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## International Trade Department

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These notes summarize recent research on global trade issues. They reflect solely the views of the author and not necessarily the views of the World Bank Group or its Executive Directors.

### Trade Note 24

## REGIONAL TRADE AGREEMENTS AND DEVELOPMENT: UPSIDE POTENTIAL AND DOWNSIDE RISKS

Regional trade agreements (RTAs) are fundamentally altering the world trade landscape.\* The number of agreements in force, now more than 200, has risen sixfold in just two decades (figure 1). Today, more than one-third of global trade takes place between countries that have some form of reciprocal RTA. The European Union and United States are playing a prominent role in this proliferation (figure 2). The Central American Free Trade Agreement is only the latest of more than a dozen U.S. RTAs.<sup>1</sup> The European Union, through its Economic Partnership Agreements, is using RTAs to restructure trading relations with the African, Caribbean, and Pacific countries that benefited from Cotonou preferences. This note addresses two questions:

- What characteristics of RTAs strongly promote—or hinder—development for member countries?
- Does the proliferation of RTAs pose risks to the multilateral trading system? If so, how can those risks be managed?

### Identifying What Works: Open Regionalism

RTAs are often one component of a larger political effort to deepen economic relations with neighboring countries.<sup>2</sup> As such, they can create

Figure 1 Regionalism is spreading ...  
The number of RTAs

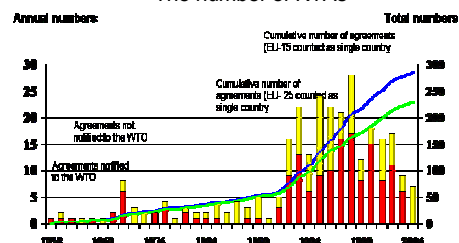
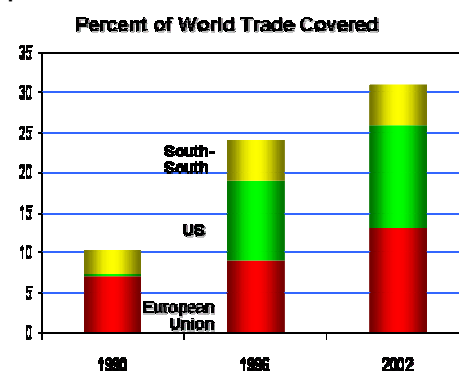


Figure 2 ... with the EU and U.S. leading the pack



Source: World Trade Organization.

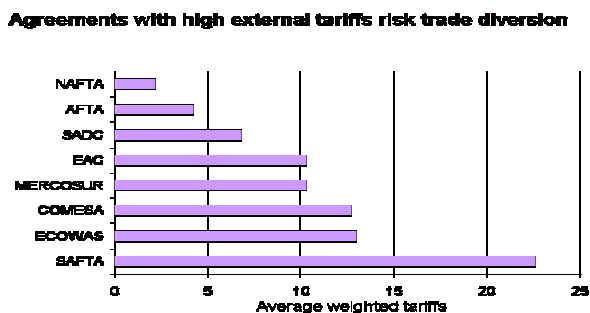
opportunities to expand trade through joint action to overcome barriers to trade, both institutional and policy-related. But the growth in RTAs also reflects the relative ease of making reciprocal reductions in border barriers when the participants are fewer and policymakers feel more in control of outcomes. RTAs also offer the flexibility to pursue trade-expanding policies not addressed well in global trading rules. RTAs therefore usually go beyond slashing tariffs to reduce trade impediments associated with standards, customs and border crossings, and regulations

\* This note is drawn from *Global Economic Prospects 2005*, Washington, DC: World Bank.

affecting trade in services—as well as broader rules that improve the overall investment climate. Because RTAs often form cornerstones of larger economic and political efforts to increase regional cooperation, RTAs can help motivate and reinforce broader reforms in domestic policy; they can be designed to contribute to a political environment that is more conducive to stability, investment, and growth.

