Module-8

Basic Concepts on Regional Trading Agreements

Suprita Jayaram*

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* Programme Coordinator, CUTS Centre for International Trade, Economics & Environment (CUTS CITEE), Jaipur; Email: sj6@cuts.org

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Acronyms

AFTA's	ASEAN Free Trade Area
AGOA	African Growth and Opportunity Act
CAN	The Andean Community
CRTA	Committee on Regional Trade Agreements
EAC	East African Community
EBA	Everything But Arms
ECOWAS's	Economic Community Of West African States
EPAs	Economic Partnership Agreement
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GSP	Generalised System of Preferences
LDC	Least Developed Country
MERCOSUR	Southern Common Market
MTA	Multilateral Trade Agreements
NAFTA	North American Free Trade Agreement
OECS	Organisation of Eastern Caribbean States
PTA	Preferential Trade Agreements
RIA	Regional Integration Agreement
RTA	Regional Trade Agreements
SAARC	South Asian Association for Regional Cooperation
SADC's	Southern African Development Community
SAPTA's	South Asian Preferential Trading Arrangement
WTO	World Trade Organisation

1. Introduction

Regional Trading Agreements (RTAs) may be comprehended through the lens of regional integration, which is not a new phenomenon. Within old arrangements that are being revived and with new groupings in the making, RTAs create opportunities to expand trade. This process is grounded on joint action to overcome institutional as well as policy barriers to trade. Conceptually, RTAs are based on the principle of free trade and hence, the implication is that there exists a free trade market, where there is a free flow of goods and services amongst trading partners. In other words, there is a free movement of goods and services amongst trading countries unhindered by government-imposed restrictions such as taxes and other legislation such as tariff[1] and non tariff trade barriers (NTBs)[2].

With RTAs burgeoning, it has become imperative for the policy makers to be fully prepared to take correct steps and make informed decisions while negotiating on such agreements. Although, RTAs has recognised the importance of trade in the economic development of the region, policy makers hailing from South Asia and Sub-Saharan Africa (SSA) are facing the challenge of capacity constraints and lack of information on trade policy issues in order to negotiate, which have hampered their crucial involvement in this process.

This training module on basic concepts on RTAs aims to strengthen the capacity of policy makers through better understanding to analyse, formulate and implement sound trade policies and programmes. This would ensure effective participation in trade negotiations in general, and RTAs in particular. This training would form the broad (knowledge) base to take off from. Further fine tuning on trade related negotiating capacity, national trade policy etc. could follow making the capacity building process complete and wholesome.

1 A tariff is a tax on foreign goods upon importation. When a ship arrives in port a customs officer inspects the contents and charges a tax according to the tariff formula. Since the goods cannot be landed until the tax is paid it is the easiest tax to collect, and the cost of collection is small

2 They are criticized as a means to evade free trade rules such as those of the WTO, the EU or NAFTA that restrict tariffs. Most common examples are antidumping measures and countervailing duties, which, although they are called "non-tariff" barriers, have the effect of tariffs but are only imposed under certain conditions. Their use has risen sharply after the WTO rules led to a very significant reduction in tariff use.

Non-tariff barriers may also be in the form of manufacturing or production requirements of goods, such as how an animal is caught or a plant is grown, with an import ban imposed on products that don't meet the requirements. Examples are the European Union restrictions on genetically modified organisms or beef treated with growth hormones.

Some non-tariff trade barriers are expressly permitted in very limited circumstances, when they are deemed necessary to protect health, safety, or sanitation, or to protect depletable natural resources.

