

# Regional Integration Agreements

## Introduction

**T**HE GROWTH OF REGIONAL TRADING BLOCS—OFTEN KNOWN as regional integration agreements (RIAs)—is one of the major international relations developments of recent years. Most industrial and developing countries in the world are members of a regional integration agreement, and many belong to more than one: more than one-third of world trade takes place within such agreements.<sup>1</sup> The structure of regional agreements varies hugely, but all have one thing in common—the objective of reducing barriers to trade between member countries. At their simplest they merely remove tariffs on intrabloc trade in goods, but many go beyond that to cover nontariff barriers and to extend liberalization to trade and investment. At their deepest they have the objective of economic union, and they involve the construction of shared executive, judicial, and legislative institutions.

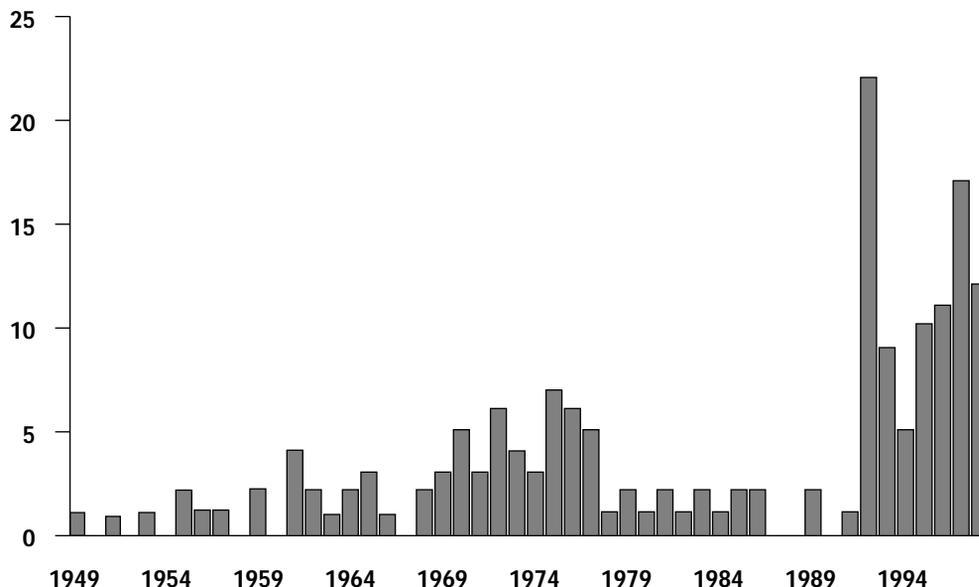
During the last decade the move to regionalism has become a headlong rush. Figure 1.1 gives the number of regional agreements notified to the General Agreement on Trade and Tariffs and the World Trade Organization (GATT/WTO)<sup>2</sup> each year, and makes apparent the dramatic increase that occurred in the 1990s. Of the 194 agreements notified at the beginning of 1999, 87 were notified since 1990. Description of some of the major agreements made in recent years is given in box 1.1, and table 1.1 lists selected trading blocs, their memberships—and their acronyms.

The last 10 years have witnessed qualitative, as well as quantitative, changes in regional integration schemes. There have been three major developments.

The first is the recognition that effective integration requires more than reducing tariffs and quotas. Many other barriers have the effect of segmenting markets and impeding the free flow of goods, services, investments, and

Figure 1.1 Notifications to GATT and WTO of Regional Integration Agreements, 1949–98

## Notifications



Source: WTO data.

ideas, and wide ranging policy measures—going well beyond traditional trade policies—are needed to remove these barriers. This so-called deep integration was first actively pursued in the Single Market Program of the European Union (EU), and elements of this program are now finding their way into the debate in other regional agreements.

The second is the move from “closed regionalism” to a more open model. Many of the trading blocs that were formed between developing countries in the 1960s and 1970s were based on a model of import-substituting development, and regional agreements—with high external trade barriers—were used as a way of implementing this model.<sup>3</sup> The new wave of regional agreements—including resurrection of some old agreements—have generally been more outward-looking, and more committed to boosting, rather than controlling, international commerce.