Not all RTAs create new trade and investment. Those with high external border protection may actually reduce members’ trade overall even as trade within the group rises, a phenomenon known as trade diversion. When regional agreements consolidate high levels of external protection (figure 3a), regional trade may expand, but at the expense of trade with lower cost suppliers. Figure 3b shows the effects of various agreements, controlling for country size, income, proximity, and other factors, on trading patterns of member; agreements with relatively low external protection, such as those in the top half of figure 3b tend to increase all trade; those with higher levels of protection increased regional trade, but at the expense of more efficient trade with the world. A statistical analysis based on findings from econometric studies suggests that many agreements cost the economy more in lost trade revenues than they earn by discriminating against efficient, low-cost suppliers in nonmember countries. This finding does not take into account the potential dynamic gains, the positive effects associated with services liberalization, or any of the benefits from adopting new regulations. But it does underscore the point that regional agreements carry risks.

**Figure 3a Some agreements have much higher levels of external protection than others**



Note: Tariffs are import weighted at the country level to arrive at the RTA averages  
 Source: World Bank, 2004; see pg. xii

As agreements proliferate, a single country may become a member of several different agreements. The average African country, for example, belongs to four different agreements, and the average Latin America country belongs to seven. The result is a spaghetti bowl of overlapping arrangements (figure 5), each with differing rules of origin, tariff schedules, and periods of implementation. Those differences delay the passage through customs of goods covered by preferential arrangements, and longer processing times drive up the cost of trade.

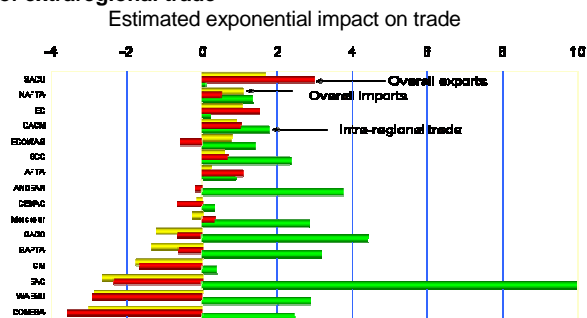
### Impact on Trade

So what characteristics of RTAs lead to expanded trade and development? A prerequisite for the success of any trade policy is that it be part of a sound domestic policy framework. It is virtually impossible for entrepreneurs to take advantage of new opportunities—whether they originate in market access through an RTA, a multilateral agreement, or other sources—in the absence of macroeconomic stability, basic property rights, and adequate infrastructure regulation. Conversely, trade agreements can reinforce positive elements in the domestic reform program by anchoring policy to the agreement itself. But an RTA cannot substitute for sound domestic policies.

With prerequisites in place, the RTAs most likely to increase national incomes over time are those designed with:

- Low external MFN tariffs
- Few sectoral and product exemptions
- Nonrestrictive rules-of-origin tests that

**Figure 3b Intraregional trade may grow at the expense of extraregional trade**



Source: World Bank, 2004; see Chapter 3 for full explanation



build toward a framework common to many agreements

- Measures to facilitate trade
- Large ex-post markets
- Measures to promote new cross-border competition, particularly in services
- Rules governing investment and intellectual property that are appropriate to the development context
- Schedules of implementation that are put in effect on time.

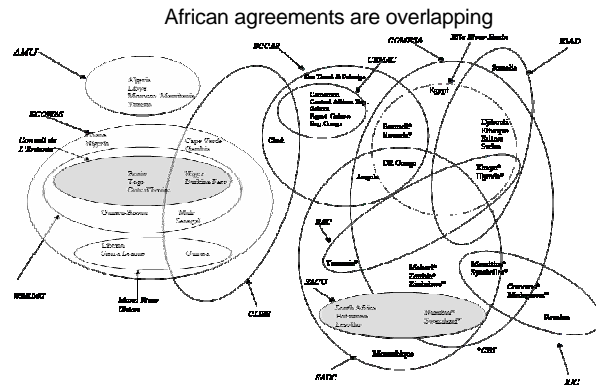
Low external tariffs and wide coverage minimize the risks of trade diversion, while nonrestrictive rules of origin promote increased trade. The practice of excluding many agricultural products is common, but it can limit development payoffs. Trade facilitation measures, though worthwhile in and of themselves, receive more attention from policymakers when they are embedded in an RTA, and they often have positive trade-creating effects for all trade partners.

Well-designed agreements are of limited value if they are not implemented, and many RTAs have more life on paper than in reality. South–South agreements, in particular, are often poorly implemented. Monitoring mechanisms may be weak or not receive the sustained, high-level political attention necessary to drive institutional improvements related to tariff schedules, customs, and border crossings.

Against these benchmarks of success, it is difficult to give universally high marks to any single category of agreement. But in general, North–South agreements score better on implementation than South–South agreements.