(source for 1 & 2 : http://en.wikipedia.org/wiki/Free_trade)

Four main trends have been identified characterising the proliferation of RTAs, including

- RTAs have become the centrepiece of commercial policy for most countries.
- They show an increasing level of sophistication**,** many new RTAs include liberalisation of trade in Services; their regulatory regimes extend to trade policy areas are not regulated multilaterally, their outreach in terms of partners is becoming both innovative and not geographically bound.
- The geopolitics of RTAs and their gradual replacement of long established non reciprocal systems of preferences; while this shift is in some cases driven by compatibility requirements with the World Trade Organisation (WTO) rules, in others, it is developing countries themselves that are opting to forego unilateral preferences in favour of more secure reciprocal arrangements. Also significant is the increasing number of South- South RTAs, a development that appears to be tied to the several major RTA hubs in the developing world.
- The process of expansion and consolidation of regional integration schemes characterised by the consolidation of an increasing number of intra-regional RTAs into continent wide regional trading blocks.[3]

Interestingly, cross-regional RTAs represent the most distinctive feature of the current "proliferation." These RTAs connote a shift from the traditional concept of 'regional integration' among neighbouring countries to preferential partnerships driven by strategic partnerships driven by strategic political and economic considerations that are unrelated to regional dynamics.[4]

Africa is home to about 30 RTAs, with each country on an average belonging to four. The globalising world promises enormous opportunities, yet it also dawns that there exists a larger proportion of challenges for the African countries, given the increased complexity of world commodity and financial markets and the multilateral trading agreements. Africa lacks the institutional and human capacities to meet these challenges as international trade and investment is managed and crafted through a maze of various interlinked multilateral, regional agreements and at the same time tied to a variety of national legislations and policies. A key to the future of the African continent is in the strengthening of South-South cooperation to improve capacities and expertise in the trade and investment area. This calls for urgent attention to the strong need for capacity building at the regional policy level.

While any trading agreement – be it Regional[5] or Multilateral – involves trade liberalisation; there are divergent views on the welfare gains of trade liberalisation. For instance, in Sub Saharan Africa (SSA), what stands out as a glaring fact that, it is the only region in the world where poverty has deteriorated steadily in the last two decades (and as per the predominant argument, this predicament is because of the trade liberalisation). Despite this sad reality, the International Monetary Fund (IMF), the World Bank, the

3 Fiorentino, R et al; RTAs Section, Trade Policies review Division, WTO Secretariat.

4 Supra

5 Including Bilateral Agreements, Free Trade Agreements, Customs Unions.

WTO and the major powers that control them are pushing for more trade liberalisation in Africa.

The US African Growth and Opportunity Act (AGOA) and the European Union's (EU's) future Economic Partnership Agreements (EPAs) are even proposing the signing of free trade agreements with sub-Saharan Africa. But both proposals aim to create the conditions for a total control of African economies by western multinational corporations. Both are a threat to African economic integration, therefore against the fundamental interests of the continent, despite the American and European propaganda machines, hailing these initiatives as being instruments of growth and development for Africa. Given this, one view is that trade liberalisation cannot be the way forward to spur economic growth in SSA. A point for further thought, and debate would then be to analyse the net benefits of RTAs in SSA countries with specific reference to Ghana, Malawi and Swaziland. The paper looks into South Asia and regional trade and its implications and consequences in South Asia (see Annex III for an overview of the existing RTAs in both these regions).

The paper focuses on some key and essential areas to understand the dynamics involved in RTAs. Section 2 provides a preliminary introduction to RTAs, which also highlights the two popular views of RTAs, as well as the various types of RTAs. Section 3 analyses the WTO vis-à-vis RTAs while Section 4 discusses the development of North-South RTAs in comparison to the South-South RTAs. This section focuses on measuring the impact of these RTAs on both member countries and non-member countries as well. Section 5 is very crucial from the point of view of policy making, as it deals with the question of whether RTAs promote conflict or build peace. An elaboration on the South Asian and Sub Saharan perspective, with questions of concern that could be taken into consideration by policy makers follows in the same section.

2. What is an RTA?

Regional integration is not new. It has been a continuing part of post-World War-II trade landscape. The recent proliferation of Free Trade Areas (FTAs) and Customs Unions (CUs) in the world trading system is manifested, for instance, in existing trading blocs that are extending their membership and deepening their coverage. With old arrangements being revived, new regional groupings are in the making. And such regional groupings have been on the increase.

