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Making Regionalism Complementary to Multilateralism

The emergence of a more proactive stance in multilateral negotiations by developing countries in parallel with an explosion of preferential regional trade agreements (RTAs) around the world raises an important question: Are these trends complementary, representing different paths to the same desired outcome of faster growth, development, and poverty reduction, or are they competing and incompatible? In principle, the best outcome for all countries would be a nondiscriminatory trading system; developing countries, in particular, would benefit from a nondiscriminatory trading system because most poor people and many poor countries might find themselves excluded from preferential deals. If the explosion in RTAs implies a higher probability that the majority of developing countries would face greater discrimination than under an MFN (or nondiscriminatory) regime, the world as a whole will be worse off, and individual developing countries may lose substantially.¹

RTAs can be a complement to multilateral reform, but they are not a substitute. Consider a scenario, modeled in the first section of this chapter, in which each developing country signed an agreement with the United States, the European Union (EU), Canada, and Japan—the Quad. Each developing country could raise its real incomes by *individually* signing bilateral agreements with the Quad countries; and in some cases they would raise their real incomes more than they would through multilateral accords. But these gains

disappear if *all* developing countries were to sign such agreements. In fact, all developing countries would lose relative to a multilateral agreement and even relative to the baseline. This scenario underscores the fact that, while stalled collective action through multilateral channels creates a strong incentive for each developing country to sign a regional agreement, if every country does so, they all lose.

RTAs do alter the incentives for countries to participate in multilateral liberalization. RTAs can be a stumbling block to multilateral arrangements by creating incentives to resist the preference erosion that can occur through new multilateral liberalization. However, because the gains are often substantially larger in multilateral agreements, concerns over preference erosion may be limited to a few small countries that could conceivably block a multilateral agreement. Those recalcitrant countries resisting reforms are likely the beneficiaries of preferences associated with distorted agreements encompassing agriculture or the clothing and textile trade, not RTAs. Large developed countries may gain more from signing individual bilateral agreements than they would from a multilateral accord, because they can use the carrot of preferential access to extract concessions in nontrade areas from developing country partners that would be resisted in the WTO negotiating framework. But we see little evidence that the high-income countries have reduced their effort to bring the current multilateral negotiations to fruition.

From a development perspective, the WTO remains the best-available forum to discipline the use of trade-distorting policies. RTAs can complement the WTO efforts by cooperating on behind-the-border policies, especially on regulation-intensive issues such as services, trade facilitation, and the investment climate. Governments pursuing this agenda through RTAs must adopt rules that are appropriate to their own level of development. To be effective, the rules must target a priority concern, must be enforceable, and must avoid becoming a tax on scarce resources that would be better used elsewhere. Getting the rules “right” so that they promote development has implications for negotiations and enforcement of the resulting disciplines. The potential for inappropriate outcomes is higher in North–South RTAs because the asymmetry in negotiating power can overtake real development priorities.

Reinforcing the complementarity between regionalism and multilateralism and minimizing the latent tensions must begin with the completion of the Doha Development Agenda. If the Doha Development Agenda is completed in a way that actually promotes development, it would bring down tariffs, enhance the gains from open regionalism, and discipline any exclusionary effects of regional accords.

All countries could take steps to promote open regionalism—the developing countries, high-income countries, and the international community working together through the WTO. Developing countries are likely to have the greatest success in harnessing trade for growth and poverty reduction if they adopt a three-pronged strategy that involves autonomous liberalization, active multilateralism, and open regionalism.

High-income countries could promote open regionalism by including agriculture in RTAs. They could adopt more common and nonrestrictive rules of origin across agreements; and, to the extent that these rules set patterns common to most agreements, the burden on customs administration would be reduced. They could work with prospective

partners to ensure that new regulations regarding investment and intellectual property are appropriate to the level of development, which would reduce risks of undue enforcement costs. Finally, they could provide trade-related technical assistance not only in the implementation phase but also in the negotiating phase, which could promote greater liberalization and supply response to new market opportunities in regional or global markets.

The international community, working through the WTO, can reduce discrimination in the system. The procedures associated with RTA disciplines as currently configured are ill-suited to limit either their proliferation or to control their discriminatory provisions. WTO members should establish stronger multilateral surveillance mechanisms to document, analyze, and monitor the effects of RTAs on nonmembers. Expanding the information on the impact of RTAs to stakeholders—firms, consumers, taxpayers—would also help ensure that the potential benefits of liberalization are both realized and distributed more equitably. Medium-term efforts should focus on implementing WTO disciplines on regional agreements.

Preferential Agreements within the Global Context

To place preferential trade arrangements in a multilateral context, we evaluate how different collections of trade agreements compare with multilateral alternatives. For this evaluation, we utilize the World Bank’s global trade model known as LINKAGE, which has been used in previous *Global Economic Prospects*. The model is built around the GTAP database that is widely used to assess the global, regional, and country implications of alternative trade liberalization scenarios. However, the results described in this year’s report reflect an update of the model’s database, which has two notable differences. First, it has a new base year, 2001 (the old base year was 1997). Second, it has a new protection database that takes better account of preferential trade access. Box 6.1 provides a brief

Box 6.1 Impacts of the new GTAP database

The simulation results from the World Bank's LINKAGE model were presented in the past three issues of *Global Economic Prospects* (2002, 2003, and 2004) and were based on the use of various versions of Release 5 of the GTAP dataset.* An updated version of the data has become available; pre-release 6.04 was released in September 2004. The main innovations of the new dataset include a more recent base year (2001 instead of 1997), revised national input-output tables, and a new database for estimating the levels of trade protection. This last innovation is likely to have a large impact on trade scenarios. First, a brief digression on a technical issue regarding the new base year: The global database, to a large extent, is the outcome of merging national data. The national input-output tables have different base years and are virtually always in national currencies. Thus they must be updated to the given base year—2001 in the case of the new release—and converted to the database's common currency (i.e., the U.S. dollar). This has a practical implication because of movements in the value of the dollar. In 1997, the U.S. dollar was relatively strong (for example, \$1.13 per euro), and it was much weaker in 2001 (\$0.90 per euro). This means that the relative weight of countries will change between the two base years (holding growth constant). In fact, the global U.S. economy as a share of global output was around 32 percent in 1997 and only 27 percent in 2001. Thus the change in the value of the dollar will have some impact on the reported gains from trade reform, both globally and by region.

The more important change in the database relates to the change in protection. The new protection data relies on the MACMaps dataset—a collaborative effort of CEPII (Paris) and the International Trade Centre (ITC, Geneva). Among the prominent features of the MACMaps dataset is the incorporation of preferential tariff regimes and the conversion of specific tariffs to ad valorem equivalents; it thus represents a more realistic picture of the bilateral levels of protection. In summary, the new database will capture the

considerable reform between 1997 and 2001 (e.g., continued implementation of the Uruguay Round and China's progress towards WTO accession), and an improved treatment of preferential trade agreements.

The overall impact of these changes is that the World Bank's estimate of the global gains from global merchandise trade reform is now around \$260 billion** (in 2015, relative to the baseline scenario), compared with around \$380 billion using the 1997-based results from previous GEPs.*** The lower number reflects, to a large extent, the impacts of trade reforms achieved between 1997 and 2001 and the incorporation of preferences.**** The allocation of the gains across regions and sectors is broadly consistent with the previous results. Thus 41 percent (instead of 45 percent) of the gains from global reform accrue to developing countries, and agricultural reform generates some 47 percent (instead of 58 percent) of the global gains.

*The GTAP dataset is a product of the Global Trade Analysis Project (GTAP), based at Purdue University, with funding from an international consortium of international and national agencies (including the World Bank), universities, and research centers. Since its initial development in the early 1990s, the GTAP dataset has become the premiere dataset for undertaking global trade analysis. The current version includes a full social accounting matrix for 87 regions (of which 69 are individual countries), 57 economic sectors, and fully consistent bilateral trade flows.

**These results should still be viewed as preliminary as the GTAP consortium is preparing for the final release sometime before the end of 2004. The final release may result in some changes at the micro level, but will probably only have a relatively minor impact at the aggregate level.

***These gains refer to the so-called "static" effects, i.e., not taking into account dynamic effects such as improvements in productivity.

****There are other technical differences, including among others, the relative change of the value of the U.S. dollar as mentioned above. The LINKAGE model, apart from the change in the database, is identical to that used in the last *Global Economic Prospects*.

summary of these changes and the impacts of using the new database relative to the results outlined in previous *Global Economic Prospects*.

To assess the relative impacts of various RTAs, it is useful to develop a benchmark simulation (apart from the baseline). The benchmark simulation is a global reform

Table 6.1 Comparison of bilateral agreements to global trade reform (change in real income in 2015 compared to baseline)

	Global	Bilateral with Quad	Bilateral minus large countries	Global	Bilateral with Quad	Bilateral minus large countries
	(1)	(2)	(3)	(4)	(5)	(6)
	\$ billion			Percent		
High-income countries	154.4	133.6	46.9	0.6	0.5	0.2
Low-income countries	16.6	-19.0	-1.9	0.9	-1.0	-0.1
Middle-income countries	92.2	-2.6	-4.7	1.2	0.0	-0.1
All developing countries	108.8	-21.5	-6.6	1.2	-0.2	-0.1
World Total	263.2	112.0	40.3	0.8	0.3	0.1

Source: World Bank simulations.

scenario in which all merchandise trade distortions are eliminated (services reform is left out for lack of sufficient data), domestic distortions in agriculture are removed (input and output subsidies, direct payments, and export subsidies), and import quotas in the textile and clothing sectors are removed. This scenario would be the ultimate long-run outcome of successful multilateralism. Under this reform scenario, the global gains in 2015 amount to \$263 billion, or an increase of 0.8 percent in baseline income (table 6.1).²

How much do regional trade agreements benefit developing countries?