The third development is the advent of trade blocs in which both high-income industrial countries and developing countries are equal partners in agreements designed to bolster the economies of all the member

### Box 1.1 Recent Regional Integration Agreements

EU HAS PLAYED A LARGE ROLE IN THE RECENT SURGE of activity, with the implementation of the Single Market Program in 1992, enlargement of its membership, and numerous agreements with other countries. These agreements account for two-thirds of the agreements notified to GATT/WTO since 1990 and include the European Economic Area, the Europe Agreements with the countries of Eastern Europe, the EU-Turkey customs union, and the development of a Mediterranean policy potentially incorporating regional agreements with most countries on the southern and eastern shores of the Mediterranean.

In Latin America, MERCOSUR was formed in 1991 and the Group of Three in 1995. The Andean Pact and Central American Common Market (CACM) were resurrected in 1991 and 1993, respectively.

In Sub-Saharan Africa, the blocs in West Africa were reformed and reorganized. The Southern African Development Community (SADC) developed out of an earlier defense-based organization, Southern African Development Coordination Conference, and was supplemented—for many of its members—by the Cross-Border Initiative. The East

African Cooperation sprang up where the East African Community had failed.

The Middle East witnessed the development of the Gulf Cooperation Council (GCC), and in 1997 Arab League members agreed to cut trade barriers over a 10-year period. In Asia, the Association of Southeast Asian Nations (ASEAN) countries developed 25 years of political cooperation into a free trade area in 1992, with the formation of the ASEAN Free Trade Area. The South Asian Association for Regional Cooperation agreed in 1997 to transform itself into the South Asian Free Trade Area becoming, in terms of the population it represents, the world's largest regional agreement.

New ground was broken in 1994 when the Canada-U.S. Free Trade Area was extended to Mexico through NAFTA. For the first time a developing country joined industrial countries as an equal partner in a trade bloc designed to bolster economic development in all three economies. Links between high-income and developing countries were also being forged in the Asia Pacific Economic Cooperation (APEC), established in 1989—a looser organization, committed to trade liberalization, on a nonpreferential basis, by 2010 for industrial country members and 2020 for developing countries.

countries.<sup>4</sup> Perhaps the most important example of this is the North American Free Trade Area (NAFTA), formed in 1994 when the Canada-U. S. Free Trade Agreement was extended to Mexico. EU has linked with the transition economies of Eastern Europe through the Europe Agreements, and has developed the EU-Turkey customs union and a Mediterranean policy potentially incorporating agreements with nearly every Mediterranean country. There has been discussion of replacing the EU's trade preferences of the Lomé agreements with reciprocal trade agreements with these developing countries.

These developments have occurred against the backdrop of globalization. New technologies and more liberal trading regimes have led to increased trade volumes, larger investment flows, and increasingly footloose

