

Trade Blocs and the World Trading System

Introduction

DOES REGIONAL INTEGRATION ENCOURAGE EVOLUTION toward globally free trade, or does it place obstacles in its way, and perhaps even increase the likelihood of trade wars between competing blocs? The stakes in the bet as to whether RIAs are stepping stones to multilateral trade liberalization or millstones around its neck are truly huge.¹ Opening trade and increasing competition have been behind virtually every sustained economic growth experience, and the unprecedented postwar growth of world output and income has clearly been allied to the growth of world trade and trade liberalization. Progress here affects everyone, and is particularly important for the small and medium economies that depend heavily on international trade, and are the principal beneficiaries of an orderly and nondiscriminatory trading regime.

This chapter takes up these issues. First, we investigate the external tariffs of RIAs, and ask whether there are reasons to believe that a world of relatively few large RIAs will have lower or higher tariffs than a world composed of a large number of separate countries. We then turn to the dynamics of the world trading system. Does the presence of RIAs create incentives for excluded countries to join existing RIAs, to form new RIAs of their own, or to change their external trade policy in other ways? What are the prospects for “open regionalism” as proposed by some APEC countries? This leads us into the effects of RIAs on multilateral trade negotiations—the rounds of GATT/WTO talks. Have RIAs prompted countries to initiate and become involved in these negotiations, and do they facilitate or impede successful outcomes of the talks? Finally, we turn to the rules of the WTO itself, and ask whether the WTO should treat RIAs differently from its present lax stance.

5.1 How RIAs Set External Tariffs

ARE THERE ANY REASONS TO BELIEVE THAT A WORLD OF trading blocs is likely to be more prone to high tariffs between blocs than a world of separate nations? Some commentators have foreseen doomsday scenarios in which “Fortress Europe” and other major trade blocs engage in trade wars, damaging to themselves and above all to excluded developing regions. Is there any basis for such views?

A famous insight on the possible effects of trade blocs on tariffs comes from Paul Krugman (1991a and 1991b).² He noted that trade barriers would be lowest—and consequently world income greatest—in two opposite circumstances. One is when there is a single world trade bloc containing all countries, that is, global free trade. The other is when trade policy is set by many small independent countries, each so small as to have no market power and no reason to deviate from free trade. However, between these extremes each trading bloc has an incentive to use external tariffs to try and improve its terms of trade (reducing trade volumes to drive up the price of exports and reduce the price of imports). This reduces world real income, which reaches a minimum for some intermediate number of trade blocs.³ Extending the insight in a simple (and not very robust) example, Krugman suggested that the worst number of similar sized RIAs for world welfare was three. Each sets a tariff to try and turn the terms of trade in its own favor, but this can only be at the expense of other blocs. The “prisoners’ dilemma” in tariffs is worst with three prisoners!

This paper sparked a large literature, and many counter-examples. Perhaps the most pertinent criticism of the analysis surrounds the fact that tariff setting and trade negotiations involve repeated interactions between the same countries or blocs, so that the simple logic of the prisoner’s dilemma need not apply. Countries or blocs may be able to cooperate, particularly if they perceive that the cost of breaking an agreement on tariffs is a future trade war, with all the costs this imposes. Analysis of this situation (for example, Bond and Syropoulos 1996a and 1996b) suggests that as bloc sizes get larger the returns to cheating on a trade agreement grow, but so too does the loss from the resulting trade war. In some cases at least, the former effect dominates, with the result that it is more difficult to maintain free trade in a world of large trading blocs, suggesting that regionalism increases the likelihood of protection. Considerable caution needs to be employed in interpreting these results;

they are not very robust, and no consensus has emerged about the magnitude nor even the net direction of general effects.

Turning from the analytical arguments, what is the evidence on the external trade policy of countries in RIAs? We start by noting that WTO rules governing RIAs expressly forbid increases in trade barriers (see section 6 of this chapter). However, in practice, the rules can be circumvented, potentially allowing RIA formation to be associated with tariff increases. For many developing countries there is a wide gulf between their actual (applied) tariffs and the maxima committed to in their formal bindings in the GATT. For example, when Mexico nearly doubled tariffs on 503 imported items from non-NAFTA sources in 1995, it did so without violating any bindings. WTO rules are ambiguous and poorly enforced, and a determined government can make trade policy more restrictive in ways more or less immune to WTO disciplines—say, through antidumping actions or health regulations. Also, in a world edging toward general trade liberalization, we need to ask not only whether RIAs raised tariffs, but whether they caused them to fall less than they otherwise might have.

We can do this by comparing the external trade policy of RIAs with that of countries not members of effective RIAs. Foroutan (1998) undertook such a study across developing countries. She divides countries according to whether or not they are in “effective” RIAs, defined as having a material effect on the share of intrabloc trade in total trade, and compares aspects of their external trade policies.⁴ Her main findings are:

- *Average applied tariffs and nontariff barrier coverage.* The Latin American RIAs now have among the lowest average tariffs and nontariff barrier coverage among developing countries and have achieved the greatest liberalization since the mid-1980s. Except for Chile, the small non-RIA group has made much less progress. Until 1994 neither RIA nor non-RIA countries in Africa had displayed much tariff liberalization, and the mean average tariff is almost the same between the two groups. The most liberal countries in the sample are the members of North-South RIAs—Israel, Mexico, and Turkey.
- *Uruguay Round Concessions.* Here the only feasible comparison is between the Latin America RIA group and all non-RIA countries. The former group cut its bound tariff by more and bound more of its tariffs in the Round than did the latter, although levels started, and remain, relatively high.

This work is useful for refuting the simple hypothesis that RIAs lead directly to protectionism and are consistent with the idea that regionalism helps to lock in previous liberalization. However, the jury is still out on the issue; evidently many countries were seeking to liberalize trade by regional, multilateral, and possibly also unilateral routes, and we are far from knowing whether incentives for the multilateral and unilateral are sharpened or blunted by following the regional route.

5.2 The Dynamics of Regionalism

IN CHAPTER 1 WE SAW THE EXPLOSIVE GROWTH OF RIAs IN RECENT years. Is this, in part at least, because of an underlying dynamic by which forming a RIA increases the incentive for outside countries to become members, and so on, until the world is completely divided into RIAs? The process has been termed “domino regionalism” by Baldwin (1995), who analyzes how, after three decades of resistance, three Scandinavian countries decided to seek EU membership in the late 1980s. Although they were still uncomfortable with the EU politically, the economic pressures from the Single Market Program and from EU expansion were overwhelming. Arguably, the same process occurred when Canada sought access to the U.S.-Mexican talks that eventually created NAFTA, and motivated several Latin American and Caribbean countries to seek accession afterward. The same happened with Chile and Bolivia seeking association with MERCOSUR, with Mediterranean countries racing to get Euro-Med Agreements, and even perhaps with a number of late entrants seeking membership in the Cross-Border Initiative in Africa.⁵

In part, the drive toward regional agreement is driven by positive example; countries perceive benefits of membership and act to join or set up RIAs. But in part, the force comes from perceived adverse effects of nonmembership.