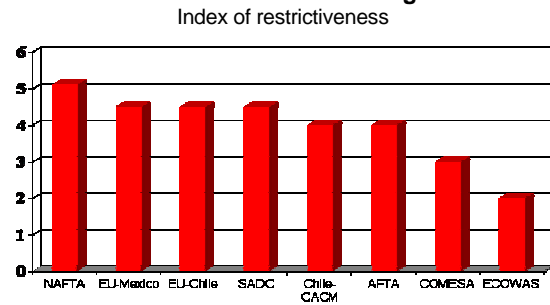
Because North–South agreements can integrate economies with distinct technological capabilities and other differences in factor proportions, and because they usually result in larger post-agreement markets, their potential gains are usually greater. However, tighter rules of origin,

Figure 4 RTAs can complicate customs administration



Sources: Schiff and Winters (2003).

Figure 5 Rules of origin in North–South agreements are more restrictive than in South–South agreements



Note: Higher values of the index indicate more restrictive rules of origin. Source: Derived from Estevadeordal and Suominen (2004).

more restrictive exclusions for particular sectors (such as agriculture), and a preoccupation with rules not calibrated to development priorities can undercut those benefits (figure 5).

North–South agreements, particularly those with the United States, have been more effective in locking in liberalization in services trade; they have pressed intellectual property rights beyond World Trade Organization (WTO) rules; and they have expanded the sphere of investment protections; but they contain few provisions to liberalize the temporary movement of labor.

South–South agreements sometimes outdo North–South deals at focusing on merchandise trade, minimizing exclusions, adopting less restrictive rules of origin, and lowering border costs. For example, the Caribbean Community (CARICOM) and the Common Market of Eastern and Southern Africa (COMESA) have reduced some border costs. But most South–South agreements have not adhered to implementation schedules, and they



suffer from their small market size and economic similarity. And like the North–South agreements, South–South agreements rarely provide for the temporary movement of labor.

### **Consequences of RTAs for the Multilateral System**

The development consequences of RTAs are not limited to their effects on members; they also extend to the multilateral system. In one sense, RTAs are a step toward greater openness in the global trade system, in that they promote trade and generate new domestic constituencies with an interest in openness. Moreover, some regional trade policies—such as measures to improve customs, speed transactions at ports or border crossings, and open services markets—can be beneficial in a nondiscriminatory way. Such measures can complement unilateral and multilateral policies.

However, this view overlooks the effects that RTAs can have on excluded countries. The fact is that preferences for some countries mean discrimination against others, whereas the General Agreement on Tariffs and Trade (GATT), born out of the sad experience of discrimination in the prewar years, is based on the principle of nondiscrimination.

Today, the adverse consequences for the excluded countries are much less severe than at GATT's inception, because tariffs and other barriers have come down sharply worldwide, mitigating the exclusionary effects of regional arrangements. (The exception—and it is not trivial—is agriculture.) Another mitigating factor is that many countries excluded by trade agreements between the United States and the European Union enjoy some degree of preferential access through voluntary preference schemes, such as the Generalized System of Preferences (GSP), the U.S. African Growth and Opportunity Act (AGOA), and the EU's Everything But Arms (EBA) program. To be sure, these programs lack the certainty of market access that MFN agreements and RTAs provide, because preferences are voluntary and subject to political whim, but they do mitigate the effects of exclusions for selected low-income countries. A third mitigating factor is that some developing

countries—the spokes in the hub-and-spoke analogy—are signing bilateral agreements with each other and with other hubs.

Inevitably some countries get left out of trade agreements because they are not favored politically, because they cannot afford the costs of many separate negotiations, or because their region is less open. Countries as diverse as Bolivia, India, Mongolia, Pakistan, and Sri Lanka do not enjoy the same level of access to the United States or the EU as Chile, Jordan, and Mexico. When bilateral agreements are signed, they see their trade diminished.