**Table 1.1 Membership of Selected Major Regional Integration Agreements (RIAs) and Date of Formation**

<i>Industrial and developing economies</i>	<p><i>European Union (EU)</i>: formerly European Economic Community (EEC) and European Community, 1957: Belgium, France, the Federal Republic of Germany, Italy, Luxembourg, the Netherlands; 1973: Denmark, Ireland, United Kingdom; 1981: Greece; 1986: Portugal, Spain; 1995: Austria, Finland, Sweden.</p> <p><i>European Economic Area</i>: 1994: EU, Iceland, Liechtenstein, Norway.</p> <p><i>Euro-Mediterranean Economic Area (Euro-Maghreb)</i>: Bilateral agreements, 1995: EU and Tunisia; 1996: EU and Morocco.</p> <p><i>EU bilateral agreements with Eastern Europe</i>: 1994: EC and Hungary, Poland; 1995: European Community and Bulgaria, Romania, Estonia, Latvia, Lithuania, Czech Republic, Slovak Republic, Slovenia.</p> <p><i>Canada-U.S. Free Trade Area</i>: 1988: Canada, United States.</p> <p><i>North American Free Trade Area (NAFTA)</i>: 1994: Canada, Mexico, United States.</p> <p><i>Asia Pacific Economic Cooperation (APEC)</i>: 1989: Australia, Brunei Darussalam, Canada, Indonesia, Japan, Malaysia, New Zealand, Philippines, the Republic of Korea, Singapore, Thailand, United States; 1991: China, Hong Kong (China), Taiwan (China); 1993: Mexico, Papua New Guinea; 1994: Chile; 1998: Peru, Russia, Vietnam.</p>
<i>Latin America and the Caribbean</i>	<p><i>Andean Pact</i>: 1969: revived in 1991, Bolivia, Colombia, Ecuador, Peru, Venezuela.</p> <p><i>Central American Common Market (CACM)</i>: 1960: revived in 1993, El Salvador, Guatemala, Honduras, Nicaragua; 1962: Costa Rica.</p> <p><i>Southern Cone Common Market (Mercado Común del Sur—MERCOSUR)</i>: 1991: Argentina, Brazil, Paraguay, Uruguay.</p> <p><i>Group of Three</i>: 1995: Colombia, Mexico, Venezuela.</p> <p><i>Latin American Integration Association (LAIA)</i>: formerly Latin American Free Trade Area, 1960: revived 1980, Mexico, Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Paraguay, Peru, Uruguay, Venezuela.</p> <p><i>Caribbean Community and Common Market (CARICOM)</i>: 1973: Antigua and Barbuda, Barbados, Jamaica, St. Kitts and Nevis, Trinidad and Tobago; 1974: Belize, Dominica, Grenada, Montserrat, St. Lucia, St. Vincent and the Grenadines; 1983: The Bahamas (part of the Caribbean Community but not of the Common Market).</p>
<i>Sub-Saharan Africa</i>	<p><i>Cross-Border Initiative</i>: 1992: Burundi, Comoros, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Swaziland, Tanzania, Uganda, Zambia, Zimbabwe.</p> <p><i>East African Cooperation</i>: 1967: formerly East African Community, broke up in 1977 and recently revived, Kenya, Tanzania, Uganda.</p> <p><i>Economic and Monetary Community of Central Africa</i>: 1994: formerly Union Douanière et Economique de l'Afrique Centrale, 1966: Cameroon, Central African Republic, Chad, Congo, Gabon; 1989: Equatorial Guinea.</p> <p><i>Economic Community of West African States (ECOWAS)</i>: 1975: Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo.</p> <p><i>Common Market for Eastern and Southern Africa</i>: 1993: Angola, Burundi, Comoros, Djibouti, Egypt, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Mozambique, Rwanda, Somalia, Sudan, Swaziland, Tanzania, Uganda, Zambia, Zimbabwe.</p>

*(Table continues on the following page.)*

Table 1.1 (continued)

	<p><i>Indian Ocean Commission: 1984:</i> Comoros, Madagascar, Mauritius, Seychelles.</p> <p><i>Southern African Development Community (SADC): 1980:</i> formerly known as the Southern African Development Coordination Conference, Angola, Botswana, Lesotho, Malawi, Mozambique, Swaziland, Tanzania, Zambia, Zimbabwe; <i>1990:</i> Namibia; <i>1994:</i> South Africa; <i>1995:</i> Mauritius; <i>1998:</i> Democratic Republic of the Congo, Seychelles.</p> <p><i>Economic Community of West Africa: 1973:</i> revived in 1994 as West African Economic and Monetary Unit, Benin, Burkino Faso, Côte d'Ivoire, Mali, Mauritania, Niger, Senegal.</p> <p><i>West African Economic and Monetary Union: 1994:</i> Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal, Togo, <i>1997:</i> Guinea-Bissau.</p> <p><i>Southern African Customs Union (SACU): 1910:</i> Botswana, Lesotho, Namibia, South Africa, Swaziland.</p> <p><i>Economic Community of the Countries of the Great Lakes: 1976:</i> Burundi, Rwanda, Democratic Republic of the Congo.</p>
<i>Middle East and Asia</i>	<p><i>Association of Southeast Asian Nations (ASEAN): 1967:</i> ASEAN Free Trade Area was created in 1992, Indonesia, Malaysia, Philippines, Singapore, Thailand; <i>1984:</i> Brunei Darussalam; <i>1995:</i> Vietnam; <i>1997:</i> Myanmar, Lao People's Democratic Republic; <i>1999:</i> Cambodia.</p> <p><i>Gulf Cooperation Council (GCC): 1981:</i> Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.</p> <p><i>South Asian Association for Regional Cooperation: 1985:</i> Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka.</p>

Source: WTO data.

production. All these considerations point to the need for a new analysis of regional integration agreements—one that takes into account political as well as economic effects, that assesses the opportunities for deep integration, and captures the new potentials created by North-South agreements.