The Costs of Nonmembership

Why might the existence of some RIAs create or increase incentives for other countries to join? One obvious reason is simply that countries perceive benefits of membership, and become increasingly unwilling to

forgo them. But another, more malign reason, is that countries suffer from being left out, and it is this that creates the rush to join. So how does the existence of RIAs affect nonmember countries?

The first and most direct way in which nonmembers are affected is through the change in trade flows caused by a RIA, causing both the exports and imports of nonmember countries to be smaller than they otherwise would have been. Such changes do not necessarily have an adverse effect, although there are several circumstances when they will. One is when they lead to a terms-of-trade deterioration for excluded economies. That is, the fall in demand for their exports (and reduction in supply of imports) may reduce their export price (and raise their import price). We saw in chapter 3 that member countries have gained from this, and that excluded country loss is simply the other side of the coin. Another set of circumstances under which excluded countries will be harmed by the relative decline in their trade is if their trade flows are already too small, that is, if they are running at a level at which marginal benefits exceed marginal costs. This will happen if the excluded economies have their own restrictive trade policies in place. It will also happen if firms are operating in imperfectly competitive markets and are making a positive price-cost margin on each unit of sales. Losing sales in a RIA market might be particularly damaging to such firms, causing them to lose profits, and perhaps causing them to be unable to cover their fixed costs.

Probably more importantly, countries fear that firms may relocate in search of the benefits of a larger market. This is consistent with what actually happened to FDI in Europe. Following announcement of the Single Market Program in the late 1980s, FDI fell in every single EFTA country. In order to restore their share of FDI, the governments of EFTA had little choice but to accept the Single Market Program. All except Switzerland did this, either by applying for EU membership or by joining the European Economic Area. Only once they had announced these moves did FDI recover (Baldwin, Forslid, and Haaland 1996).

Another source of loss from nonmembership of RIAs is the risk attached to being isolated if a trade war occurs. Of course, all countries—inside or outside RIAs—will usually lose from a trade war, but countries in RIAs have the insurance of knowing that they will still have free trade with partner countries. Whalley (1996) undertakes some numerical simulations of the costs of being outside a bloc during a trade war, showing

that they can be very sizable. He argues that this creates a strong insurance motive for being inside a large RIA.

The argument is not all one-sided, however. Against these losses, there are a number of sources of gains that the rest of the world might expect from the formation of a RIA. We saw in chapter 3 that a RIA might improve the supply side of the integrating economies—perhaps by improving policy, increasing firms' efficiency, and thereby raising income levels. Such supply-side improvements will tend to reduce the prices of products exported by the RIA. This will be beneficial to countries who import these goods, although damaging to competing exporters.

Generally all these third country effects are likely to be small, particularly when the RIA is between relatively small economies, but there are exceptions. The important role NAFTA seems to have played in mitigating Mexico's 1994 peso crisis clearly benefited the rest of the world.

Bloc Formation

If we accept that the existence of RIAs creates demand for additional RIA membership, the demand can be met either by formation of new RIAs or by expansion in the membership in existing ones. Expansion requires the permission of existing members, and we discuss it in the next subsection (on open regionalism). Formation of new blocs has been an important alternative, as is evident from the figures on new RIA notifications. The process of bloc formation has been analyzed by Frankel (1997). He studies a hypothetical world of many countries and four continents, with zero trading costs between countries within the same continent and positive costs between continents.⁶ Starting from a situation in which each continent has a nondiscriminatory trade policy, any one continent could then improve its welfare by forming an FTA and imposing preferential tariffs. This would harm overseas producers since they would have to lower their prices to mitigate their loss of competitiveness, and would then suffer from the terms-of-trade decline. From here a second continent benefits by creating a RIA, switching a loss of welfare into gain, and thence a third continent, converting larger losses into smaller ones. Even the fourth continent gains by creating a RIA, although by then all continents are worse off than under nondiscriminatory policies. World welfare falls at every stage, but no continent has the incentive to undo the regionalism unilaterally.

Open Regionalism?

Open regionalism originated from APEC whose leaders envisioned a community based on openness and free exchange of goods, services, and investment.

The term open regionalism has been used in different ways, and with two quite distinct meanings. One is *unconditional nondiscriminatory liberalization (or concerted unilateralism)*. The idea is that as member states liberalize trade within the bloc, so they simultaneously cut trade barriers on imports from external countries as well. This was the definition of the early APEC advocates, who saw the coalition as a means of encouraging countries to liberalize together and so provide for each other some of the terms of trade and political economy benefits of a full GATT/WTO round. Relative to forming a RIA, the policy brings the additional gains of liberalizing external trade and thereby removing the source of trade diversion. Relative to a liberalization by a single country, the fact that it would be *concerted*, with all members liberalizing together, brings additional benefits as access for imports is eased, so firms get improved access to partner markets; this reduces the likelihood of liberalization leading to a terms-of-trade loss. However, despite these attractions, the idea of concerted unilateralism does not now seem likely to make headway. Within APEC, the United States is implacably opposed to the idea. More generally, the WTO system is so firmly based on the notion of trade liberalization being a concession (to be granted in return for some concession by trading partners) that the idea is unlikely to catch on.

A second, and quite different concept is *open access* whereby the RIA announces that any country willing to abide by its rules may join. In terms of the economics, such an arrangement is still preferential, giving discriminatory benefits to members. Its main importance would be as a stepping stone to multilateralism: Could an open access RIA attract an increasing number of members, to the point where almost all countries became members?

Analytical treatments of this issue are not optimistic. As we saw in chapter 4, there is generally an optimal size for a RIA, from the point of view of existing members, so it is not clear why members should want unrestricted access. In practical terms, the feasibility of open access depends crucially on the depth of the scheme. Where a RIA involves few conditions, then open access can be quite easily envisaged. Perhaps the best example is the Cross-Border Initiative in East and

southern Africa, in which neither internal preferences nor external tariff harmonization are rigorously enforced. But for deeper agreements, open access is harder to envisage.

NAFTA, where the principal rules are completely free trade in goods and open investment, might seem to be a candidate, but has in fact rejected many overtures. This seems more to avoid adjustment in the United States than because other issues such as quotas for professional migration or dispute settlement require negotiation. MERCOSUR has expressed willingness to accept new members, implying a degree of open access. However, given that fairly deep integration is planned, detailed negotiation is required. Association—the status preferred by Chile—is easier, but does not offer full integration and still requires several years of talks.