Just like in the Multilateral Trading System (MTS), RTAs seek to liberalise trade. However, the distinction lies in the fact that, whereas, the former is non-discriminatory, the latter is discriminatory. More than half of the world trade is conducted under the rules of preferential agreements, the remainder being mostly trade between the major economic powers, EU, US, Japan and China.[6]

6 Manger.S, The political Economy of discrimination: Modelling the spread of Preferential Trade Agreements.

Some observers believe that a third wave of integration is currently underway. RTAs in the recent years have become a much debated issue, the seriousness of which is becoming more significant given its burgeoning proliferation. Between January 2005 and December 2006 a further 55 RTAs have been notified to the WTO raising the total number to 214[7]. In addition to this many more agreements are being negotiated and being considered.

The rationale to explain the proliferation of such preferential trading groups are not few. Domestic politics explanations have noted the role of economies of scale in motivating multinational firms to lobby for preferential trading agreements. Drawing on Manger's study on the political economy of Preferential Trading Agreements (PTAs), it may be noted that *economies of scale* and *regional production sharing* are important insofar as they aid in designing the PTA and mustering political support. By contrast, *regional competition* over export markets may be sufficient causes in instances where production sharing and unrealised economies of scale are not. A further incentive to form a PTA (especially for developing countries, undertaking the process of economic reform, who are facing domestic resistance), is the relative ease with which overcoming domestic resistances can be managed upon signing of PTA.

The inclination to go in for RTAs for countries is due to the speed, flexibility and selectivity of such agreements. Although negotiation of an FTA may take years to conclude, evidence suggests that the duration to conclude negotiations has been shrinking in the recent years. FTAs could afford their parties more flexibility in terms of desired trade policy scope and choice of partners; the latter consideration appears to be particularly relevant to the current wave of cross-regional FTAs where the focus is often on strategic market access or strange political alliances, unbound by geographical considerations. [8] In a nutshell then, RTAs mean a subset of countries which liberalise trade between themselves but not *vis-à-vis* the rest of the world.

2.1 The Various Types of RTAs

Following the WTO convention, the term *Regional Trade Agreement* encompasses both reciprocal bilateral free trade or customs areas and multi-country (plurilateral) agreements. Regional and bilateral trade agreements provide for one type of trade liberalisation, and they must be seen in the broader context of alternative methods of liberalisation. Members of RTAs liberalise trade on a reciprocal and preferential basis. While programmes such as the US' AGOA and the EU's *Everything but Arms* (EBA) also liberalise trade preferentially (different partners receive different treatment), the US and the EU extend these preferences unilaterally rather than reciprocally. In contrast to both these types of preferential liberalisation, countries often lower trade barriers in a non-discriminatory fashion for all trade partners. They might do so multilaterally-through GATT/WTO negotiating rounds- or do so autonomously, as in the case of Pakistan in the late 1990s. The matrix below illustrates the taxonomy of liberalisation methods.

7 This number totals notifications made under GATT Article XXIV, GATS V, and the Enabling Clause as well as accession to existing RTAs.

8 ibid

RTAs are commonly divided into several basic categories, according to the way they operate. The canonical taxonomy of RTAs contains the following four levels of integration:

- In an FTA, members eliminate barriers to trade in goods (and increasingly in services also) among members, but each member is free to maintain different MFN barriers on Non-members. This latter characteristic requires members to develop rules of origin to prevent imports from third countries from being transhipped through the member country with lowest tariffs.
- A *Customs Union* moves beyond a free trade area by establishing a common external tariff on trade between members and non-members. *Customs union* typically contains mechanisms to redistribute tariff revenue among members.
- A *Common Market* deepens a CU by providing for the free flow of factors of production (labour and capital) in addition to the free flow of outputs.
- In an *Economic and Monetary Union*, members share a common currency and macroeconomic policies. [9]