## This Report

**N**O COUNTRY IS IMMUNE FROM THE EFFECTS OF regionalism as it shapes world economic and political relationships and influences the development of the multilateral trading system, and all countries face policy choices concerned with regionalism. Should they enter a regional integration agreement? With what other countries? What measures should be implemented—simple trade liberalization or deeper harmonization of domestic policies? There are no simple answers to these questions. Countries differ in their

circumstances and in their political and economic objectives. Nevertheless, the economic tradeoffs that they face in making these choices can be identified and the process of decisionmaking made better informed. This is the objective of this report. We use the latest research on regionalism—research undertaken in the World Bank and elsewhere—to evaluate the experience of existing regional integration agreements and to draw inferences from this for the tradeoffs faced by decisionmakers.

An important question in analyzing the effects of RIAs is: Compared to what? The choice of counterfactual—including the status quo, unilateral trade liberalization, or multilateral liberalization—depends on the objective of the analysis. Answers will vary according to the choice of counterfactual. In fact, disagreements between policymakers or analysts may be due as much to differences in counterfactuals they have in mind as to differences in views. It is therefore important to be clear about the counterfactual that is being used as the basis for the analysis.

Given the wave of new RIAs in the last decade, and the fact that many developing countries have approached the World Bank for technical support and policy advice on whether to join or form a RIA, on the choice of partner, on the type of RIA, and on details of implementation, we choose the status quo as the counterfactual. However, when appropriate, we will also compare our results with those obtained under unilateral trade liberalization.

## **Politics and Policymaking**

Many of the arguments for membership in a regional agreement are political, and we address these in the next chapter. There are three main issues. The first issue is security. There may be perceived benefits from using a regional agreement as a basis for increasing security against non-members, and there are some examples where this has occurred. A regional agreement may also enhance a country's security in its relationship with other members, an important argument in the early days of European integration. These security arguments are driven by a variety of mechanisms. Interlocking economies can make conflict more expensive; regular political contact can build trust and facilitate other forms of cross-border cooperation. But a regional agreement can also create internal tensions, particularly if driven by economic rather than security considerations and if the economics appears to bring an unfair distribution

of benefits. History provides examples where this has led to the breakup of economic unions and to conflict.

The second sort of political effect is bargaining power—the hope that from unity comes strength. The likelihood of this occurring depends on who the member countries are. The EU has probably been able to secure more in some international negotiations than could its member states acting independently. Regional agreements between small developing countries cannot aspire to the EU's economic weight or political power, but can nevertheless enter negotiations more effectively than separate countries might be able to. They are more likely to “be noticed,” and thence more likely to be able to make deals. Of course, these benefits depend on members being able to formulate a common position on relevant issues, a goal that has often proved elusive.

The third issue is “lock-in,” and relates to the effect of the regional agreement on domestic politics. Attempts at reform are often undermined by expectations of reversal. A regional agreement can provide a “commitment mechanism” for trade and other policy reform measures. It can be a way of raising the cost, and thereby reducing the likelihood, of policy reversal. This argument can apply to political as well as economic reform, and there are examples where regional integration agreements have reinforced democracy in member states. However, the effectiveness of regional agreements as “commitment mechanisms” depends on the interests and degree of involvement of all the countries concerned. Domestic political pressures and the activities of lobbies will also influence the form of many regional agreements—quite possibly preventing them from being as effective as they might otherwise have been.

### **Economic Costs and Benefits**

The economic effects of regional agreements are studied in chapter 3, and are of two main types. The first are “scale and competition” effects. Removal of trade barriers is like a market enlargement, as separate national markets move toward integration in a regional market. This allows firms to benefit from greater scale and attracts investment projects for which market size is important, including foreign direct investment (FDI). Removing barriers also forces firms from different member countries into closer competition with each other, possibly inducing them to make efficiency improvements. Although these are major sources of benefit, we

will see that the effects are not always achieved, and that the effects depend on the design and implementation of the agreement. Some of these benefits may be achievable with unilateral trade liberalization, although the latter may not always be politically feasible.

The second source of economic change is “trade and location” effects. The preferential reduction in tariffs within a regional agreement will induce purchasers to switch demand toward supply from partner countries, at the expense of both domestic production and imports from nonmembers. This is trade creation and trade diversion. Governments will lose tariff revenue, and the overall effect on national income may be positive or negative, depending on the costs of alternative sources of supply and on trade policy toward nonmember countries.

