world economy (the European Union, the North American Free Trade Area, or Closer Economic Relations between

¹⁹ This alternative view of the role of distance arises from the New Location Theory (Krugman, 1991; Fujita, Krugman and Venables, 2002) in which the existence of cities implies some scale economies. When such agglomeration effects spill across borders, the phenomenon is often referred to as a sub-regional economic zone (Pomfret, 1996).

Australia and New Zealand) all have liberal external trade policies, so that they could properly be called regional arrangements for matters beyond trade.

In a world where tariffs and simple non-tariff trade barriers have diminished, other trade costs come to the fore, and as markets become more regionally or globally integrated there are increasing pressures for harmonization in a greater number of policy areas. In this process, regional arrangements have a role to play as some policy regimes may desirably be supra-national but sub-global. Regional arrangements may also be testing grounds for innovations in policy coordination or harmonization, and hence act as building blocks towards identifying well-designed global policies. On the other hand, the increased complexity of regional arrangements which cover such areas opens up opportunities for managed trade that can benefit insiders and become a stumbling block to progress at the global level.²⁰

²⁰ The stumbling block case has been most forcefully argued by Jagdish Bhagwati, and in joint contributions by Bhagwati and Panagariya (1996). Bhagwati emphasises the negative systemic consequences of eroding the non-discrimination principle. Estevadeordal and Suominen (2003), whose catalogue of RoOs shows them to be often product-specific and rarely consistent from one RTA to another, conclude that failure to harmonize RoOs exacerbates hub-and-spoke relationships and is an obstacle to freer global trade. Özden and Reinhardt (2005) provide empirical evidence, based on eligibility for favourable treatment under the Generalized System of Preferences for developing countries, that preferential access to export markets is associated with less liberal trade policies towards imports. There is also evidence in the Doha Round negotiations that countries benefiting from preferential market access for important exports are opposed to multilateral trade liberalization by their trading partners because that will erode their margin of preference.

References

- Alesina, Alberto, and Enrico Spolaore (2005): War, Peace, and the Size of Countries, *Journal of Public Economics* 89, 1333-54.
- Alesina, Alberto, Enrico Spolaore and Romain Wacziarg (2000): Economic Integration and Political Disintegration, *American Economic Review* 90, 1276-96.
- Anderson, James, and Eric van Wincoop (2003): Gravity with Gravitas: A Solution to the Border Problem, *American Economic Review* 93(1), 170-92.
- Anderson, James, and Eric van Wincoop (2004): Trade Costs, *Journal of Economic Literature* 42(3), 691-751.
- Arzaghi, Mohammad, and J. Vernon Henderson (2005): Why Countries are Fiscally Decentralizing, *Journal of Public Economics* 89, 1157-89.
- Balassa, Bela (1961): *The Theory of Economic Integration* (Richard D. Irwin, Homewood IL).
- Bhagwati, Jagdish, and Arvind Panagariya (1996): *The Economics of Preferential Trade Agreements* (American Enterprise Institute Press, Washington DC).
- Cooper, Charles, and Benton Massell (1965): A New Look at Customs Unions Theory, *Economic Journal* 75, 742-7.
- Crawford, Jo-Ann, and Roberto Fiorentino (2005): The Changing Landscape of Regional Trade Agreements, *WTO Discussion Paper No.8*, World Trade Organization, Geneva.
- Engel, Charles, and John Rogers (1996): How Wide is the Border? *American Economic Review* 86, 1113-25.
- Estevadeordal, Antoni, and Kati Suominen (2003): Rules of Origin: A World Map – draft paper presented at a conference on *Regional Trade Agreements in Comparative Perspective: Latin America and the Caribbean and Asia-Pacific*, organized by the Pacific Economic Cooperation Council (PECC) and the Latin America/Caribbean and Asia/Pacific Economic and Business Association (LAEBA), Washington DC 22-3 April.
- Fujita, Masahisa, Paul Krugman and Anthony J. Venables (2002): *The Spatial Economy: Cities, Regions, and International Trade* (MIT Press, Cambridge MA).
- Johnson, Harry (1965): An Economic Theory of Protectionism, Tariff Bargaining and the Formation of Customs Unions, *Journal of Political Economy* 73, 256-83.
- Kemp, Murray, and Henry Wan (1976): An Elementary Proposition Concerning the Formation of Customs Unions, *Journal of International Economics* 6, 95-7.