To examine how bilateral agreements affect developing countries, we look at three simulations: One in which *all* developing countries sign a bilateral agreement with Quad-plus countries (United States, EU, Japan, Canada, plus Australia and New Zealand);³ a second simulation—similar to the first simulation—in which the large countries, such as Brazil, China, and India are excluded, which is perhaps a more plausible scenario; and a third in which *each* developing country/region signs an individual bilateral agreement with the Quad-plus countries, assuming other developing countries do not sign agreements.⁴ Note that these scenarios *overstate* bilateral and multilateral effects because they assume that no sectors are exempt, and rules of origin are not restrictive. In reality, the United States and EU bilateral agreements usually exclude important sectors, such as sensitive agricultural products, or attach extended phase-in periods

beyond even our 2015 time horizon, and rules of origin tests often limit preferential market access.

The first simulation, in which all developing countries sign a bilateral agreement with the Quad-plus countries (columns 2 and 5 in table 6.1), shows that, as a group, developing countries are substantially worse off than with a multilateral agreement. Instead of gaining \$109 billion from global reform, they lose \$22 billion relative to a baseline scenario, with no change in protection. If one looks at individual countries (table 6.2), the effect is nearly universal; only a handful of developing countries—for example, Brazil and China—would gain from a full hub-and-spoke system of bilateral agreements, and all developing countries would lose compared to full multilateral trade.

It is interesting that some of the Quad countries would benefit from this strategy. Although the high-income countries would generally lose from this set of bilateral agreements compared to global reform, the impact is not uniform.⁵ Both the United States and the EU (the most aggressive advocates of bilateral deals) would appear to benefit more from pursuing bilateral agreements with all developing countries than from global reform (table 6.2); the United States would gain an additional \$7 billion (0.1 percent of GDP), while the EU would gain \$27 billion (0.4 percent of GDP). Although they would have to open up their agricultural markets to some extent (assuming exemptions are disallowed), they would not have to dismantle domestic

**Table 6.2 Comparison of bilateral agreements with global trade reform
(change in real income in 2015 compared to baseline)**

	Global merchandise trade reform (1)	Bilateral agreements between Quad and all developing countries (2)	Bilateral agreements between Quad and developing countries excluding large countries (3)	Bilateral agreements between Quad and each developing country (4)	Global merchandise trade reform (5)	Bilateral agreements between Quad and all developing countries (6)	Bilateral agreements between Quad and developing countries excluding large countries (7)	Bilateral agreements between Quad and each developing country (8)
	\$ billion				Percent			
Australia, Canada, and New Zealand	8.4	6.0	0.5		0.7	0.5	0.0	
United States	24.9	32.3	10.7		0.2	0.3	0.1	
European Union with EFTA	55.0	82.4	33.6		0.7	1.1	0.4	
Japan	29.7	25.0	4.8		0.9	0.8	0.1	
Republic of Korea and Taiwan (China)	26.4	-9.8	-2.3		2.6	-1.0	-0.2	
Hong Kong (China) and Singapore	9.8	-2.4	-0.3		2.8	-0.7	-0.1	
Brazil	8.0	1.5	-1.7	7.3	1.4	0.3	-0.3	1.3
China	14.1	9.7	-7.2	21.8	0.6	0.4	-0.3	1.0
India	4.3	-10.0	-3.1	2.1	0.5	-1.2	-0.4	0.2
Indonesia	3.6	-2.3	3.0	5.1	1.4	-0.9	1.2	2.1
Mexico	0.3	-1.5	-1.3	2.6	0.0	-0.2	-0.2	0.3
Russia	2.9	-1.7	-1.3	0.8	0.8	-0.5	-0.3	0.2
SACU	2.5	-0.3	0.8	3.7	1.8	-0.2	0.5	2.6
Vietnam	2.4	-0.2	0.6	0.9	5.0	-0.5	1.3	1.9
Rest of East Asia	19.6	-5.0	-2.8	7.4	4.7	-1.2	-0.7	1.8
Rest of South Asia	0.4	-3.2	-1.1	1.2	0.2	-1.3	-0.4	0.5
EU accession countries	0.8	-2.0	-0.5	0.9	0.2	-0.4	-0.1	0.2
Rest of ECA	2.3	-3.3	-1.3	0.4	0.5	-0.7	-0.3	0.1
Middle East	6.1	-2.7	-0.1	1.3	0.9	-0.4	0.0	0.2
North Africa	19.1	1.9	4.3	5.7	6.7	0.6	1.5	2.0
Rest of Sub-Saharan Africa	2.9	-3.0	-2.5	-0.2	1.1	-1.2	-1.0	-0.1
Rest of LAC	16.3	0.9	6.4	9.6	1.6	0.1	0.6	0.9
Rest of the World	3.0	-0.3	1.2	4.0	1.3	-0.1	0.6	1.8
High-income countries	154.4	133.6	46.9		0.6	0.5	0.2	
Low-income countries	16.6	-19.0	-1.9		0.9	-1.0	-0.1	
Middle-income countries	92.2	-2.6	-4.7		1.2	0.0	-0.1	
All developing countries	108.8	-21.5	-6.6		1.2	-0.2	-0.1	
World Total	263.2	112.0	40.3		0.8	0.3	0.1	

Source: World Bank simulations.

support programs. Hence the EU and the United States improve market access in highly protected markets in developing countries, but they do not face the full force of competition between themselves, particularly in agriculture, nor the full brunt of competition in developing countries. For example, when India opens up to Quad country imports, Quad country exporters do not simultaneously face increased competition from developing country exporters as they would in a multilateral agreement. In agriculture, Quad producers will face greater competition from relatively efficient developing country exporters, but some of the fiercest competition will be among themselves. And the terms of trade losses that they would suffer from removing agricultural protection between Quad countries is muted when signing the bilateral agreements. Note that this is not the case with Japan, whose agriculture is relatively more threatened by developing country market access; it would gain more from a multilateral agreement, although it nonetheless gains significantly from bilateralism. It is the Quad-plus agricultural exporters—Australia, Canada, and New Zealand—that would prefer multilateralism, because the gains from access to European, Japanese, and the American markets, and the dismantling of distortionary agricultural support programs would be highly beneficial for their farmers.

Were the large developing countries⁶ to be excluded from the hub-and-spoke bilateral arrangements (perhaps a more plausible scenario), the broad conclusions still hold, but are muted (columns 3 and 6). First, many developing regions still lose in absolute terms compared with the baseline scenario. Second, all lose relative to the gains from a global reform scenario, though for some, the hub-and-spoke gains approach those in the global reform scenario (e.g., Indonesia, and to a lesser extent, the rest of LAC and rest of the world regions). The gains for the high-income countries, on the other hand, are significantly lower when the large developing countries are

excluded—not surprising given their weight in global trade with the Quad countries. Finally, the impacts on the excluded countries are mixed: Brazil and China, which would gain in a full hub-and-spoke system, lose when excluded. The other excluded regions—India, Mexico, Russia, rest of East Asia, and rest of South Asia—would see a dampening of their losses.

This adverse outcome from bilateral agreements with the Quad raises the question of why developing countries are so anxious to pursue them. There are a number of possible reasons, not necessarily mutually exclusive. First, countries may hope to maximize their benefits through first-mover advantages. Second, countries aim to guarantee market access on a permanent basis. Third, there might be a desire to pre-empt other countries. Fourth, a bilateral agreement may be used as leverage to facilitate domestic reforms. And fifth, other components of an agreement (for example, services, trade facilitation, and so on) may have significant benefits in addition to simply improving market access for merchandise goods. Focusing on the first of these possible reasons, we use the model to simulate the impact of *each* developing country signing an agreement with the Quad countries, but with no other country doing so. The results (table 6.2 columns 4 and 8) provide some justification for developing countries' pursuit of RTAs with the Quad if they believe they can do so exclusively, or at least capture a "first mover" advantage by getting there first. About one-half of the developing regions would be better off with a bilateral agreement than with a global agreement; the winners (relative to global liberalization) include China, Indonesia, Mexico, Southern African Customs Union (SACU), rest of South Asia, and EU accession countries. Losers include Brazil (slightly), India, Russia, Vietnam, rest of East Asia, rest of ECA, Middle East, North Africa, rest of Sub-Saharan Africa, and rest of LAC.

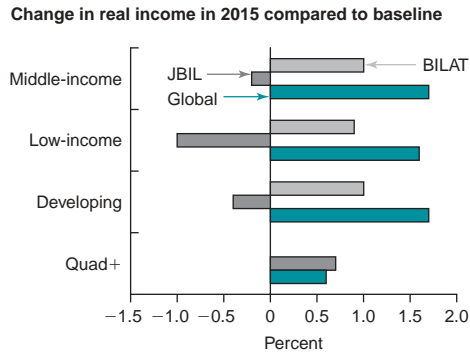
A few cases deserve special mention. The rest of the Sub-Saharan Africa region could

suffer losses from a bilateral agreement with the Quad. Because this region already has relatively free access to the Quad markets, opening up to permit greater imports from the Quad worsens their terms of trade and negates any gains from the bilateral agreement. Russia and the Middle East are dependent on energy exports and these face low tariffs in industrial countries (even if energy is heavily taxed), so these regions have little to gain from additional market access. These cases highlight one of the key findings from recent *Global Economic Prospects*, that developing countries have much to gain from greater market access to other developing countries. First, because protection is, on average, higher in developing countries, and second, because of the high growth potential of developing countries over the next decade compared with the industrial countries.

The idea that a single developing country or region would be able to sign bilateral agreements with the Quad countries without other developing countries doing the same over the next decade is unrealistic. Indeed, the increase in the number of agreements over the last decade means that a portion of any first-mover advantage has been eroded already. But as a conceptual exercise, it does help illustrate what may have motivated some developing countries to aggressively pursue deals with one or more Quad members.