Changes in trade flows induce changes in the location of production between member countries of a regional agreement. These relocations are determined by the comparative advantage of member countries, by agglomeration or clustering effects, and by possible technology transfer between countries. In some circumstances, relocations can be a force for convergence of income levels between countries. Labor-intensive production activities may move toward lower-wage countries, raising wages there. In other circumstances, relocations can be a force for divergence. Industry may be pulled toward a country with a head start or with some natural advantage, driving up incomes ahead of other countries. We argue that divergence is more likely in “South-South” regional agreement schemes between economically small low-income countries. It can create tensions that lead to failure of the agreement. “North-South” regional agreements are also more likely to generate useful technology transfers for Southern members, particularly if the Northern member is an important producer of knowledge.

### **Policy Choices**

Regionalism confronts countries with four broad areas of policy choice; analysis of these choices is the subject of chapter 4. The first choice is with whom, if anyone, to form an agreement. A developing country may face options ranging from an agreement with another low-income country, to partnership with a high-income country or bloc, or membership of a large regional grouping such as the Asia Pacific Economic Cooperation (APEC). The political and economic effects differ widely

across these cases, and we identify circumstances under which we think gains or losses are more or less likely. We also investigate the costs and benefits of belonging to more than one agreement.

The second policy choice concerns the policy stance members of a regional agreement take toward the outside world. A regional agreement is inherently preferential, discriminating in favor of members—how discriminatory should it be? Trade policy may be set regional agreement wide (as is the case in a customs union) or left to the discretion of individual members (as in a free trade area). These different arrangements each have costs and benefits, as well as creating different incentives for setting external trade policy.

The third area of policy choice is the “depth” of integration to be pursued. Different countries enter regional agreements with very different objectives and constraints. For some the objectives are to secure economic integration and to build deep political links, and there is a willingness to exert political effort to meet these objectives. Thus, the EU seeks “economic union” and the development of shared political institutions. “Deep” integration of this type may bring larger benefits in many areas of activity. For example, deep integration might involve harmonization of product standards and of parts of the fiscal system. This will make it more likely that economic “scale and competition” gains are realized. However, it also involves greater loss of sovereignty, greater political commitment, and far more complex policymaking than would a looser free trade agreement.

In addition to the depth of integration, countries must also decide on the “width” of an agreement, and this is the fourth policy area. How wide a range of activities should be covered by an integration agreement—just trade in goods, or also extension to services and factor mobility? We look at some of the economic issues that arise, and some of the practical problems that may be encountered as countries choose the depth and width of integration.

## **Regionalism and the World Trading System**

One of the most hotly debated issues in the area is the effect of regionalism on the world trading system. To some, regionalism is a “stepping stone” toward global free trade, while to others it is a “stumbling block,” inhibiting progress in multilateral trade liberalization. We address these

issues in chapter 5, and find no evidence that regionalism has caused tariffs on nonmembers to be higher than they otherwise would have been. But neither do we accept the arguments that regionalism sets in train a “liberal dynamic,” or facilitates multilateral liberalization. We find some case for strengthening the operation of WTO procedures to ensure that regional agreements are genuinely trade liberalizing, and for increased access to Organisation for Economic Co-Operation and Development (OECD) markets for developing countries.

### The Scope of this Report

Although we argue that analysis of regional integration agreements should go well beyond traditional approaches of trade creation and trade diversion, we must also circumscribe the scope of this report. Our focus is trade, and we do not discuss either free movement of labor or monetary union. These are both features of the EU, but they are rare elsewhere. The EU is the only major regional agreement that gives all citizens right of abode and employment in all member countries. Monetary union occurs in francophone Africa, but it is outside the terms of reference of most regional agreements.

## Notes

1. This figure increases to 59 percent if APEC is included.

2. General Agreement on Trade and Tariffs, which from 1994 onward has been part of the World Trade Organization.

3. This model of “closed” regionalism was widely implemented, especially in Sub-Saharan Africa and Latin America and the Caribbean. Examples in Africa include the Economic Community of West Africa (created in 1973),

the Economic Community of West African States, ECOWAS (1975), the Economic Community of the Countries of the Great Lakes (1976), and the East African Community (1967). In Latin America and the Caribbean, examples include the Central American Common Market, CACM (1960), Latin American Free Trade Area (1960), the Andean Pact (1969), and the Caribbean Community and Common Market, CARICOM (1973).

4. Unlike the preferential trade agreements implied by colonial preferences.