RTAs can also undercut the incentives of governments to press for further multilateral trade liberalization. There is little evidence that major players in the current WTO negotiations have changed their negotiating positions or retreated from the multilateral process, even as they avail themselves of regional trade deals. However, as the discussions become politically difficult, the risk is ever present that they will abandon multilateralism in favor of regional agreements that are “good enough.” The risk for smaller players, especially poor ones, is different. One consequence of the spread of regional agreements is that many poorer developing countries have diverted scarce negotiating resources to regional negotiations at the expense of more active participation in the Doha round of global trade discussions. The average developing country belongs to five separate RTAs and is negotiating more. To protect hard-won market access under regional agreements, countries may choose to fight multilateral liberalization or even oppose further regional liberalization. A few small developing countries are indeed likely to lose advantages in preferential markets with further multilateral liberalization and may scuttle global talks if their legitimate concerns are not addressed.

### **The Importance of the Doha Round to “Open Regionalism”**

The policy solution to these twin concerns—the need to design regional agreements that create trade and regional agreements that have minimal exclusionary effects—comes together in the form of further reductions in MFN tariffs and other border barriers. An agreement that lowers border



protection around the world promotes open regionalism by mitigating trade diversion. At the same time, it would diminish the exclusionary effects of discriminatory preferences built into regional agreements. The first order of business for the international community, therefore, is to accelerate progress on the Doha Agenda and to fill in the blanks of the July 2004 framework agreement with reductions in protection, especially for products produced by the world's poor.

**For Developing Countries, a Three-Part Strategy**

Developing countries wishing to harness trade to their development strategy should see regional integration as one element in a three-pronged strategy that includes unilateral liberalization, multilateral liberalization, and regional liberalization.

Historically, *unilateral liberalization*, which is usually linked to a broader program of domestic reform, has accounted for most reductions in border protection. Most comprehensive trade reforms undertaken by large countries (Argentina, Brazil, and China in the early 1990s and, more recently, India) began as unilateral reforms designed to increase the productivity of the domestic economy. Many small countries, too, have adopted similar reforms. Of the 21 percentage point cut in average weighted tariffs of all developing countries between 1983 and 2003, unilateral reforms accounted for almost two-thirds. Tariff reductions associated with the multilateral commitments in the Uruguay Round accounted for about 25 percent, and the proliferation of regional agreements amounted to about 10 percent (see figure 6).

Autonomous liberalization promotes global competitiveness by lowering costs of inputs, increasing competition from imports to drive productivity growth, and integrating the national economy into the global economy. In the presence of RTAs, autonomous trade reform loses none of its importance, because low border barriers minimize the risks of trade and investment diversion. They also promote trade in world markets, which is highly correlated with increases in intraregional trade, whether or not an RTA is in place.

**Figure 6 Source of total tariff reduction, by type of liberalization, 1983–2003**



Source: World Bank, 2004; Chapter 2

*Multilateral liberalization* has the effect of translating domestic reforms into increased market access around the world. Collectively, developing

countries stand to gain much more in the WTO arena than in any smaller regional market. Moreover, the multilateral forum is the only one in which developing countries, working together, can press for more open markets in agriculture and can seek disciplines on trade-distorting agricultural subsidies and contingent protection (i.e. anti-dumping measures and the like).

Some argue that RTAs are a good alternative to multilateral liberalization. They are not. Gains for all developing countries from RTAs, even under the most generous assumptions, are usually only a fraction of those from full multilateral liberalization. The appearance of benefits derives from the fact that countries signing early trade agreements with a high-income, large-market economy may benefit substantially, particularly if most other countries are excluded from preferential access. But those benefits wither as new countries sign additional agreements. In fact, developing countries would collectively lose if they were all to sign preferential agreements with the Quad (Canada, the European Union, Japan, and the United States) (figure 7) (see World Bank, 2004, Chapter 6). On balance, developing countries have a powerful collective interest in a successful Doha Round—even as they scramble to gain preferential market access to the Quad.



Forging policies on *open regionalism* is the third component of trade policy strategy. Desirable as multilateral liberalization is, the Doha Round is likely to realize only part of its development potential. For some types of policy, collective regional actions may be the first, best course and may result in effective nondiscriminatory benefits.<sup>3</sup> For example, RTAs can reduce regional political tensions, take advantage of scale economies in infrastructure provision, and lead to joint programs to improve border crossings related to liberalization in services.

But countries should sign on with their eyes wide open. The lessons of the study on which this note is based (and others before it) are that—as with unilateral or multilateral policies—design and implementation determine the ultimate effects. It is important, therefore, to use trade policy to leverage domestic reforms that promote growth. It is essential that South–South agreements focus on some combination of full trade liberalization behind low external border protection, greater services deregulation and competition, and proactive trade facilitation measures that together benefit both intra- and extra-regional trade.