The EU stands ready to sign association agreements with many neighboring countries, and ostensibly with the African, Caribbean, and Pacific countries, but only on its own terms covering issues such as rules of origin, excluded sectors, the use of antidumping duties, and so on. Full membership in the EU is anything but open access. The United Kingdom had to ask three times before it was allowed to join, and Turkey was rejected until recently. Negotiations are tortuous once accession is agreed in principle. Each of the five current Eastern European candidates faces a formidable list of demands and requirements prior to membership. In several cases they are required to adopt policies from which some existing members have negotiated exemptions (such as the Social Chapter). Still, EU membership has increased from 6 to 15 countries and is expected to increase to 25 countries over the next decade or so.

In practice, what we are seeing here is essentially that any country is free to apply; but the price of entry is set separately for each entrant. This can lead to asymmetric agreements in which benefits to developing country candidates are reduced and possibly appropriated by existing members through side conditions on issues such as the environment, labor regulations, and rules of origin. Since the more complex aspects of RIAs—especially those with budgetary implications—*have* to be negotiated, access can never be automatic and unconditional. In practice, it will not be easy for the WTO to write or enforce general rules for open access, and it is unlikely that this route will lead to ever expanding membership.

However, even though full and unconditional open access to RIAs is unlikely to be feasible, increased access by developing countries to the markets of the trade blocs in the industrial North is more likely through

a successful WTO or through association agreements with the EU, the United States, or Japan. The latter requires the WTO to modify its rules regarding RIAs and create a presumptive right of association. As with the most favored nation (MFN) clause, if association is granted to one country, there should be a presumption that it should be available to others. For instance, if Iceland is offered reciprocal freedom from anti-dumping suits by the EU, the same option should be available to Ghana. In practice, association is complex and each accession needs to be negotiated, but the poor should not be automatically denied association rights provided to middle-income countries by the EU and NAFTA. This issue is examined in more detail in section 5.6.

What about APEC itself, where the idea originated? It has yet really to decide between these alternatives, because there has not yet been any APEC liberalization. Members have certainly not yet introduced any discriminatory trade policies (with the minor exception of the APEC business visa), but neither have they yet moved beyond implementing their Uruguay obligations and, for developing members, their own unilateral reforms. The manifesto still contains a commitment to global liberalization, but it is worth recalling that, although more positive in its approach and timetable, this manifesto is not very different from the EEC's 1957 statement that "by establishing a customs union between themselves, member states aim to contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers" (Article 110.1, Treaty of Rome).

5.3 Regionalism and Multilateral Trade Negotiations

ONE OF THE MAIN VEHICLES FOR TRADE LIBERALIZATION HAS been the series of GATT/WTO rounds of trade negotiations. From the late 1940s through the present, these rounds have reduced average tariff rates on manufactures from more than 40 percent to less than 5 percent. How do RIAs impact on multilateral trade negotiations? Do they promote the initiation and conclusion of these rounds, or provide obstacles to their progress? Three sorts of arguments have been made.

Multilateralism as a Response to Regionalism

The first argument is that countries outside RIAs may react to their exclusion by attempting to accelerate multilateral liberalization. Many commentators suggest that the creation of the EEC in 1957 had this effect. This, they suggest, led directly to the Dillon and Kennedy Rounds of GATT negotiations as the United States sought to mitigate the EEC's potential for diverting trade (Lawrence 1991; Sapir 1993; WTO 1995). Although perfectly conceivable, this is not a straightforward argument.

First, it seems unlikely that multilateral negotiations would have stopped completely had the EEC not been created, especially given the global reach of the United States during the 1960s. Thus, at most, the EEC affected the timing, not the occurrence, of the Rounds. Second, agriculture played an important role in the formation of the EEC, and the EEC was probably more successful in resisting that sector's liberalization in the multilateral trade negotiations than its individual members would have been. This has probably made future liberalization more, not less, difficult. Third, suppose that the hypothesis were true, that the creation of the EEC had led to negotiations. The logic of the argument is essentially coercive: EEC members did something that their trading partners considered harmful, and then offered to mitigate it in return for concessions. Coercion may be warranted and the outcome may have been beneficial, but this is a dangerous game. It depends critically on the willingness of the partners to fold—(by negotiating) rather than fight (by raising tariffs) and to respond multilaterally rather than regionally.

It has also been argued that regionalism was behind the Tokyo Round. Winham (1986) reports both the first EEC enlargement (including free trade with EFTA) and the restrictiveness of Europe's Common Agricultural Policy as factors in the United States desire for a Round. The former observation seems no more compelling than those surrounding the creation of the EEC, while the latter is distinctly two-edged: it is based on regionalism having increased trade restrictions in agriculture (Common Agricultural Policy), and a response to this being negotiation. For the net effect of this on multilateral progress to be beneficial requires a negotiating structure in which might and countervailing power are the critical elements of liberalization.

Finally, consider the Uruguay Round, of which the WTO (1995) says, "There is little doubt that...the spread of regionalism [was a] major factor in eliciting the concessions needed to conclude" the Round. There

was, indeed, a perception that the failure of the Round would lead to regional fragmentation. This almost certainly encouraged the spread of defensive regionalism, but whether this pressured the two major parties to agree is not clear, for they were the prime “regionalists,” and they would certainly not have been the principal casualties of fragmentation. Some senior EU negotiators have said that the 1993 Seattle APEC Summit induced the EU finally to concede on agriculture and conclude the Uruguay Round (Bergsten 1997). Again, this may be true, but there are counter-arguments. For example, APEC was not advertised as a discriminatory RIA, and any discrimination would, anyway, have been far in the future. Also, the principal necessary condition for the EU to complete the round was agricultural reform, which was initiated in 1990 and completed in 1992 (Hathaway and Ingco 1996).

Does Regionalism Facilitate Negotiation?

If regional integration agreements made trade negotiations easier, perhaps they would help the world evolve toward freer trade. Coordinated coalitions may have greater negotiating power than their members do individually and such coalitions may facilitate progress just by reducing the number of players represented in a negotiation (Kahler 1995). Whether this really occurs is a moot point. For example, a negotiation comprising one dominant partner and a competitive fringe of small countries might be easier and proceed further than if the fringe coalesced into a significant counterforce.

This line of reasoning prejudices the issue of whether blocs are genuinely unified in their approach to trade negotiations. This is not usually so, meaning that any gains from having fewer players in the last stage of a negotiation are offset by the complexity of agreeing joint positions in the first phase. The difficulties of achieving a European position on agriculture and cultural protection in the Uruguay Round are well known, and formulating EEC positions in the Tokyo Round proved complex (Winham 1986). Moreover, two-stage negotiations need not be more liberal than single-stage ones (Basevi, Delbono, and Mariotti 1995). To be sure, Germany and the United Kingdom pressured France to agree to the agricultural deal in the Uruguay Round, but the liberalizers had to make potentially trade-restricting concessions on “commercial defense instruments” to clinch the deal. Wang and Winters (1998) argue that

the benefits to African countries of enhancing their bargaining power by cooperation are likely to be outweighed by the costs of combining their different interests into a single negotiating position.