To summarize, developing countries could gain an (unweighted) average of 1.7 percent in real income from a global agreement (figure 6.1). But if all developing countries sign bilateral agreements with the Quad, creating a complex hub-and-spoke system, developing countries actually suffer losses averaging 0.4 percent (1.0 percent for the low-income countries alone). While some individual developing countries might have gained from entering exclusive agreements with Quad countries, RTA proliferation has already eliminated that first-mover advantage. Moreover, RTA-induced structural changes could produce disincentives for achieving broad-based multilateral

Figure 6.1 Global outcomes dominate alternatives



Note: *Global* refers to the global merchandise trade reform scenario, *JBIL* corresponds to the simulation where all developing countries sign bilateral agreements with the Quad-plus, and *BILAT* corresponds to the simulation where the bilateral agreements are signed individually. Results reflect un-weighted regional averages.

Source: World Bank simulations.

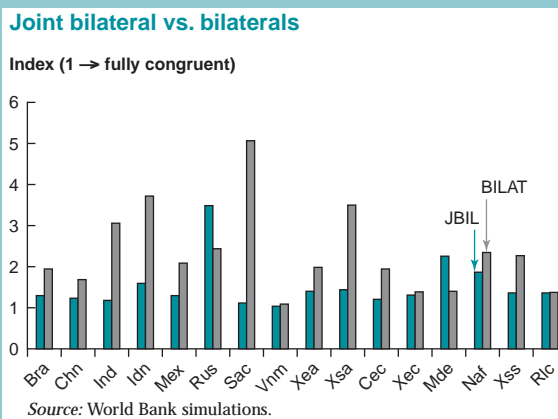
reforms (box 6.2). The implications are clear: The most development friendly outcome is associated with global reform, and a full set of bilateral agreements would leave virtually all developing countries worse off than at present.

Countries are also pursuing other RTAs, both North-South and South-South. These agreements are linked to the ongoing talks on the Free Trade Areas of the Americas (FTAA), the ASEAN+3 negotiations, and the EU's various agreements/negotiations with the EU-accession countries toward the east, partners around the Mediterranean, and in Sub-Saharan Africa toward the south. Chapter 2 of this report documents the large number of existing or prospective agreements among developing countries. Figures 6.2 and 6.3 summarize the overall impacts from simulating selected North-South and South-South agreements.⁷ Some of these proffer relatively significant gains (for example, a broad free trade region in East Asia), but are nonetheless clearly inferior to the gains from global merchandise

Box 6.2 Regional trade agreements, structural change, and congruence

While impact assessment of RTAs and global agreements often focus narrowly on the real income impacts, from a political economy point of view, the main drivers of these agreements typically will be at the micro or institutional level, where it is easier to identify the potential winners and losers. Moreover, the macro analysis typically ignores the transitional costs. A final issue deals with the compatibility of partial reforms (as represented by preferential trade agreements) with multilateral reforms, which is arguably where the world economy is heading. In other words, how compatible are the structural changes induced by a partial reform with the structural changes one would anticipate from a multilateral reform? For example, what if a country such as Vietnam has a regional comparative advantage in agriculture, but a global comparative advantage in apparel? Would a regional agreement then make it more difficult to achieve a multilateral accord?

The figure above provides a summary indicator of the congruence or compatibility of the bilateral agreements—both the individual (BIL) and joint (JBIL). The indicator measures the average structural change of moving from the baseline to the partial agreement, and then moving from the partial agreement to global free trade, relative to the structural change induced by the global agreement. If the partial agreement is compatible (or congruent) with the global agreement, this measure is 1; that is, the two-step structural change is identical to the one-step structural change from implementing directly a global free trade agreement. For example, a global agreement of a 50 percent tariff cut is largely congruent with a 100 percent tariff cut and would most



likely lead to a 50 percent change in our structural adjustment measure.

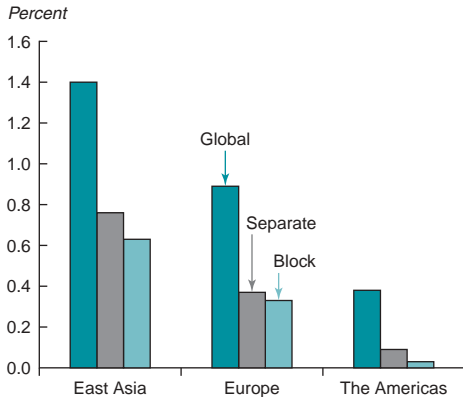
For most of the developing regions, the joint bilateral agreements are broadly consistent with the global agreement, with the structural index varying from around 1 (or near perfect congruence) to a high of around 2—for example, for Middle East and North Africa. On the other hand, the individual bilateral agreements are clearly not congruent with a global agreement. The pattern of structural change induced by the individual bilateral agreements is markedly different from what one would anticipate with a global agreement. Developing countries therefore face a tradeoff. They can get short-term benefits from signing a bilateral agreement with the Quad—assuming other countries do not—but the longer-term gains from a global agreement may be more difficult to attain because the patterns of capital and labor allocation would be misaligned by the partial agreement.

trade reform. Two additional comments regarding the results of these regional simulations are suggested by the figures.⁸ First, when North-South agreements are implemented simultaneously, the gains are dampened relative to when they are implemented in isolation—a reflection of the impacts of trade diversion. In

the case of the South-South agreements, the weak gains reflect, in part, the preferences already granted in many of these regions as well as a lack of distinct comparative advantage.⁹ This again emphasizes that broad South-South and North-South trade reform is needed to reap significant gains.

Figure 6.2 Global reform dominates North–South agreements

Change in real income in 2015 relative to the baseline



Note: *Global* refers to the global merchandise trade reform scenario, *separate* is when the North/South regional blocks are formed individually and *block* is when the North/South regional blocks are implemented simultaneously.

Source: World Bank simulations.

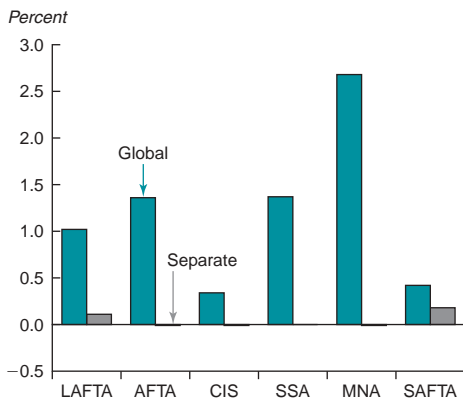
Building Blocks versus Stumbling Blocks

Whether regional agreements are *building blocks* or *stumbling blocks* to open global markets—the terms Jagdish Bhagwati (1991) used—remains a central question.¹⁰ Proponents of the *stumbling block* theory emphasize that: (1) RTAs may promote costly trade diversion rather than efficient trade creation, especially when sizable MFN tariffs remain—these tariffs create vested interests to maintain preferential margins in “their” markets; (2) proliferating regional agreements absorb scarce negotiating resources (especially in poorer WTO members) and crowd out policy-makers attention; (3) competing RTAs (especially different North-South combinations) may lock in incompatible regulatory structures and standards, and may result in inappropriate norms for developing country partners; and (4) by creating alternative legal frameworks and dispute settlement mechanisms, RTAs may weaken the discipline and efficiency associated with a broadly recognized multilateral framework of rules.

Building block proponents stress that moving forward in smaller steps is often easier to accomplish, and it creates a certain reform momentum: (1) regional/bilateral agreements can help sensitize domestic constituencies to liberalization and keep the stakes lower to allow for incremental progress on trade; (2) expanding the number and coverage of RTAs can erode vested opposition to multilateral liberalization because each successive RTA reduces the value of the margin of preference, thereby reducing the discriminatory impact; (3) RTAs are often more about building strategic and/or political alliances or locking in domestic reforms than about actual trade liberalization, and so are not necessarily competitive with multilateral efforts; (4) regional arrangements can provide an incubator for developing country firms/producers to learn to trade with RTA partners without facing full global competition; and (5) for some issues, such as regulatory cooperation, RTAs may be a viable

Figure 6.3 Global reform dominates South–South agreements

Change in real income in 2015 relative to the baseline



Note: *Global* refers to the global merchandise trade reform scenario, and *separate* is when the South/South regional blocks are formed in isolation.

Source: World Bank simulations.

and more manageable alternative to the WTO, where “lowest common denominator” outcomes tend to prevail.

One strand of analysis in the literature explores theoretical bargaining models to shed light on these divergent perspectives. For example, Saggi (2004) considers how RTA formation affects incentives to participate in multilateral trade liberalization. Using a stylized three-country oligopoly model of intra-industry trade, he reasons that while formation of RTAs can reduce tariffs in the short run, in the long run it hinders multilateral trade liberalization because it lowers the incentives for nonmembers to pursue multilateral cooperation. In a three-country model, where country size and costs differ, Saggi and Yildiz (2004) look at tariff outcomes under two different sets of rules: One where countries can form RTAs, and another where they cannot. They find that free trade is less likely to occur as an outcome when countries can join RTAs as well. Moreover, the outcome depends on size and cost features: When countries are relatively similar, the RTA option tends to lower world welfare; whereas with larger differences among countries, welfare increases. In the latter case, gains are somewhat larger for the small country getting access to the larger country (because it gains more in new export earnings and loses less in domestic surplus) than for the country with lower costs (because gains from expanded market access increase when their own costs are lower and partner costs are higher). Aghion and others (2004) construct a dynamic bargaining model to assess the relative effects of simultaneous multilateral liberalization or sequential bilateral liberalization, and they identify situations in which the latter can lead to worldwide free trade. Their model concludes that, as long as large coalition payoffs are higher than if all countries were combined in alternative coalition structures, the outcome is likely to end up in global free trade, regardless of sequencing.

The Saggi findings support the empirical evidence that North-South RTAs with small developing countries yield the biggest benefits

for developing country participants. This intuition comes from the fact that most empirical models derive their impact from the effect of RTAs on prices and quantities of traded goods. But when one partner is much smaller than the other, its participation in an RTA has virtually no impact on prices, and any incremental exports it sells are a tiny share of the large country trade flows—so the resulting gains or losses for the larger partner are also small. Support for this conclusion comes from the computable general equilibrium model (CGE) simulations on the impact of RTAs; in most cases, the net impact on the Northern partner has been exceedingly small, whether measured in terms of trade flows, terms of trade, or welfare changes.