- Krueger, Anne (1999): Free Trade Agreements as Protectionist Devices: Rules of Origin, in James Melvin, James Moore and Raymond Riezman (eds) *Trade, Theory and Econometrics: Essays in Honor of John S. Chipman*, Studies in the Modern World Economy, vol.15 (Routledge, London UK), 91-102.
- Krugman, Paul (1991): *Geography and Trade* (MIT Press, Cambridge MA).
- Lawrence, Robert (1996): *Regionalism, Multilateralism, and Deeper Integration* (Brookings Institution, Washington DC).
- McCallum, John (1995): National Borders Matter: Canada-USA Regional Trade Patterns, *American Economic Review* 85, 959-67.
- Messerlin, Patrick (2005): The Directive on Services: Rent Seekers Strike Back, *Intereconomics* 40(3), 120-4.
- Panagariya, Arvind (2000): Preferential Trade Liberalization: The Traditional Theory and New Developments, *Journal of Economic Literature* 38, 287-331.
- Patterson, Gardner (1966): *Discrimination in International Trade: The policy issues, 1945-1965* (Princeton University Press, Princeton NJ).
- Özden, Çağlar, and Eric Reinhardt (2005): The Perversity of Preferences: GSP and Developing Country Trade Policies, 1976-2000, *Journal of Development Economics* 78, 1-21.
- Pomfret, Richard (1996): Sub-Regional Economic Zones, in Bijit Bora and Christopher Findlay (eds.), *Regional Integration and the Asia Pacific* (Oxford University Press, Melbourne), 207-22
- Pomfret, Richard (1997): *The Economics of Regional Trading Arrangements* (Clarendon Press, Oxford; paperback edition with new Preface, Oxford University Press, Oxford, 2001).
- Pomfret, Richard (2005a): Sequencing Trade and Monetary Integration: Issues and application to Asia, *Journal of Asian Economics* 16(1), 105-24.
- Pomfret, Richard (2005b): Currency Areas in Theory and Practice, *Economic Record* 81 (253), 166-76.
- Pomfret, Richard (2005c): Trade Policies in Central Asia after EU Enlargement and before Russian WTO Accession: Regionalism and integration into the world economy, *Economic Systems*, 29(1), 32-58.
- Rodrik, Dani (2000): How far will International Economic Integration go? *Journal of Economic Perspectives* 14(1), 177-86.
- Viner, Jacob (1950): *The Customs Union Issue* (Carnegie Endowment for International Peace, New York).

World Bank (2005): *Global Economic Prospects 2005: Trade, Regionalism, and Development* (World Bank, Washington DC).

Table 1: RTAs notified to the WTO January-June 2005

Agreement	Notification date	WTO Provisions	Type of agreement
Thailand-Australia	5 January	Article XXIV	Free trade agreement
Thailand-Australia	5 January	GATS Art.V	Services agreement
Moldova-Bulgaria	28 January	Article XXIV	Free trade agreement
Moldova-Bosnia &H	28 January	Article XXIV	Free trade agreement
Moldova-Serbia &M	28 January	Article XXIV	Free trade agreement
Moldova-Croatia	31 January	Article XXIV	Free trade agreement
Moldova-FYROM	31 January	Article XXIV	Free trade agreement
Romania-Bosnia &H	14 February	Article XXIV	Free trade agreement
Romania -Serbia &M	14 February	Article XXIV	Free trade agreement
Romania -FYROM	14 February	Article XXIV	Free trade agreement
Bulgaria-Bosnia &H	11 March	Article XXIV	Free trade agreement
Bulgaria -Serbia &M	11 March	Article XXIV	Free trade agreement
Panama-El Salvador	18 March	Article XXIV	Free trade agreement
Croatia-FYROM	1 April	Article XXIV	Free trade agreement
Panama-El Salvador	5 April	GATS Art.V	Services agreement
Japan-Mexico	22 April	Article XXIV	Free trade agreement
Japan-Mexico	22 April	GATS Art.V	Services agreement
Romania-Israel	25 April	Article XXIV	Free trade agreement
FYROM-Bosnia &H	11 May	Article XXIV	Free trade agreement
EFTA-Tunisia	7 June	Article XXIV	Free trade agreement

Source: <http://www.wto.org> – accessed 19 October 2005