While the EU has internal procedures for arriving at a common position, many of the CUs that attend the next round of global trade talks have not yet developed procedures for determining their negotiating positions. SACU's previous practice of delegating all responsibility to South Africa begins to look less tenable as divisions emerge between members, and MERCOSUR has yet to devise really robust internal decisionmaking capacity. Thus, at least into the foreseeable future, RIAs do not seem likely to facilitate even a traditional trade negotiation. Moreover, as WTO has extended its reach, it has embraced subjects in which most central CU authorities have no mandate to negotiate. Mixing national and CU responsibilities seems unlikely to simplify matters, and it is not realistic to expect member countries to surrender sovereignty on sensitive issues to regional bodies just because trade negotiations are in process.

Successful trade negotiations also require political will and administrative effort. Reserves of administrative skill, political capital, or imagination are finite; if they are devoted to a RIA they are not available for multilateral objectives. These arguments were advanced to explain both EU and U.S. behavior during the Uruguay Round, but they must be several times more important for developing countries. Negotiating a RIA, especially with a major power that has its own objectives, will absorb a huge proportion of the scarce policymaking skills of a developing country. Perhaps one of the opportunity-costs of RIAs is that less negotiating capacity and political capital are available for multilateral negotiations.

One alarming possibility is that regionalism might undermine U.S. or EU willingness to participate actively in the multilateral system.⁷ Over the last three decades they have been major players, monitoring both smaller countries' policies and each other's. A loss of interest by either would reduce WTO's overall effectiveness and could upset the current fine balance.

Regionalism and the Frontiers of Liberalization

One of the strengths that is frequently claimed for the regional approach to liberalization is that it makes it easier to handle the tough issues (Kahler 1995); there are areas in which regional liberalization or

harmonization between similar or like-minded countries is feasible when multilateral progress is not. As we have seen (chapter 4) the EU has addressed a wide range of “deep integration” issues; NAFTA has tackled investment; Brazil has free trade in information technology goods within MERCOSUR; Chile and Canada have eschewed antidumping actions on mutual trade.⁸

But until recently even RIAs among industrial countries, let alone those among developing ones, had not advanced much further with liberalization than had the multilateral system (Hoekman and Leidy 1993). Thus, for example, agriculture frequently remained restricted, transport, culture, and other sensitive services were excluded; and government procurement was ignored *de facto* if not *de jure*. The EU, especially in the Single Market Program, has now advanced further, but this took 30 years to initiate and is, to date, unique. Overall, RIAs have not led on the tough issues to the extent that is sometimes supposed.

The benefit of having RIAs tackle these “tough issues” depends heavily on whether they are liberalizing and whether they are otherwise well-suited to developing country needs and capacities. The EU has used the Europe Agreements to obtain action on environmental and labor conditions and on intellectual property, and the United States has used NAFTA as a tool for enforcing Mexican labor and environmental standards. It is quite possible that practices developed by the major RIAs will not suit developing countries well, and may also be less open and liberal.

An extension of the “tough issues” argument is that RIAs help develop blueprints for subsequent multilateral negotiations (Bergsten 1996). For example, the EU pioneered “bulk” mutual recognition for industrial standards and services harmonization, and NAFTA’s investment chapter may inform a multilateral investment negotiation (if there is one). On the other hand, the EEC also suggested the Common Agricultural Policy as a model for agriculture in the Kennedy Round. Once again then, the blueprints might not suit developing countries well. There is the further danger that coming to negotiations with a fully developed blueprint can appear to be a pressure tactic that actually makes negotiation more difficult; developing countries’ *de facto* rejections of the OECD draft Multilateral Agreement on Investment in 1998 contains at least an element of this.

Overall then, we find the arguments that regionalism has promoted or facilitated multilateral trade negotiations to be rather weak. There is little evidence that RIAs have either prompted or facilitated negotiations, and real dangers that they might dilute countries’ involvement in such negotiations.

5.4 Regionalism and the WTO

THE PREVIOUS ANALYSIS SUGGESTS THAT INTERNATIONAL policy toward regionalism should aim to:

- Encourage RIAs to achieve trade creation and avoid trade diversion, both for the sake of members and to minimize harm to excluded countries, for instance, by setting low external tariffs
- Permit deep integration, including nation building, between members
- Preserve the effects of previous liberalization and provide credibility for any liberalization that form part of the RIA
- Support a liberalizing dynamic within member countries and in the world trading system as a whole.

The instrument we have for international policy on regionalism is the WTO, and this section explores how it manages regionalism and whether its rules could be reformed to help it do better.⁹ RIAs are officially sanctioned—but conditional—exceptions to the GATT's rules on nondiscrimination. The conditions imposed on RIA formation doubtless constrain and mold the pattern of regionalism in the world, but they are neither adequate, nor adequately enforced, to ensure that regionalism is economically beneficial for either its members or excluded countries. The responsibility for good outcomes falls on governments themselves; they cannot tie their own or each other's hands sufficiently tightly in the WTO to preclude the possibilities of signing harmful RIAs.

The world trade system works—pragmatically and consensually. The GATT was created in 1947 as a temporary body to assist countries in trade liberalization. Its role was to codify and record a series of tariff reductions that its members wished to make, and provide a structure to give credibility to those reductions. It discouraged the reversal or nullification of tariff cuts by restricting policies that impose duties on an ad hoc basis, such as antidumping duties and emergency protection, and equivalent policies such as internal taxes on imports. It also defined important mechanics of trade, such as the valuation of trade for customs purposes. A key concept of the GATT, indeed the cornerstone of the present world trading system, is nondiscrimination between different sources of the same imported good, which is achieved by requiring members to give each other MFN treatment, except in specified circumstances. With an assurance of

nondiscrimination, when A negotiates a reduction in one of B's tariffs, it knows that the commercial value of its effort will not be undermined by B then offering C an even lower tariff. This, in turn, makes A more willing to "buy" the concession by reducing one of its own tariffs on B, and so encourages trade liberalization.

Over 50 years of operation the GATT continued in this low-key, member-driven, fashion. It was essentially consensual in approach and pragmatic in operation. The GATT did not adjudicate trade disputes, but had a dispute settlement process, less concerned with law than with solving disputes in a way that preserved consensus and allowed the liberalizing bandwagon to continue to roll. The WTO, which was created in 1995 to oversee the GATT and certain other agreements, is more legalistic, but still focuses heavily on pragmatic and mutually acceptable solutions to problems. The WTO/GATT administers a set of rules for behavior, not a set of outcomes—it is concerned with meeting agreed obligations and rights rather than with economic outcomes per se. The WTO/GATT has undoubtedly been a force for economic good, but its role has not been defined in those terms.