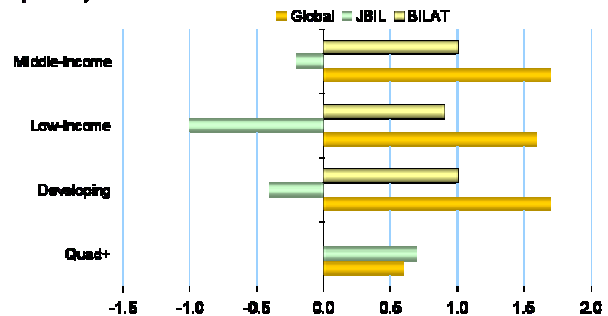
### High-Income Countries and Development

High-income countries, in order to realize their broad development objectives, must intensify their efforts to realize the development promise of the Doha Agenda. Doing so has the potential to open up trade, particularly in agriculture, in a way that would benefit low-income groups around the world. Because the high-income countries are the most powerful players in the system, they have a special interest in—and responsibility for—using effective multilateral reforms to discipline the discretionary aspects of the regional agreements. And if developing countries are to be convinced to concentrate scarce negotiating resources on the multilateral agenda the high-income countries may have to slow their efforts at expanding RTAs.

High-income countries should consider the following basic notions when designing agreements to promote development. First, the extensive exclusions for agriculture should be reversed. Doing so would bring income gains in rural areas of participating developing countries. Second, rules of origin should be more consistent

**Figure 7 Multilateral liberalization is far more beneficial than RTAs**

(change in real income in 2015 compared to baseline in percent)



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 countries. “BILAT” corresponds to the simulation where the bilateral agreements are signed individually. Results reflect unweighted regional averages.

Source: World Bank simulations with the Linkage model and GTAP release 6.04.

and less restrictive across agreements to reduce the administrative barriers that increase the burden on customs administration and so often undermine agreements. Third, new regulations affecting investment and intellectual property should be

appropriate to the level of development to reduce risks of undue enforcement costs.

Finally, trade-related technical assistance should be provided, not only in the implementation phase but also in the negotiating phase, to promote greater liberalization of services and lower MFN tariffs.

### Acting Collectively to Mute the Effects of Discrimination

To minimize the discriminatory effects of RTAs at the multilateral level, all countries must assume greater responsibility for maintaining the multilateral system. The international community, working through the WTO, should revisit Article XXIV of its charter. If the stated disciplines cannot be enforced in the near term for collective political reasons, then increasing transparency and information should become a priority. At present, the WTO collects little or no information on the implementation of specific provisions—and on the trade consequences of those actions. It even fails to take advantage of extant public monitoring efforts in specific regions, which could inform its data collection effort. Collecting and publishing specific information on RTAs would allow



members that find themselves excluded to challenge these agreements in the court of public opinion. Even the more modest goal of transparency will require building a new consensus and providing the staff of the WTO with more resources than are currently available. WTO members also should consider enhancing the existing rules to ensure that regional agreements have positive development and systemic outcomes. Enhancements (requiring only a modest tightening of current practice) might include setting quantitative indicators that define the term “substantially all trade.” They might also include efforts to simplify and harmonize the rules of origin that are applied to both developed and developing countries. These items are on the Doha Agenda and may be ready for action.

<sup>1</sup> Negotiated as bilateral or multicountry treaties, regional trade agreements grant members assured preferential market access, usually at zero tariffs for eligible products. Following WTO convention, the term “regional trade agreement” includes both reciprocal bilateral free trade or customs areas and multicountry (plurilateral) agreements. These are distinct from nonreciprocal voluntary agreements, such as the generalized system of preferences (GSP). Also, for statistical purposes, unless otherwise noted, intra-EU trade is excluded from quantitative trade analysis. The EU is defined as including the 15 countries that belonged to the union before its enlargement in 2004.

<sup>2</sup> See Devlin and Estevadeordal (2004) and Schiff and Winters (2003), among others.

<sup>3</sup> See Robert Lawrence (1997), who develops the idea of subsidiarity as applied to regional agreements.

<sup>4</sup> See Schiff and Winters (2003).

This Trade Note was written by Richard Newfarmer, Economic Adviser, World Bank. It can be downloaded at <http://www.worldbank.org/trade>.

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