This result in turn has implications for how RTA proliferation affects incentives to pursue multilateral liberalization. If the impact of additional North-South RTAs on the industrial partner is indeed quite marginal, then it seems likely that the *economic* consequences of these agreements would not dampen their willingness to pursue multilateral deals. As we see below, neither the EU nor the United States seem to be less disposed toward multilateral negotiations because of their RTAs or the RTAs of each other.

Other studies show less sanguine results. Limão (2003) notes that North-South RTAs can involve more than just the mutual lowering of tariffs; industrial countries often lower their tariffs and expand market access in exchange for cooperation in a variety of nontrade areas, such as labor standards, intellectual property, migration, security, and so forth. Limão models the interaction between such RTAs and multilateral liberalization, and concludes that pursuit of RTAs creates a strategic incentive for industrial countries to maintain their multilateral tariffs at a higher level than they otherwise would—to hold back tariff concessions in the multilateral arena in order to have bargaining room for negotiating RTAs. In the case of the United States, multilateral trade liberalization commitments are less deep for products that are produced by regional firms.¹¹

A more compelling argument is that developing countries with preferential access may have a vested interest in perpetuating the tariff walls that screen out competing countries from preferred markets. In fact, Barbados, Jamaica, and Mauritius have all been outspoken opponents of the agricultural liberalization that would erode their preferences in EU sugar markets, and Bangladesh has advocated measures that would delay the phaseout of the textile and apparel quotas required under the WTO Agreement on Textiles and Clothing. Nonetheless, this seems confined to a handful of relatively small countries heavily dependent on a narrow range of preference-benefiting products.

An illuminating example of how preferences can be a stumbling block to multilateral liberalization is provided by rum. Low-valued bottled and bulk rum is one of the largest exports from several Caribbean countries to the United States. It enters the United States duty-free under the Caribbean Basin Initiative. In 1994 there was a single tariff line for rum in the U.S. schedule (HS 22084000) with a tariff of 37 cents/liter. As result of WTO discussions, the United States and EU in 1996 agreed to phase out all tariffs on rum and other “white spirits” by 2000. Caribbean governments were concerned that this would be costly to Caribbean exporters because they would have to compete with the rest of the world in the U.S. market. In response to this concern, the United States agreed to substantially liberalize the duties on expensive rum but to maintain duties on low-valued rum. As of 2003, the U.S. schedule now has four tariff lines for rum, two for high-valued rum with no MFN tariff charged, and two for low-valued rum with an MFN tariff of 23.7 cents/liter.¹² Since then, the imports of rum from the affected Caribbean countries have fallen sharply, apparently replaced by imports from Mexico—another bilateral RTA partner. So efforts to prevent erosion of preferential access may have only limited the impact temporarily.

An increase in RTA activity may be associated with multilateral trade negotiations.

Mansfield and Reinhardt (2003) argue that multilateral trade negotiations motivate countries to conclude RTAs; the motivation is for increased negotiating power and the desire to obtain or maintain preferential access to markets. They also note that as WTO membership expands, larger membership reduces individual countries’ ability to influence the content and pace of MFN liberalization and makes it more difficult to formulate coordinated positions. Finally, they find that countries use RTAs to increase leverage against third parties with which they are embroiled in a WTO dispute. In their empirical analysis they conclude that countries are more likely to form RTAs when: (1) GATT/WTO membership rises; (2) a multilateral round is taking place; and (3) parties have recently been involved in a GATT/WTO dispute in which they lost.

Others have argued that RTAs are a mechanism to enhance the pressure to move on the multilateral front, and they act as laboratories for international cooperation on behind-the-border policy issues. This line of reasoning has a long history. Winham (1986) and Lawrence (1991) have both argued that the creation and subsequent expansion of the European Economic Community (EEC) motivated earlier General Agreement on Tariffs and Trade (GATT) rounds—the objective being to reduce European external protection. More recently, Schott (2004) noted that the United States has pursued bilateral trade agreements over the last two decades in part to complement and cajole progress at the multilateral level. He argues that tensions from the GATT meetings in 1982 were the impetus to pursue bilateral deals with Canada and Israel; he also claims that the start of the NAFTA negotiations in 1991 reflected some frustration over failure to conclude the Uruguay Round negotiations on time in late 1990. In the early 1990s, the United States also began to pursue broader umbrella regional initiatives, including Asia Pacific Economic Cooperation (APEC)—whose members have never formally committed to a binding RTA—and the FTAA.

In short, there is only limited evidence from the theoretical literature and a handful of empirical studies that the proliferation of RTAs affects multilateral liberalization either way. On balance, the evidence does point to tactical behavior in trade negotiations, which seems to provide mild additional incentives for greater liberalization. The exception is for small countries that suffer from preference erosion—a nontrivial obstacle to future liberalization.

The Competitive Liberalization Game: The Case of Doha

The rapid proliferation of RTAs may have affected the *negotiating* dynamics of the Doha Round, and it is unclear whether the increase in bilateral deals is in response to slow progress in the Doha talks. Concerns over RTA proliferation played a role in the launch of the Round and came back full force after the failure of the Cancun ministerial. Consider the actions of the major players in the global and regional game.

The U.S. pursuit of like-minded partners

With the change in U.S. administration in 2001 and the subsequent congressional approval of the Trade Promotion Authority in 2002, the pace of bilateral, regional, and multilateral efforts increased. Then, in the absence of progress on the Doha agenda in Cancun in September 2003, the U.S. Trade Representative (USTR) indicated that the United States would pursue deals with “like-minded” partners, and the result has been an unprecedented spurt of U.S. negotiating activity. The United States had negotiated RTAs with six countries/groups by 2004 (Australia, Bahrain, Central America and Dominican Republic, Chile, Morocco, Singapore), and another dozen are under negotiation, including SACU (Botswana, Lesotho, Namibia, South Africa, and Swaziland), Colombia, Ecuador, Panama, Peru, and Thailand. As discussed in chapters 2 and 5, the United States is pursuing new rules in key areas (investment, intellectual property,

and services liberalization)—areas where multilateral efforts have gone slowly or halted altogether—while developing countries seek market access.

Eligibility is not guided by a single criterion or ranking system (box 6.3). Political criteria include national security-cum-foreign policy concerns (a major factor in the recent agreements and ongoing discussions with Arab countries), while others reflect a mixture of classic market access goals and a desire to export U.S. regulatory standards (for instance, in the area of investment and IPRs—see chapter 5). The U.S. decision to pursue bilateral arrangements in Latin America also has the effect of putting pressure on Brazil and other countries, which are seen to be impeding progress on the now-stalled negotiations on the FTAA. Reaching these agreements does not appear to have reduced the United States’ participation in the WTO negotiations, nor to have had much effect on the content of its negotiating position.

Recent EU regional initiatives

Having been a leading (and early) player in the RTA game, the EU had established many RTAs prior to the launch of the Doha Round (see chapter 2). Since then, it has pursued market access agreements with a few individual partners (notably Chile and Mexico, with South Africa predating 2001) as well as MERCOSUR. The EU has preferred to negotiate with blocs of countries and has encouraged the Mediterranean countries to sign agreements with one another; the EU made the RTA with Gulf Cooperation Council (GCC) countries conditional on the adoption of a common external tariff by the GCC and supported the development of a web of bilateral RTAs between Southeastern European economies. The recent Economic Partnership Agreements (EPAs)¹³ were launched to replace the Cotonou agreement with the African, Caribbean, and Pacific (ACP) group in a WTO-compatible set of agreements, and the EPAs are seen by the EU as a development-promoting vehicle rather than as a way to gain additional market access.

Box 6.3 Choosing partners: Selection criteria for U.S. RTAs

The U.S. choices of developing country RTA partners reflect a range of different objectives, which makes categorization difficult. In a report prepared for the U.S. Congress, U.S. General Accounting Office (GAO) (2004) reports that early RTA proposals were (according to the USTR) based on evaluation of 13 different factors (without any formal weighting scheme) that covered five themes: Congressional guidance, business interests, political will of partners, security and foreign policy concerns, and regional parity. Following consultations with relevant agencies, there is now a shortened list of six factors to guide the choice of future U.S. FTA partners: country readiness (political, trade, and legal); economic/commercial benefit; benefits to broader trade liberalization strategy (including success in meeting WTO obligations and support of key U.S. positions in FTAA and WTO negotiations); compatibility with U.S. interests (including foreign policy positions);

congressional/private sector support; and U.S. government resource constraints. The report emphasizes that the selections are not mechanical and argues that trade strategy and foreign policy factors dominate the selection criteria.

Schott (2004) identifies the same broad criteria, but also notes the role of partner choice in selection of U.S. FTA partners. Current U.S. law requires that potential partners must request negotiations with the United States, rather than the other way around. He notes that most of these requests reflect concerns over discriminatory treatment (from other agreements, especially NAFTA) and serve to demonstrate commitment to domestic audiences who may need to be convinced of the benefits of reform trade and domestic policies.

Source: Schott 2004.

These agreements do not appear to have altered the EU's approach to the Doha Round. After the conclusion of the Mexican and Chilean bilateral deals, the EU had declared it would negotiate no new trade agreements, save for the EPAs that were necessary to replace the Cotonou agreement set to expire in 2008. However, this stance may be short-lived. In September 2004, the incoming EU Trade Commissioner announced that he would review this policy and consider launching new negotiations.