The GATT traditionally did not intrude into domestic politics. It had no ability to force member countries to liberalize if they did not wish to, and was extremely light-handed in its requirements about the shape of domestic legislation. The WTO is rather more far-reaching; through its greater breadth and its "single undertaking," under which members must subscribe to virtually all its rules, rather than, as previously, treat some as optional extras, it has constrained governments more tightly. Nevertheless, the WTO can still be effective only if it proceeds more or less by consensus.

Given this background, the WTO can enhance the economic well-being of developing countries in four ways. First, if sufficient members wish, it can organize periodic rounds of tariff negotiations that offer opportunities and incentives to members to reduce their barriers to trade. Second, it provides guidelines for domestic policy—directly in some cases, but more often indirectly by shaping the terms of the debate. Governments resisting pressures to protect particular lobbying groups are immeasurably strengthened if they can point to prohibitions in the WTO agreements. Third, the WTO can protect the rights of members against certain rules violations by other members. It cannot necessarily, however, protect members against harm.¹⁰ Fourth, it provides a forum and mechanism for governments to manage the spillovers from members'

trade policies onto their partners. These four links provide the framework for assessing the WTO's current rules about RIAs and exploring whether they can be improved.

5.5 The Rules for RIAs

ARTICLE XXIV OF THE GATT SETS LIMITS ON THE RIGHTS OF RIA member countries to violate the MFN principle. It imposes three principal restrictions (appendix 1). A RIA must:

- Not “on the whole” raise protection against excluded countries
- Reduce internal tariffs to zero and remove “other restrictive regulations of commerce” other than those justified by other GATT articles
- Cover “substantially all trade.”

These conditions ensure that RIAs do not undermine the access of other countries to the RIA market. The first preserves the sanctity of tariff bindings by ensuring that forming a RIA does not result in a wholesale dissolution of previous bindings. It is supplemented by a rule that compensation is due to individual partners for tariff increases induced by the RIA if other reductions to keep the average constant do not maintain a fair balance of concessions. Together with the 1994 Uruguay Round Understanding on the Interpretation of Article XXIV on how to measure tariff barriers for RIAs, these provisions offer reasonable assurances that the barriers facing nonmembers will not be raised.

The second condition helps defend the MFN principle by making it subject to an “all-or-nothing” exception. If countries were free to negotiate different levels of preference with each trading partner, binding and nondiscrimination would be fatally undermined: no member could be sure that it would receive the benefits it expected from negotiating and reciprocating for a partner's tariff reduction. Also, if a customs union is a first step toward nation building, it is inappropriate for an international trade treaty to stand in the way of such progress. Thus, internal free trade, such as one (usually) achieves within a single country, would seem to be an acceptable derogation of MFN, whereas preferences would not. The third condition reinforces this by requiring a serious degree of commitment to a RIA in terms of sectors.

The second and third conditions—no internal tariffs and substantial coverage—are important in heading off pressure to use tariffs to fine-tune

political favoritism toward either domestic industries or partner countries; they help to prevent governments that restrict RIAs from swapping trade-diverting concessions and, thus, from avoiding politically more painful trade creation. These conditions essentially require a serious commitment to integrating member markets as a condition for proceeding.

Article XXIV is generally an aid to better RIAs, but it is certainly not sufficient for good economic policy. Even if the conditions were applied without exception they would not preclude harmful RIAs: Wholly GATT-compatible RIAs can be predominantly trade diverting, excluded countries can suffer terms-of-trade declines, and institutions can arise that make liberal policies less likely.

There are major difficulties in interpreting the conditions of Article XXIV. Even following the Uruguay Round Understanding there is no agreement about what “substantially all trade” means, nor even whether it refers to the proportion of actual trade covered or the inclusion of all major sectors of the economy. Similarly the treatment of nontariff barriers in assessing the overall level of trade restriction is not defined, nor is that of rules of origin. The requirement that “other restrictive regulations of commerce” be removed between members is ambiguously worded: several exceptions to this requirement are identified explicitly but other barriers, including antidumping duties and emergency protection, are not. Complete integration between members of a RIA would abolish these barriers and so their continuation—in NAFTA or the Euro-Med agreements—suggests an unwillingness to proceed too far in that direction.

Perhaps because of its ambiguities, Article XXIV has been notoriously weakly enforced. RIAs have to be notified to the GATT and until 1996, each was then reviewed by an ad hoc working party to see if it was in conformity with the Article. WTO (1995) reports that of 69 working parties reporting up to and including 1994, only 6 were able to agree that a RIA met the requirements of Article XXIV, of which only CARICOM and Czech-Slovak CU remain operative. However, the remainder did not conclude that agreements were not in conformity—they merely left the matter undetermined.

This agnosticism is essentially the product of the GATT’s consensual nature. The first major test of the article was the Treaty of Rome establishing the EEC. The political pressure to permit it was enormous: EEC countries would almost certainly have put the EEC before the GATT in the event of conflict and the United States strongly supported the treaty. The treaty, however, clearly violated Article XXIV, and so the only feasible solution was not to push the review to conclusion.¹¹ Given a start

like this, the EEC's willingness to support more or less any RIA in the GATT, the need for working parties to reach consensus, and the GATT's inability to make an adverse determination without the acquiescence of the party at fault,¹² it is hardly surprising that future reviews proved little more demanding. Nor have matters improved with the establishment in 1996 of a single Committee on Regional Trading Agreements to conduct the reviews. The inability to rule on whether RIAs conform to article XXIV does not mean that the rules have had no effect, for we do not know the extent to which they have influenced the structure of RIAs that have come forward, nor which potential arrangements they have discouraged.¹³ It is not an encouraging record, however, either from the point of view of enforcing current rules or from that of rewriting the rules to increase their ability to distinguish good from bad RIAs.

Finally, Articles XXIV.10 and XXV of the GATT can be used to grant waivers to make otherwise inadmissible policies GATT-legal. This was done for the European Coal and Steel Community (1952) and the U.S.-Canada Auto Pact (1965). Under WTO, waivers are still feasible but are time-limited.

Article XXIV of the GATT refers to trade in goods. The equivalent for services is Article V of the GATS, which is modeled closely on it. The requirement not to raise barriers to third countries is rather tighter: it is applied sector by sector rather than "on the whole," and third country suppliers already engaged in "substantive business" in a RIA territory before the RIA is concluded must receive RIA treatment. The "substantially all trade" ambiguity is only slightly abated, with an explicit note that the word "substantially" be "understood in terms of number of sectors, volume of trade, and modes of supply." For covered sectors "substantially all discrimination" is to be removed, but since this is defined as comprising elimination of barriers *or* prohibition on new or more discriminatory barriers, or both, it need amount to very little.¹⁴ Developing countries receive "flexibility" on "substantially all" discrimination and exemption from the need to give RIA treatment to least third country firms with "substantial business" in member countries.

The Rules for Developing Countries

If all this were not enough, a further complication for developing countries is an "Enabling Clause"¹⁵ introduced in 1979 that significantly

relaxes the conditions for creating RIAs that include only developing countries. It drops the conditions on the coverage of trade, and allows developing countries to reduce tariffs on mutual trade in any way they wish, and nontariff measures “in accordance with criteria which may be prescribed” by the WTO members. It then supplements the first condition with the nonoperational requirement that the RIA not constitute a barrier to MFN tariff reductions or cause “undue difficulties” for other contracting parties.

In practice, developing countries have had virtual *carte blanche*. Twelve preferential arrangements have been notified under the Enabling Clause, including the Latin American Integration Association, ASEAN, and the GCC. Internal preferences of 25 percent and 50 percent figured in ASEAN’s trading plans and also in many of the arrangements concluded under the Latin American Integration Association and in the GCC. There is little sign that internal preferences have undermined MFN agreements with other trading partners but then, until recently, these countries did not make many MFN agreements. Indeed, until the late 1980s, the Latin American and African countries’ frequent use of regional arrangements and weak participation in the multilateral rounds might suggest a substitution of one form of liberalization for the other. More worrying were the sectoral agreements that abounded in Latin America.

The Enabling Clause dilutes the weak discipline that Article XXIV imposes. Even if Article XXIV does not actually stop many harmful practices, it does at least avoid automatically giving them the respectability of legal cover. Thus, while the GATT knowingly and willingly permitted Latin American Free Trade Area (1960) and the initial notification of ASEAN (1977) to violate Article XXIV (Finger 1993), at least it required continuing consultation with partners and left open the possibility of challenge in the dispute settlement process. The Enabling Clause offers more cover in various areas, and thus erodes even this discipline.¹⁶

Reform of the Rules?

The WTO rules on RIAs are not exactly broken, but they are creaky, and it is worth asking what might be done about them. We focus here on their economic content, and on the feasibility of reform. Feasibility seems to be a more binding constraint than devising economically sensible rules. Indeed, major political backing for tightening looks im-

probable, as few countries within RIAs appear to seek tighter discipline, as the EU continues its Mediterranean agreements and considers replacing the trade provisions of the Lomé Convention with an FTA, and as the United States contemplates the Free Trade Area of the Americas.¹⁷ However, see section 5.6 for a proposal on changing rules for both industrial and developing countries.

A RIA that does not reduce external barriers may cause trade diversion. One discipline on this would be to require RIA members to liberalize, both to reduce diversion and to induce external trade creation with nonmembers. Finger (1993) views these reductions as a price to be negotiated to persuade nonmembers to forgo their MFN rights. How far the parties are prepared to go in a negotiation, however, is determined by the prevailing rules and enforcement mechanisms that define the outcome if negotiations fail; unfortunately, these currently leave nonmembers almost no negotiating power. Hence other authors have made more concrete proposals.

Bhagwati (1993) suggests requiring that for each tariff heading a CU's common external tariff be bound at the minimum tariff for that heading among all members. This does not guarantee the elimination of trade diversion—suppose the tariffs of three members were 98 percent, 99 percent, and 100 percent—but it will clearly reduce it. It would impose a high (mercantilist) price on RIA formation, so only “serious” integrators would pay it, and would, overall, be quite trade-liberalizing. As a reform it is admirably clear, and if feasible, it would be desirable economically. Its demanding nature, however, makes it very unlikely to succeed in the present circumstances.

Related is a proposal that members of FTAs be required to bind their tariffs at actual applied rates on the eve of the RIA. Apart from what this might do to pre-FTA applied rates, this suggestion is random in its liberalizing effect, which reduces its moral force. Bhagwati would just ban FTAs. This is also consistent with seeking to restrict RIAs to those that are committed to far-reaching integration, but again faces severe feasibility constraints, especially since some FTAs proceed quite far in other directions.

Tied up with the FTA question is that of rules of origin. Some suggest a requirement that they be no more restrictive than before the RIA, but this is difficult to determine, ad hoc, manipulable in nature, and potentially very complex in the face of technological changes. Better would be a requirement precluding the manipulation of such rules

for protectionist purposes, such as that countries should adhere to a single set of rules of origin agreed internationally, or that a country's preferential rules should be the same as its nonpreferential ones. Wonnacott (1996) suggests a number of milder reforms in this direction: for example, that rules of origin be banned where tariffs differ between members by less than, say, 2 percentage points, or that for each commodity they be banned for the FTA member with the lowest tariff. These might be acceptable, but would only scratch the surface.

One proposal has been made to adopt *ex post* reviews to determine whether nonmember exports have fallen since a RIA was created and demand changes in policies if they have (McMillan 1993). Although frequently taken seriously (for example, Frankel 1997), the proposal is wrong in virtually every respect. Exports are the wrong criterion, quantitative targets are the wrong way to formulate trade policy, the internal costs of trade diversion are ignored, economic modeling is still too imprecise to identify causes with any credibility, and *ex post* adjustment after five years is no basis for the policy predictability sought by investors.

There are three major proposals for creating a "liberal dynamic." Srinivasan (1998) proposes that RIAs be permitted only temporarily by requiring all RIA concessions to be extended to all countries within, say, five years. This is effectively a ban on RIAs, and certainly foregoes any gains that they might offer in terms of deep integration or nation building. It is not a serious contender.

Second, stretching back at least to the United States submission to the Preparatory Committee of London Monetary and Economic Conference of 1933, scholars and policymakers have argued that requiring RIAs to admit any country willing to accept their rules both reduces their adverse effects on excluded countries and establishes a liberal dynamic (Viner 1950). While this may be true if admission can be guaranteed, virtually every RIA extant has geographical restrictions on membership and has features that require negotiation. The latter vitiate the promise of "open access." However, though unconditional open access seems unfeasible, section 5.6 suggests a way to improve developing countries' access to the large blocs in the North.

A more feasible approach than unconditional open access is to define and enforce current rules more rigorously. A precise definition and enforcement of "substantially all trade" would be a useful innovation. A quantitative indicator would be clear, but it would need to be high given that the kinds of trade restrictions countries wish to maintain typically

constrain existing trade quite fiercely. The frequently cited 80 percent, which dates from consideration of the Treaty of Rome is not adequate. Even 90 percent, which seems to inform current EU-MERCOSUR talks, is not indicative of serious intent to integrate. We would advocate 95 percent after 10 years and 98 percent after 15 years. Similarly, a more constraining view of “other restrictive regulations of commerce” would be useful—ensuring that they include the effects of rules of origin on excluded countries, and that obvious barriers such as safeguards actions and antidumping duties are abolished internally. The latter requirement would increase the degree of trade creation, since these policies are explicitly aimed at preserving domestic output levels. Thus they would raise the bar for “serious” regionalism.