Japan is a latecomer but moving quickly

Until recently, Japan remained disengaged from the RTA trend and instead pursued a voluntary approach that centered on APEC. A distinguishing feature of APEC is that it focuses primarily on exchanging information and identifying good practices in the trade policy (and other) areas. While it also sets specific targets for trade policy (e.g., free intra-APEC trade by 2020), implementation of the

good practices and targets are left to individual members. The primary enforcement devices are mutual surveillance and peer review. More recently, it appears that competitive pressures that emerged from the more intensive activity by the United States—also an APEC member—and the concern that even in the Asia region there was a risk of being left out of the new generation of RTAs, have prompted new Japanese activity. Japan completed the negotiation of its first RTA with Singapore in 2002. Negotiations with Mexico are advanced. The competitive disadvantage in Mexican markets relative to the United States and the EU is a strong inducement, with Japanese products facing an average customs duty of 16 percent (Tojo 2004). Negotiations are beginning with Republic of Korea, which are considered important because Japan-Korea could form the basis of a future East Asian economic zone. Talks have also begun with three individual members of ASEAN (Thailand, Malaysia, and the Philippines), and

consultations have been initiated over how to move forward with a proposed Comprehensive Economic Partnership between Japan and the full ASEAN group. Finally, there are preliminary discussions and analysis of a possible ASEAN+3 RTA (including China, Republic of Korea, and Japan) in the context of efforts to strengthen economic relations among this group.

Developing country objectives and negotiating strategies

Developing countries have three general approaches to RTAs. Some have adopted an aggressive approach and pursued a serial RTA strategy; that is, they negotiate a string of agreements and use the sequence to demonstrate their commitment to trade reforms by locking these in and increasing the incentive for excluded countries to negotiate. Harrison, Rutherford, and Tarr (2002) have labeled this negotiating dynamic “additive regionalism.” Its most prolific proponents include Chile, Mexico, and Singapore, which have pursued RTAs with most of their geographic neighbors, as well as with many of the other major players (Schott 2004). The idea is that negotiating additional RTAs will progressively lower the effective average tariff (reducing potential trade diversion costs) and assure stability of market access for partner countries. A second, much larger group of countries has pursued a strategy more explicitly regional in focus, which seeks to deepen ties with neighboring countries; examples include ASEAN, the GCC, MERCOSUR, and SADC. A third group has focused on negotiating North-South RTAs, often in parallel with their regional integration efforts with neighbors; examples are the southern Mediterranean countries with the EU and the US-CAFTA agreement. The ACP-EU Economic Partnership Agreements are another example.

Additive regionalism could create adverse global effects by reducing the incentives for countries to participate in multilateral liberalization efforts. That has not been the case with Chile, Mexico, or Singapore. The fact remains

that these countries still have incentives to see lower barriers in the many countries with which they do not have RTAs and to harness the multilateral process to achieve movement in areas outside of the RTAs, such as agriculture and anti-dumping. The WTO provides a forum to achieve these objectives at a lower cost than negotiating a plethora of bilateral RTAs. Countries pursuing such strategies are very much a minority—most developing countries are not in this game (box 6.4). Chile, Mexico, and Singapore are all economies that moved substantially toward free trade and thus have already captured most of the potential gains from unilateral trade reforms. From a global point of view, therefore, these are not countries that have a vested interest in maintaining high MFN barriers. These countries are examples of open regionalism.

The determinants of the multilateral negotiating stance of the broader group of developing countries are more varied. For a handful of countries, existing preferences under unilateral accords as well as multilateral and regional agreements are openly driving their opposition to multilateral liberalization. For some other developing countries, it is possible that RTAs are undermining their interest in multilateral negotiation, either because they mistakenly see RTAs as an alternative, because they feel subsumed in large coalitions with other countries, or because they do not have the resources to negotiate with both the WTO and with potential regional partners.

This discussion suggests a few impressionistic conclusions. It is hard to argue that competitive liberalization through RTAs has much influence on the behavior of the major players in the WTO, either in their fundamental negotiating positions or their willingness to compromise to achieve a result. As evident in the July WTO Framework Agreement, major players are still working with commitment toward an agreement in Doha. To be sure, for smaller countries with scarce negotiating capacity, RTAs do absorb resources that could be devoted to multilateral negotiations; but these countries tend to participate in the WTO

Box 6.4 Sequencing of RTAs: Is there a good practice?

Debates over trade liberalization have often included extensive discussions of whether there is a preferred (or even optimal) sequence for reforms. Theoretical guidance for policymakers in the design of RTAs speaks to two dimensions of the question—the choice (and sequence) of partners over time and the substantive coverage of an RTA (and the sequencing of inclusion of different elements)—that have implications for the debate. On the former, the sequencing of partners may affect incentives of members to pursue MFN liberalization. Thus as discussed elsewhere in this report, the formation of large blocs creates incentives to join for smaller countries that trade heavily with members—what has been termed “domino regionalism” (Baldwin 1993). The EU is the best example of this phenomenon: EFTA countries that were not in favor of the EU integration model ultimately concluded that the costs of staying out were too high. Whether this process makes RTAs more or less receptive to MFN reforms depends in part on the preferences and interests of those who join the bloc over time—which in turn will affect the willingness of incumbent countries to accept new members.

On the product/policy coverage issue, the conventional wisdom appears to be that agreements should first focus on trade liberalization and then move on to behind-the-border areas—that is, go from shallow to deeper integration. There is no theoretical justification for this, however, and there is a well-documented history that, in the case of the EEC, many policymakers were of the view that the two needed to be pursued in tandem. The rhetoric of policymakers and their advisors often suggests that deeper integration is necessary to attain free trade. During the period leading to the creation of the EEC,

Jelle Zijlstra, the Dutch Minister of Economic Affairs argued that credible tariff removal required common policies on taxes, wages, prices, and employment policy. Similarly, the Belgian government felt that policy harmonization was required to equalize costs, and that without it, a customs union would not be feasible because countries would impose new forms of protectionist policies. French officials persistently demanded harmonization in social policies—equal pay for both sexes, a uniform work week—as a precondition for trade liberalization—French standards in this area were higher than in other countries (Milward 1992).

Recent research on the effects of, and interplay between, efforts to liberalize trade and investment in services (and FDI more generally) suggests that countries may be better off pursuing both shallow and deeper forms of liberalization in tandem. Hoekman and Konan (2001) and Konan and Maskus (2003), for example, note that not only can this generate much greater welfare gains, it can also reduce aggregate adjustment costs over time—through avoiding outcomes in which factors of production must move repeatedly across sectors (as will, by definition, occur if goods are liberalized first and then services/investment, or vice versa). They also note that because many services continue to be less tradable than goods, there is greater scope for employment opportunities to be created as a result of allowing greater competition in services markets, thus helping to absorb labor from other sectors as prices change due to trade reform.

Source: World Bank staff.

as members of coalitions, and it is not clear that these constraints impede compromise. If the effects on the multilateral round are negligible, it does seem that all players appear to be quickening their efforts to seek new preferential agreements. The outcome of the game of RTA-based competitive liberalization is likely more RTAs.

One negative incentive effect created by preferences—reciprocal RTAs or voluntary programs—is that members’ desire to safeguard their preferential access to the regional market may result in less support for MFN-based trade reforms. This incentive effect has long been recognized; it was one of the arguments made against the Generalized System of

Preferences when they were initially proposed in the 1960s. Indeed, unilateral preference programs, especially the more comprehensive and meaningful schemes adopted in recent years, such as the EU's Everything But Arms (EBA) program and the United States' African Growth and Opportunity Act (AGOA), potentially make matters worse, because their value to recipients depends on the existence of trade barriers against imports from other countries—with the greatest rents generated by programs that distort markets the most, such as in the sugar market. Maintaining preference margins—whether for RTA partners or beneficiaries under unilateral preference programs—is not the answer. What is needed is a willingness on the part of developed countries to move away from preferential access as an instrument to assist lower-income partner countries and to move toward greater reliance on direct transfers of technical and financial assistance (Stoeckel and Borrell 2001). This has the advantage of allowing high-income countries to target their trade-related development assistance to those countries most in need, something the system of preferences cannot do.

Multilateral Disciplines on Regional Arrangements

Efforts to deal with the implications of RTAs within the multilateral trading system are long standing. The primary disciplines are laid out in Article XXIV of the GATT—others are discussed in box 6.5. They permit RTAs if: (1) external trade barriers do not rise (Article XXIV:5); (2) all tariffs and other regulations of commerce are removed on substantially all exchanges of goods between the partner countries within a reasonable length of time (Article XXIV:8); and (3) notification is made to the WTO Council.

The first criterion is intended to limit the negative impact of an RTA on nonmembers.¹⁴ The second condition might at first seem counterintuitive—after all, the more extensive is the liberalization with an RTA, the more

detrimental it is likely to be to nonmembers. But the rationale here was in fact different; as noted by Finger (1993), the objective was to ensure that participants in RTAs are serious. In other words, while more trade in an RTA hurts nonmembers, pursuit of numerous partial RTAs can severely undermine the incentives for multilateral trade negotiations and create opportunities for special interests (farmers, specific industries) to carve out special arrangements. As a counterexample, if a restrictive interpretation (say 99 percent of all trade) of this criterion were agreed to and enforced, it is likely that the appetite for RTAs would be substantially diminished.

Determining whether the GATT or General Agreement on Trade in Services (GATS) tests are met is left for the Committee on Regional Trade Agreements (CRTA). Before the creation of the WTO, the GATT Council usually created a working party to evaluate whether its conditions were satisfied. Under the WTO, the CRTA was established for this task. The GATT experience in testing reciprocal preferential trade agreement (PTAs) against Article XXIV was very discouraging. Starting with the examination of the treaty establishing the EEC in 1957, almost no examination of agreements that were notified under Article XXIV led to clear conclusions or specific endorsements that the GATT requirements had been met. Only one working party could agree that a regional agreement fully satisfied the requirements of Article XXIV (the Czech-Slovak Customs Union).

There had been a conscious political decision made by GATT contracting parties in the late 1950s not to scrutinize the formation of the EEC because the EEC member states had made it clear that if the EEC treaty was found to be inconsistent with Article XXIV, they would withdraw from GATT (Snape 1993). Given that the EEC did not meet all the requirements of Article XXIV—agricultural trade was not liberalized—it created a precedent. It is also true that the criteria and language of Article XXIV are ambiguous. Legitimate differences of opinion are possible

Box 6.5 RTAs and WTO disciplines

The fundamental building block of the multilateral system is the principle of nondiscrimination. This is enshrined in Article I of the original text of the GATT signed in 1947. But from the start, there have been exceptions. One such provision is Article XXIV of the GATT, which permits WTO members to enter into preferential trade agreements (RTA) that extend trade concessions to RTA participants not offered to nonparticipants, as long as certain criteria are satisfied—in particular, regarding the scope of the RTA. Second, rules covering preferential agreements that deal with trade in services are set out in Article V of the GATS. Finally, developing countries may, if they wish, invoke the provisions of the 1979 Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries (the so-called Enabling Clause) to exchange tariff and, to a certain extent, nontariff preferences among them. Unlike Article XXIV, the Enabling Clause does not require that internal barriers be removed on “substantially all” trade among participants in those arrangements. MERCOSUR was notified to GATT under this provision, not under Article XXIV. The

Enabling Clause also legitimizes non-reciprocal programs such as the Generalized System of Preferences (GSP).

The task of verifying the WTO compliance of RTAs notified under GATT Article XXIV and GATS Article V is entrusted to the CRTA. The CRTA was established in 1996, in particular to (1) oversee, under a single framework, all regional trade agreements, and (2) consider the implications of such agreements and regional initiatives for the multilateral trading system and the relationship between them. RTAs among developing countries, when notified under the Enabling Clause, are not, in principle, subject to review by the CRTA. As was the case under the GATT, however, the CRTA has been unable to carry out effectively its functions of examining the consistency of RTAs with the rules, and overseeing their implementation. The reason for this is essentially a fear of setting a precedent and opening up agreements to dispute settlement proceedings. The CRTA has thus far been unable to conclude the examination of any of the 110 RTAs currently under scrutiny and has a backlog of about 35 RTA reports to prepare.

regarding issues such as the definition of “substantially all” trade; how to determine whether the external trade policy of a customs union has become more restrictive on average; and what a reasonable time period is for the transition toward full implementation of an RTA (Hoekman and Kostecki 2001).

In the Uruguay Round some of these issues were clarified: Specific criteria were adopted to assess whether a customs union’s external tariff satisfies Article XXIV; a 10-year maximum for the transition period for implementation of an agreement was imposed; and, as mentioned, a standing committee was created to oversee RTAs. None of these changes had any effect on the ability of WTO members to agree on whether an RTA conformed to WTO requirements. Most observers would agree that existing WTO disciplines and enforcement mechanisms have no teeth, and are not

particularly effective at controlling, limiting, or shaping the growth and coverage of RTAs. At the Fourth Ministerial Conference in Doha, ministers agreed to launch negotiations to clarify and improve the disciplines and procedures under the existing WTO provisions that apply to RTAs, taking into account the developmental aspects of these agreements.

The Doha Agenda negotiations on rules for preferential trade agreements have been conducted on two tracks, one focusing on transparency issues and the other addressing the substantive disciplines. Transparency is generally less contentious, and includes:

- **Administrative overload in reviewing proposals.** Review of long, detailed, and often unclear RTA documents imposes a substantial workload on committee members. One possible solution would

be an expanded “first review” by WTO staff based on clear and objective criteria; this would require a significant expansion of resources allocated by the Secretariat.

- **Notification of RTAs to the WTO.** The WTO has been notified of around 300 agreements (of which about 140 are currently in force), and another 60 or so are in advanced stages of negotiation (see chapter 2). Many of these are for RTAs among developing countries. Moreover, few RTAs have been designated as “interim arrangements,” even though most RTAs have been implemented in stages.
- **Data and information requirements.** There is no clarity on the type, quantity, and level of detail to be provided when the WTO is notified of an agreement. Developing countries often lack the capacity to undertake this task. While some members want more detail, it is understood that unduly straining the capacity in developing countries should be avoided. Some suggest that WTO assistance could be provided for the notification process if necessary.
- **Review of South-South agreements.** The Enabling Clause does not provide for any consistency examination. Current practice is for RTAs formed between developing countries (and notified under the Enabling Clause) to be reported to the Committee on Trade and Development (some developing countries have chosen to notify the WTO of agreements under Article XXIV). Countries have raised the issue of reporting Enabling Clause Agreements to a single body, the CRTA.
- **Services.** Some of the requirements of the provisions of Article V of GATS are unclear (e.g., in terms of the departure from MFN obligations in key areas such as transparency, emergency safeguards, and administration of domestic regulations).
- **Process.** Some delegations want notification of RTAs to occur before they are

implemented. Others support issuing a final report that does not pass or fail a RTA, but allows members to register concerns. Finally, some delegations want greater diligence in encouraging RTA participants to file biennial reports on the implementation of RTAs.

Although no early harvest on transparency issues was undertaken for the 2003 Cancun Ministerial, negotiations for a (provisional) application of strengthened surveillance mechanisms are considerably advanced. Such mechanisms would require more detail in the RTA notification procedures and might involve an enhanced role for the Secretariat in preparing an assessment of each RTA that would be provided to WTO members.

Informal discussions on the substantive rules began in June 2004, and there are many issues under consideration. The fact that WTO rules on RTAs relate to several other regulatory areas (some of which are under negotiation)—including rules of origin, trade facilitation rules on trade remedies, the GATS—adds to the complexity. Issues under consideration include:

- **Product coverage of RTAs.** One central issue is whether to make more specific the requirement that “substantially all” trade be covered in each RTA. Lack of clarity regarding this criterion is viewed by many as a source of the CRTA’s inability to reach clear-cut conclusions on WTO compatibility for most RTAs. Many RTAs exclude agriculture, which is a major problem. Some have proposed that “substantially all” trade should be defined as a percentage not only of actual trade but also of all the six-digit tariff lines listed in the Harmonized System. This approach could ensure that the standard is set high, but that there is also sufficient flexibility to set aside product areas that remain sensitive for one reason or another. A related issue concerns how (if at all) such a criterion would be

applied to RTAs already notified—would they be subject to the same percentage, or grandfathered in under the existing imprecise criterion? Although inherently arbitrary, a more specific coverage criterion could help to move the review process for RTAs along. Schiff and Winters (2003) suggest adopting a coverage criterion of 95 percent of the value of trade after 10 years of operation of the agreement, rising to 98 percent after 15 years. This would require that at least some sensitive products be included (e.g., agriculture), but not all, and would imply that over time the set of excluded products would decrease.

- **Policy coverage of RTAs.** GATT Article XXIV.5 requires that duties and other regulations of commerce applied by members of a RTA are not more restrictive than those existing prior to its formation. In assessing the impact of a RTA, there is no agreement on what this covers. In particular, it is unclear to what extent it covers policies such as safeguards, anti-dumping measures, mutual recognition agreements, or rules of origin—and if they are covered, how they should be evaluated. Many RTAs continue to allow for the use of antidumping and safeguards on intra-member trade—that is, conflict with the supposedly free trade objective of RTAs. Only a few RTAs have abolished the reach of antidumping (the EU, ANZCERTA, Canada-Chile). Alternatively, some RTAs preclude the use of safeguards on goods originating in partner countries—for example, Canada and Mexico were exempted from the recent U.S. steel safeguard action. This increases the negative effect of the action for nonmembers.

Whether rules of origin are a regulation of commerce has been a key source of disagreement for decades. The rules of origin are relevant not just for normal trade flows, but also

play a role in the application of safeguards and other contingent trade policies. Issues related to rules of origin were already being discussed in the early 1970s in working parties that were considering RTAs. Thus in connection with the 1972 free trade agreement between the EEC and European Free Trade in Europe (EFTA) member states, the United States argued that the rules of origin would harm nonmembers.¹⁵ Not surprisingly, preferential rules of origin are being discussed in the current Doha talks, although expectations are low that there will be agreement on common disciplines. Discussions on harmonization of nonpreferential rules of origin have been under way for almost 10 years and have yet to be concluded.¹⁶ In any event, these harmonized rules of origin will not apply to regional agreements or to GSP schemes. Because rules of origin facilitate the fine tuning of preferential liberalization at the product level, many countries do not want to see constraints imposed on their policy freedoms in this arena.

Many proposals have been made in the WTO for stronger rules for RTAs. One suggestion is that all RTA members be required to extend their preferential concessions to the rest of the world within a specific time frame (Srinivasan, 1998).¹⁷ Another suggestion is to minimize the adverse discriminatory consequences of RTAs by requiring (or exhorting) members to allow any developing country to “opt in” on the same terms as existing members, perhaps after a certain time period. This goes back to Viner (1950). As noted, virtually every existing RTA has geographic restrictions on membership and has features that require negotiation, so the practical promise of such open regionalism is limited. Other suggestions do not make good economic sense (see Schiff and Winters, 2003).

Many observers have concluded that the quest for stronger rules is unlikely to succeed because many RTAs will not satisfy the rules, which will, in turn, lead countries to prefer the status quo. Schiff and Winters (2003) conclude their discussion of regionalism and the WTO with a section called “Rules Are Not the

Answer.” From this perspective, the primary function of the WTO is to act as a negotiating forum to bring down the discrimination created by RTAs. The importance (and feasibility) of this depends, in part, on the motivation of governments to pursue RTAs.

Making Open Regionalism Work for Development

Defining the role of the WTO

Numerous observers and analysts of RTAs, who are interested in enhancing their compatibility with the global trading system, propose that WTO disciplines be applied more stringently. Years of discussion in the GATT/WTO on the interpretation of existing criteria, and the many papers proposing more specific criteria have had no impact on the spread or content of RTAs. Improving the enforcement of Article XXIV or strengthening/changing WTO disciplines on regionalism is unlikely to fare any better.