However, even these changes might encounter fierce opposition and will require major political commitment by many WTO members to be implemented. To be acceptable to the major powers, they will certainly need to be accompanied by a grandfathering clause to assure current RIAs that they will not be undermined by new interpretations.

A vehicle to take forward reform measures is the Committee on Regional Trading Agreements (CRTA), which reports to the WTO’s General Council, and was established in 1996 to increase the transparency, efficiency, and consistency of the WTO’s treatment of RIAs. It was seen as a means of ensuring more rigorous review of new RIAs because a single group would review all of them using the same criteria and with more searching notification and information requirements. It would also undertake periodic review of existing RIAs, and could resolve some of the systemic issues that remained after the Uruguay Round. The more thorough review was seen as a route to better compliance with WTO requirements, while the consideration of conceptual issues was a step toward refining and codifying the rules more precisely.

Unfortunately the CRTA has not yet reached its stride. Its assessments of particular cases have been stymied by the lack of clear systemic rules, and the discussion of rules stalemated on exactly the same “substantially all” and “other regulations” issues as the previous Uruguay Round discussions. By December 1997 the Committee had initiated consideration of 59 RIAs (including 32 inherited from previous working parties). It had completed factual analysis of 30 of these, and was “elaborating conclusions” on 26. To date, no analyses have been released or conclusions reached.

The future development of the CRTA could take several routes. Review of existing RIAs is not likely to be productive. Although RIAs are open to dispute if third party countries feel aggrieved (at least until the

CRTA has formally certified their WTO-conformity), the rules seeking serious intent to integrate are not really susceptible to this process. Non-member countries are unlikely to press RIAs to include more sectors when they expect this to increase trade diversion. Similarly, why would a nonmember country seek to free RIA members from the threat of each other's antidumping legislation? Members do not normally bring internal disputes to the WTO.¹⁸

When it comes to new RIAs, one possibility is to have a detailed case-by-case study of the likely effects to the RIA. But the CRTA faces a serious timing problem. Unless agreements are submitted to the WTO early in the process of negotiation—in which case they will be very provisional—reviews will generally be too late to influence their initial form. Otherwise, reviews will be too late to affect public debate and will, if they call for changes, upset carefully negotiated compromises. For that reason they will be resisted and resented by members, which is bad news for a consensual organization. Thus considerable political courage will be called for to enforce CRTA findings until their requirements are sufficiently understood and respected by members to be met *ab initio*. This process of review and response would have to be aided by detailed economic studies of RIAs stretching well beyond the legalities of Articles XXIV and V.

The better way forward is for review of new RIAs to be restricted to ensuring compliance with the tighter Article XXIV rules on liberalization of “substantially all trade” and “other restrictive regulations of commerce” which we proposed above. As we have argued, these rules would raise the bar for “serious regionalism,” while leaving it clear that WTO approval does not validate the economic benefits of a RIA for its members. The responsibility for good RIAs lies with governments themselves.

5.6 Post-Seattle

THE FAILURE OF WTO MEMBERS TO AGREE TO A NEW ROUND of negotiations at the Ministerial in Seattle in December 1999 has dealt a blow to the WTO. One of the dangers is likely to be that developing country members that were thinking of fuller participation in the WTO and were considering further unilateral trade liberalization and binding their lower tariffs at the WTO may have become further disappointed by the multilateral system after Seattle and may be looking more seriously at regional options. As examined in the report, RIAs among developing countries are unlikely

to provide the benefits available in North-South RIAs or in the multilateral system. Developing countries have much to gain from multilateral liberalization as enforced by the MFN clause: it strengthens weaker countries by limiting the ability of stronger ones to make deals with each other that exclude the weaker ones.

In order to more fully integrate the developing countries in the multilateral system and make it work for them, simply extending the disciplines of Articles XXIV and V to their RIAs will not work. We believe a quid pro quo is necessary where industrial countries offer something in return for the developing countries' acceptance of these disciplines.

Mike Moore, secretary-general of the WTO, argued at the January 2000 United Nations Conference on Trade and Development-X Conference in Bangkok that richer nations need to bring down trade barriers to exports from developing countries. In his presentation he stated that, "It makes no sense to spend extra billions on enhanced debt relief if, at the same time, the ability of poorer countries to achieve debt sustainability is impeded by a lack of access for their exports." James Wolfensohn, president of the World Bank, provided a similar message.

Industrial countries are trying to help developing countries through foreign aid, technical assistance, and debt forgiveness, especially to the heavily indebted poor countries. What is the logic in providing foreign aid, debt forgiveness, and other assistance, but not opening up markets in order to help developing countries expand their exports and get out from under these large debt burdens? Moreover, the least-developed countries export mostly products that do not compete with OECD industries, and the GNP of all these countries put together does not even amount to that of a mid-sized European country. Thus, the cost of opening markets to these countries would be small for the OECD and would help ensure that these countries continue with their own unilateral liberalization efforts by enabling them to obtain more benefits from liberalization.

The poor need secure access to the North and they can get this in only two ways: through a successful WTO pursuing multilateral nonpreferential liberalization as enforced by the MFN clause, or through association agreements with the EU, NAFTA, or Japan. These are, in fact, the two different uses of the term "open regionalism": concerted multilateralism, and open access to membership of the Northern clubs. The poor can both support the WTO against the menace of Northern protectionist lobbies and at the same time pressure for the right of access to the clubs.

We have proposed that the WTO should modify its rules concerning trade blocs to create a presumptive right of association. Analogous to the MFN clause, if association is granted to one country, there should be a presumption that similar terms should be available to others: if Iceland is offered reciprocal freedom from antidumping suits by the EU, then the same option should be available to Ghana. Naturally, association is complex, and so in practice each accession must be negotiated; regardless, the poor should not be denied the association rights already conferred on several middle-income countries.

We have proposed a package negotiating offer by the South to the North concerning the WTO rules governing trade blocs. The South would offer to extend the existing rules concerning North-North trade blocs to South-South blocs. Although this is a concession, it would strengthen the MFN principle that is very much in the interest of the South. In return, the South would demand an open access rule, in which the right to equal treatment of applications for association in all trade blocs would be enshrined.

5.7 Conclusion

THE CONCLUSION FIRST DEALS WITH CHANGES IN WTO RULES to benefit developing countries, and second, with improvement and enforcement of rules. We first recommend that:

- Industrial countries should fully open their markets to developing country exports, particularly those from least-developing countries.
- The WTO should modify its rules concerning trade blocs to create a presumptive right of association.
- In return, developing countries should accept the disciplines of Articles XXIV and V for their RIAs.

Second, we recommend that:

- The WTO enforce the disciplines of Articles XXIV and V rigorously in the CRTA, especially those on coverage and depth of liberalization.
- The WTO define the rules more rigorously: On “substantially all trade,” we advocate 95 percent of trade after 10 years and 98 percent after 15; on “other restrictive regulations of commerce,” we

advocate inclusion of the abolition of internal barriers, such as safeguard actions and antidumping duties.