Whether it is helpful to articulate more specific criteria delimiting what “substantially all” trade means, or tightening up disciplines on “other regulations of commerce,” depends in large part on the feasibility of attaining a consensus on specific criteria. Given the plethora of RTAs that are in force, and the share of global trade notionally covered through such agreements, a strong case can be made that the horse has already bolted from the barn—shutting the barn door will make little difference. The problem is a political one; any number of countries will oppose stronger rules because they are already members of RTAs that would violate them. Indeed, even if groups of developed countries—such as the EU—make a case that their agreement satisfies whatever criteria might be proposed, or that their model should become the benchmark, other countries could legitimately argue that if it was acceptable for the EEC to pass muster in the 1960s and 1970s, it would be hypocritical to impose stronger rules on all WTO members today.

Nonetheless, WTO members should look for ways that existing disciplines on RTAs can be reinforced and new disciplines introduced to enhance their development impact. One area where knowledge is much more extensive now, compared to when the original GATT rules were written, regards rules of origin. It is clear that complex and restrictive rules of origin limit the benefits of RTAs for developing country participants and divert trade in intermediate products. Rules of origin that differ across agreements complicate world trading conditions and contribute to the emergence of hub-and-spoke patterns. Thus there would be substantial benefits from an agreement that promoted common, simple, less restrictive, and easy-to-apply rules of origin. That being said, the delays and problems in achieving the objectives defined in the Uruguay Round for the nonpreferential rules of origin are not propitious in this case.

From a development perspective, the most useful and immediate step for the WTO is to improve transparency. Information and analysis are important inputs for a well-functioning trading order. Greater monitoring and assessment of the impacts of RTA-related policies would allow more informed and proactive engagement by civil society (think tanks, non-governmental organizations, consumers, and taxpayers) in the policy formation and negotiation process. It is true that to reduce protection and protectionist pressures, those that lose (pay) need to be aware of the costs of such policies. The suppliers of and the clients for such analysis and information are not necessarily governments, but the constituencies in individual countries who are affected by policy. In order for trade agreements to promote good policy-making in member countries, stakeholders must be able to be active in the domestic policy formation process.

This could be achieved by augmenting the capacity of the WTO Secretariat and the CRTA to review, document, and analyze the effects of RTAs. That is, WTO attention in this area should focus on gathering information and analysis. Efforts could concentrate on

addressing such questions as: Are RTAs being implemented? How? What is the effect on member countries and on nonmembers? How much trade is covered by the RTA (and is it “substantially all”)? Ideally, stronger surveillance would involve those responsible for implementing each RTA and, in the process, empower them to engage policymakers and stakeholders. Such surveillance and analytical monitoring should extend to South-South RTAs—which should all be notified to the CRTA.

Strengthening information exchange and mutual (multilateral) dialogue, (including through the establishment of formal monitoring mechanisms), would facilitate cooperation on new regulatory issues. If existing or proposed policies could be evaluated using objective criteria on their ability to achieve the stated national objectives, countries and stakeholders could assess their efficacy and, if needed, adjust the policies. Greater analysis of the effects of trade discrimination—both unilateral preferences and RTAs—should be part of this agenda.

Information of this type would help RTA stakeholders to hold governments accountable for outcomes and to assist nonmembers by providing data that could feed into demands in the context of WTO negotiations.¹⁸ As argued by Hoekman and Kostecki (2001) among others, the primary means through which the WTO can impose limits on RTAs is by providing a venue for negotiation to reduce MFN barriers, which will automatically limit the discrimination against outsiders that is inherent in RTAs.

Priorities for the industrial countries

The major industrial countries must strike a difficult balance in their pursuit of bilateral and regional deals with developing countries. On the one hand, there are legitimate reasons to pursue such initiatives, rather than relying only on multilateral channels. The ongoing EU effort to deepen relations with a wider Europe is an important example. Cooperation among a smaller number of countries may

also be the most effective solution to mitigating environmental externalities, addressing nontrade issues such as labor migration (legal or illegal), or attaining national security objectives. But it must be recognized that the aggressive pursuit of RTAs with developing country partners in all corners of the globe serves the cause of global liberalization poorly if it delays or halts altogether the progress toward multilateral liberalization.

Fostering development is increasingly identified as a key rationale for North-South RTAs. In part this reflects economic interests—growing markets abroad are expanding export markets—and in part it is due to the recognition that there is a correlation between sustained economic growth in partner countries and national security. From this vantage point, several recommendations emerge.

The highest priority should be to ensure that the Doha Development Agenda is completed in a manner that provides new market access to exporters in developing countries. In addition to their interests in development, the large countries have an important historical and systemic responsibility to ensure that the world trading system remains as open as possible.

Supporting open regionalism by encouraging partner countries to adopt low external barriers would create momentum toward integration with the world, establish a more efficient development path, and reduce the adverse negative implications of RTAs on nonmembers. Because these countries are less likely to be preferred RTA partners of the United States and the EU, they will continue to have an incentive to engage at the WTO level.

Adopting the widest possible product coverage and greatest market access expansion would increase the development impact. This means that agricultural trade policies should be included in RTAs. Excluding agriculture from RTAs—the dominant practice at present—does not promote development. Although inclusion of agricultural market access will increase the incentives for small countries to seek RTAs with the large players, it will also increase the

Box 6.6 Tunisia's Association Agreement with the European Union

In July 1995, Tunisia signed the Association Agreement with the European Union (AAEU). The agreement, which came into effect in March 1998, would liberalize trade for industrial goods over a 12-year period and ultimately create a free-trade zone. Trade in agricultural goods and services was left out for future negotiations. By the mid-1990s, Tunisia had already become a successful exporting country, thanks to the establishment, in 1972, of a special offshore system for exporting enterprises that mitigated the anti-export bias of the highly protective trade regime.* Exports of manufactured goods had increased from 4 percent of GDP in 1975 to 20 percent by 1994. Free market access to EU markets under the AAEU further enhanced Tunisia's export performance, with manufactured exports increasing to 25 percent of GDP in 2002.

The AAEU gave momentum to trade liberalization in Tunisia. Average MFN tariffs were reduced from 33 percent in 1994 to 26 percent in 2003. However, Tunisia still posts the second highest average MFN tariffs in the broader EU neighborhood, including in the EU accession countries. For example, only Morocco, with a tariff rate of 30 percent, has a higher border barrier, but countries as diverse as Turkey, Bulgaria, Ukraine, Lebanon, and Moldova have tariffs of 10 percent or lower.

High MFN tariff differentials in the presence of EU preferential access risks diverting trade away from the lowest cost sources, denying Tunisian producers and consumers the benefit of less expensive imports from outside the preferential trade zone with the EU. As a result of high MFN tariffs and geographical proximity, about 75 percent of Tunisia's

trade is dependent on the European market—especially in EU neighborhood countries.

A trade strategy linked to the domestic reform agenda would help Tunisia fully realize the development promise of deeper trade integration. First, ambitious reduction of MFN tariffs for industrial goods would prevent trade diversion. Second, removing beyond-the-border obstacles to trade—by reducing the still-high trade logistics costs—would enhance firms' ability to exploit export opportunities and improve their competitiveness; liberalization of backbone services, especially in transport, ICT, and finance, are also essential. Third, once the free-trade zone with the EU is fully implemented in 2007, preferential tax treatment of exporting firms will become much harder to justify, because both offshore and onshore firms will be equally exposed to foreign competition. The regulatory framework of investment incentives and trade facilitation will thus have to become more even. The EU could also liberalize market access for Tunisian agricultural exports in products in which Tunisia is competitive. Unless market access is improved, the scope for farmers to shift into these products will remain limited, and sectoral adjustment in agriculture will continue to be impaired.

*This system covers those companies located anywhere in the country and it grants duty-free imports of capital and intermediate goods, exemptions from the VAT and excise taxes, and exemption from the corporate income tax for the first 10 years of operation.

Source: World Bank staff.

downside of RTAs for large agricultural producers in the developing world. The latter will then have a greater incentive to push for WTO-level MFN reforms; the marginal increases in competition from preferred partners may help overcome the domestic interests opposed to reforms through a process of gradual, piecemeal expansion of access to agricultural markets.

Industrial countries negotiating North-South RTAs should adopt liberal cumulation provisions in their rules of origin. Because the

least-developed countries (LDCs) already have nearly free access to OECD markets, North-South RTAs will erode such preferences. Cumulation will ensure that rules of origin do not impose an additional burden on these countries. For member countries, liberal rules of origin will enhance the benefits of North-South RTAs. A demonstrated willingness of industrialized countries to put partner country interests before those of national industry groups (who prefer restrictive rules of origin)

would show that development objectives are being taken seriously in RTAs.

Industrial countries could also enhance the development credentials of their RTAs by taking action to abolish antidumping and similar instruments of contingent protection. There is a plethora of evidence that antidumping is straightforward protectionism and that insofar as there is a rationale for intervention, other policy instruments can be used (i.e., competition policy). A number of RTAs—ANCERTA, Canada-Chile, the EU itself—have proceeded down this path, which illustrates that it is feasible.¹⁹

Industrial countries should exercise caution regarding their demands for new regulatory policies in RTAs. Behind-the-border, regulatory policies are critical for a positive impact on development outcomes, but getting the rules right—ensuring that rules are calibrated to development capacities and do not detract from other, more pressing priorities—is as essential as it is difficult to orchestrate. Applying regulatory norms in RTAs on a nondiscriminatory basis will avoid creating another complex set of discriminatory preferences. In other words, RTAs will be supportive of development if the negotiation and implementation process is designed to ensure that such priorities are set appropriately, and the preconditions for benefiting development are in place. Many RTAs are far from satisfying this prescription.