- The WTO use the dispute settlement procedure to enforce the rights of third countries not to face increases in protection either directly or indirectly through the use of tools such as rules of origin.

Appendix I: WTO Provisions on Regional Integration Arrangements (Extracts)

Article XXIV of GATT

4. The contracting parties...also recognize that the purpose of a customs union or of a free trade area should be to facilitate trade between the constituent territories and not to raise barriers to trade.
- 5(a). With respect to a customs union...the duties and other regulations of commerce imposed at the institution...shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union...
- (b). With respect to a free trade area...the duties and other regulations of commerce maintained in each of the constituent territories and applicable at the formation of such free-trade area...shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free-trade area...
- (c). Any interim agreement...shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time.
- 7(a). Any contracting party deciding to enter into a customs union or a free-trade area, shall promptly notify the CONTRACTING PARTIES and shall make available to them such information...
- 8(a). A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that: (i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Article XI, XII, XIII, XIV, XV and XX) are eliminated with respect to...substantially all the trade in products originating in such territories...
- 8(b). A free trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive

regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories.

The Enabling Clause

1. Notwithstanding the provisions of Article I...contracting parties may accord differential and more favorable treatment to developing countries, without according such treatment to other contracting parties.
- 2(c). The provisions of paragraph 1 apply to the...regional or global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which may be prescribed by the CONTRACTING PARTIES, for the mutual reduction or elimination of nontariff measures, on products imported from one other;

The Uruguay Round Understanding on the Interpretation of Article XXIV

2. The evaluation...of the duties and other regulations of commerce...shall...be based upon an overall assessment of weighted average tariff rates and of customs duties collected...For this purpose, the duties and charges to be taken into consideration shall be the applied rates of duty. It is recognized that for the purpose of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected may be required.
3. The “reasonable length of time” referred to in Article XXIV 5(c) should exceed ten years only in exceptional cases.

GATS Article V

1. This Agreement shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services

between or among the parties to such an agreement, provided that such an agreement:

- (a). has substantial sectoral coverage¹⁹ and
 - (b). provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII, between or among the parties, in the sectors covered under subparagraph (a)....
- 3(a). Where developing countries are parties to an agreement of the type referred to in paragraph 1, flexibility shall be provided for regarding the conditions set out in paragraph 1, in particular to subparagraph (b), in accordance with the level of development of the countries concerned, both overall and in individual sectors and subsectors...
4. Any agreement referred to in paragraph 1 shall be designed to facilitate trade between the parties to the agreement and shall not in respect of any Member outside the agreement raise the overall level of barriers to trade in services within the respective sectors or subsectors compared to the level applicable prior to such an agreement.

Notes

1. Multilateral trade liberalization means nearly all countries reducing barriers on imports from nearly all partners.

2. We have already discussed some of the different incentives for external tariff setting in CUs as compared to FTAs (chapter 4), where we argued that CUs might be inclined to higher tariffs than FTAs. Krugman's analysis concentrates on CUs.

3. In addition, the welfare loss due to trade diversion for a given level of tariffs is greatest when trade is fairly evenly divided between partner and nonpartner countries.

4. Effective RIAs among developing countries (up to 1995) are defined as including: CACM (1960–75; since 1990); Andean Pact (since 1990), MERCOSUR, UEMOA, and SACU. Individual countries affected by their RIA memberships include: Cameroon, Israel, Kenya, Mexico, and Zimbabwe.

5. The interwar period offers further examples. Between the 1920s and the mid-1930s the world trading system switched rapidly from being relatively even-handed to a pattern of regional preferences. First Britain and France introduced colonial preferences. In response, Germany built its own system of preferences, starting with a proposed customs union with Austria in 1931. In 1934 the United States responded with the Reciprocal Trade Agreements Act.

6. Frankel's model is not at all robust, but it does demonstrate formally the interaction between RIAs.

7. Levy (1995) shows theoretically how acquiring fringes of FTA partners could weaken EU and U.S. interest in mutual negotiations.

8. Oye (1992) argues that the 1930s also fit this description. He argues that regional arrangements, such as U.S. bilateral arrangements, under the Reciprocal Trade

Agreements Act were politically feasible, because they almost guaranteed export expansion in partner markets in return for import liberalization. In this way they started to relax restrictions that were immune to multilateral efforts.

9. The rules of international commerce are embodied in three main agreements: GATT, GATS, and the Agreement on Trade-Related Aspects of Intellectual Property Rights. They are administered by the WTO, two of whose major tools are the Trade Policy Review Mechanism and the Understanding on Dispute Settlement. The WTO has 132 members; the major nonmember economies, all of which are seeking accession, are China, Russia, Saudi Arabia, and Taiwan (China); the other major group of current candidates are the countries of Eastern Europe and Central Asia.

10. For example, if a country is harmed by another's breaking into its export markets, there is "properly" no redress under the GATT.

11. For example, in reviewing the treaty, the GATT executive secretary expressed the view, with which he thought there was no disagreement, that the incidence of the common tariff was higher than that of the rates actually applied by the member states at the time of entry into force of the Treaty of Rome (GATT Document C/M/8 p.6; cited in GATT 1994, p. 750).

12. Under GATT procedure, finding a party in violation of its obligations required unanimity. This is not true of WTO.

13. Within the GATT there was a feeling that the article had influenced the structure of U.S.-Canadian and U.S.-Israeli agreements (private communication). We can also identify cases where WTO rules, or their equivalent, have prevented RIAs. For example, in 1932 Britain and

the United States refused to waive their MFN rights, preventing the implementation of the Ouchy Convention, a forerunner of Benelux (Viner 1950). Similarly, negotiators of the draft Multilateral Agreement on Investment found no way of preventing some concessions on services among member from also applying to nonmembers via the GATS MFN clause. Hence, they held back such concessions. GATS Article V permits regional arrangements, but the Multilateral Agreement on Investment was far too narrowly defined to qualify.

14. Together these requirements seem to impose no discipline on the sectors that are excluded from the RIA, although they may still be covered by the members' GATS obligations.

15. The Decision on Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries (1979).

16. There is also an unresolved dispute about whether Article XXIV can be applied to an arrangement notified under the Enabling Clause, as the United States demands for MERCOSUR.

17. The EU has explicitly decided that it will not propose any changes to Articles XXIV and V in the next round of trade talks.

18. The United States and its partners still use the WTO dispute settlement, but in recent years there has been no WTO dispute between the EU and any country with which it has a formal RIA.

19. This condition is understood in terms of number of sectors, volume of trade affected, and modes of supply. In order to meet this condition, agreements should not provide for the *a priori* exclusion of any mode of supply.