Increasing the effectiveness of development assistance for trade can help. Aid is an important part of the equation motivating RTA negotiations, especially for agreements with the EU. Export growth in many LDCs and other small and low-income countries is limited by the lack of supply capacity and the high-cost business environment. Firms in these countries may also find it difficult to deal with the regulatory requirements that apply in export markets. Health and safety standards, for example, are often regulatory barriers to entry; the standards can be excessively strict and the compliance costly, which weighs disproportionately on producers in low-income countries. Development assistance can help to build

the institutional and trade capacity needed to benefit from increased trade and better access to markets. This assistance will be more effective when it is focused more broadly on supply capacity, and when it addresses the adjustment costs associated with reforms. Recently attention has been given to expanding programs that provide aid for trade, but only when trade issues are integrated into a nation's overall development priorities. Although priorities will differ, in many cases assistance will be needed to address trade-related policy and public investment priorities. More could be done to replace preferential access as the primary carrot for RTAs with financial transfers. It has been argued at length (e.g., Hoekman, Michalopoulos, and Winters 2004), that trade preferences should not be a permanent feature of the global trading system. Appropriately designed aid would offer a similar result to preferences and at a lower overall cost.

Challenges for developing countries: A three-pronged strategy

Developing countries would benefit from adopting a coherent three-part strategy that integrates unilateral, multilateral, and regional initiatives. A number of middle-income countries have enunciated a clear set of priorities and objectives regarding regional and multilateral efforts, and have the technical and negotiating capacity to pursue them; however, many developing countries show less evidence of a coherent strategy on how to use RTAs to maximum advantage.

At the *multilateral* level, the Doha Agenda negotiations are the best instrument for most developing countries to reduce the discrimination they face from the prevailing web of RTAs. Doha is also critical insofar as it provides the greatest potential new market access for the greatest number of the world's poor. It is also the only venue in which key policy areas such as agricultural support policies or antidumping can be negotiated in a comprehensive and substantive manner. As with the high-income countries, completing the Doha deal is the highest priority.

Unilateral reforms can increase the benefits of RTAs. Governments should generally lower external (MFN) barriers to trade in conjunction with the reduction of trade barriers against partners and build this commitment into the agreements signed. This not only reduces the scope for detrimental trade diversion, it also helps to support multilateralism and increase global welfare. Such commitments can be made in the context of the ongoing Doha Round, with the advantage of potentially generating additional quid pro quo reductions by other WTO members. That said, strategies that deliberately delay trade liberalization and domestic reforms in order to conserve bargaining chips for either RTA or Doha Agenda negotiations are misguided. Most developing countries have only limited leverage within any such negotiations, and the costs of delayed reforms outweigh any transitory negotiating advantage. The rapid growth rates realized by countries such as India following trade liberalization and related reforms in the 1990s illustrate this point.

Pursuing bilateral or plurilateral North-South RTA arrangements at the *regional* level may yield short-term market access benefits to participating developing countries. But countries should be aware that preferential access is likely to be eroded as more countries sign such deals, reducing the value preferences, if not the access. Moreover, the impact of commitments on nontrade regulatory policies must be taken into account. As noted above, it is important to get the rules right. For RTAs to be beneficial in the longer term, there needs to be mechanisms through which governments and stakeholders are assisted in implementing a set of reforms that will help sustain growth and reduce poverty. The establishment of these national mechanisms is an important precondition for benefiting from the RTA game.

South-South RTAs, especially regional agreements among neighboring countries, can generate substantial benefits to participants in non-trade policy areas such as border crossings, infrastructure, standards and regulatory frameworks, and related enforcement institu-

tions. Emphasis should be directed toward enhancing cooperation in areas where there is a strong public goods dimension—collaboration here can yield large gains. Such cooperation can have positive spillovers on the multilateral process by helping to identify what type of multilateral rules might be beneficial.

Only by adopting a three-part integrated strategy built around unilateral, multilateral, and regional components can developing countries ensure that their trade policy will contribute the most to growth and poverty reduction. To be fully effective, each trade policy lever must be used to its best purpose, and coherent trade policy and associated technical assistance resources have to be integrated into a national development strategy. In the case of low-income countries, the Poverty Reduction Strategy Paper (PRSP) is an example of such an instrument. Governments and stakeholders have an interest in building such a three-part strategy into their development strategies. In this way, open regionalism can help countries improve their standards of living.

Notes

1. For a summary of earlier World Bank research on the linkage and compatibility of regionalism and multilateralism, see World Bank (2000) or Schiff and Winters (2003).

2. The results reported herein refer to so-called “static” gains, that is, it is assumed that trade reform has no impact on productivity. Thus the gains are mainly associated with the efficiency gains from removing the trade (and perhaps other) distortions.

3. This grouping is referred to as the Quad-plus, or Quad+, because of the inclusion of Australia and New Zealand.

4. Note that under the bilateral agreements, domestic distortions are not removed because they are not specific to any individual trading partner.

5. Note that some of the high-income Asian countries—for example, the Republic of Korea and Singapore—are excluded from the bilateral agreements and therefore tend to lose, in part, because of trade diversion effects.

6. The excluded countries/regions are Brazil, China, India, Mexico, Russia, rest of East Asia, and rest of South Asia.

7. The three North-South agreements include a broad East Asian region that encompasses both the high-income and developing countries, the FTAA in the Western Hemisphere, and a broad free trade area centered on the EU, including the new accession countries, extending to the Middle East and North Africa and Sub-Saharan Africa. The South-South agreements include a Latin American-wide RTA (LAFTA), a developing East Asia RTA (AFTA), a Europe and Central Asia RTA excluding the EU-accession countries (CIS), a Sub-Saharan African RTA (SSA), the Middle East and North Africa (MNA), and a South Asian RTA (SAFTA).

8. In a result not shown in these figures, South Asia is not included in any of the three broad North-South agreements, but is simulated to create its own RTA. In isolation, the gains from SAFTA, the South Asian regional trade agreement, yields a positive gain of some 0.2 percent of baseline income, as shown in figure 6.3. However, SAFTA's exclusion from the 3-block North-South agreements induces a loss of 0.3 percent of baseline income, largely due to trade diversion and a loss in the terms of trade.

9. The simulated South/South agreements reflect free trade among geographic neighbors where the differences in comparative advantage are slight. Reductions in South/South trade barriers across more distant countries have significantly more potential for increasing trade and incomes.

10. Concerns about the impact of discrimination on multilateralism in trade has a long history, e.g., Patterson (1965). There is voluminous literature on this issue, much of it conceptual. Interested readers are referred to Bhagwati (1991), De Melo, Panagariya and Rodrik (1993), Winters (2000, 2001), and Schiff and Winters (2003).

11. Much of the early theoretical literature that analyzed the incentive effects of RTAs for multilateralism assumed, for simplicity, that the latter implied free trade—see Levy (1997), and Krishna (1998). [Winters (2000) provides a thorough review of the theory.] As a result, the focus was on a binary choice between multilateral free trade and no MFN liberalization. However, in practice countries can choose to conclude a multilateral round with considerable liberalization or with very little. Thus an empirical perspective that focuses on whether RTAs change the probability of concluding a trade round is too narrow. Moreover, it is virtually impossible to test this in a systematic way because one never observes simultaneously a country with and without RTAs. Therefore an empirical assessment of the stumbling block hypothesis must use Bhagwati's definition and investigate if RTAs lead to less multilateral liberalization.

12. Testimony before the House Committee on Ways and Means, May 8, 2001; accessed June 2003 on

<http://waysandmeans.house.gov/legacy/trade/107cong/5-8-01/5-8chri.htm>; U.S. tariff schedule 1994 and 2003. See Limão (2003).

13. These are described in chapter 2.

14. A practical problem faced by the drafters of Article XXIV was that in the case of a customs union, changes in the external tariffs of member countries would occur as they adopt a common external tariff. The rule that applies to customs unions is that duties and other barriers to imports from outside the union may not be, on the whole, higher or more restrictive than those preceding the establishment of the customs union (Article XXIV:5a). The interpretation of this phrase became a source of much disagreement among GATT contracting parties. However, except for customs unions, (in which a common tariff structure would be adopted), the rule for RTAs was unambiguous. Duties applied by each individual member country may not be raised (Hoekman and Kostecki 2001).

15. The RTA was argued to lead to "trade diversion by raising barriers to third countries' exports of intermediate manufactured products and raw materials. This resulted from unnecessarily high requirements for value originating within the area. In certain cases ... the rules disqualify goods with value originating within the area as high as 96 percent. The rules of origin limited non-originating components to just five percent of the value of a finished product of the same tariff heading [for] nearly one-fifth of all industrial tariff headings" (GATT, 1974:152-53, cited in Hoekman and Kostecki 2001).

16. The WTO Agreement on Rules of Origin aims to foster the harmonization of the (nonpreferential) rules used by members. The objective is that common rules be applied equally to all nonpreferential trade policy instruments by WTO members—tariffs, import licensing, antidumping, and so forth. The agreement calls for a work program to be undertaken by a Technical Committee, in conjunction with the WCO, to develop a classification system regarding the changes in tariff subheadings (CTH), based on the Harmonized System (HS); this would constitute a substantial transformation. In cases where the HS nomenclature does not allow substantial transformation to be determined by a CTH test, the Technical Committee is to provide guidance regarding the use of supplementary tests such as value-added criteria. Although the harmonization program was to be completed by July 1998, deadlines have also been missed, in part, reflecting lack of consensus among members over the formulations to be adopted for sensitive products, especially agriculture, textiles, and clothing.

17. As the implied move to full global free trade is unlikely to be politically feasible, the implication would be to impose a ban on most if not all RTAs—also unlikely to be acceptable.

18. Clearly there would be budgetary implications associated with a stronger surveillance role, and a precondition is that WTO members accept that the Secretariat be given the independence to undertake the analysis and form an explicit judgment of the effects of specific agreements. However, if the required resources or willingness for the WTO to undertake the task cannot be found, this in itself would be a good indication of the importance that is accorded by WTO members to the spread of RTAs.

19. See Hoekman (1998) for a discussion.

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