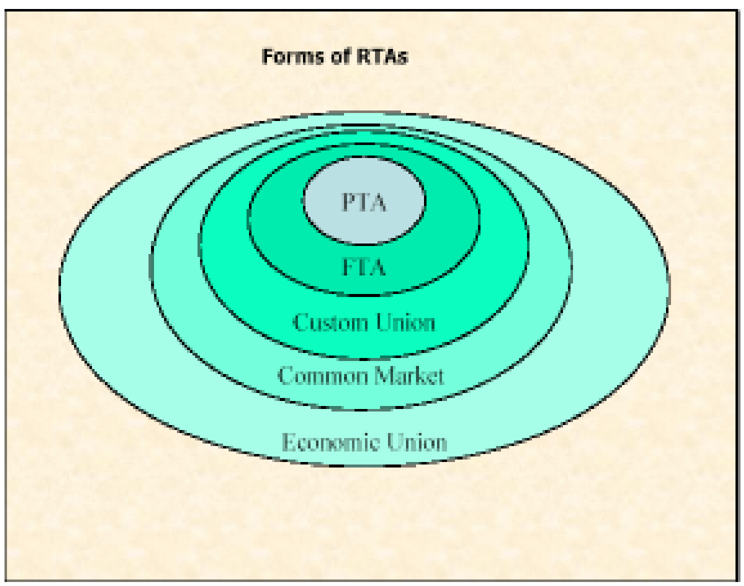

Figure 1: Forms of RTAs

The international experience with RTAs is much richer than what this simple taxonomy suggests. North American Free Trade Area (NAFTA) and other more recent agreements establishing free trade areas contain provisions governing domestic labour standards and other regulatory issues, which one traditionally associated with for agreements for deeper integration. On the other hand, many free trade agreements exclude important categories of goods (notably agriculture) from trade liberalisation. In some cases customs union still levy tariffs on trade between members.

9 RTAs and types of trade liberalisation; Global Economic prospects,2005

2.2 RTAs- Its Advantages and Disadvantages

The point that brings one to debate on the issue is that the 'discrimination' is generally *bad* since it creates new barriers between various foreign producers, thereby messing up the pure logic of economics, and questioning whether regionalism helps or hinders multilateralism. This debate, in other words has thrown up questions on effects of regional integration on trade creation and trade diversion, terms of trade, the 'dynamic' effects of regional trade per se in other words, it is a question of the welfare gains of RTAs. This leads to the next step of shallow and deep integration, each of which has their own characteristics.

Shallow integration implies the removal of barriers to cross-border flows of commodities, whereas Deep integration involves exploiting externalities and correcting for market changes. Shallow integration eliminates some distortions, (such as tariff on trade within the RTA) while the others remain (such as other within RTA-domestic tax/subsidy policies and tariff on non- RTA trade). Theoretically, the welfare impact of an RTA is determined by a few crucial variables:

- Changes in the commodity trade in the countries within the RTA (trade 'creation' effects),
- changes in trade between the RTA and the rest of the world (trade 'diversion' effects)
- And changes in international prices facing the countries (terms of trade effect).

In general, trade creation and terms of trade gains are welfare enhancing and trade diversions and terms of trade losses are potentially damaging. Deep integration both regionally and globally is commensurate with a growing body of 'new trade theory' that has sought to incorporate the impact of forces that go beyond efficiency gains, from reallocating resources according to comparative advantage.

New regionalism may be characterised as involving many of the elements found in the deepest level of integration, or the achievement of full economic (and monetary) union, and may include in rough order of increasing depth:

- facilitating financial and foreign direct investment flows (real and financial capital mobility) by establishing investment protocols and protections;
- liberalising movement of labor within the RTA;
- harmonising domestic tax and subsidy policies, especially those that affect production and trade incentives;
- harmonising macro policies, including fiscal and monetary policy, to achieve a stable macroeconomic environment within the RTA, including coordinated exchange rate policy;
- establishing institutions to manage and facilitate integration (e.g., regional development funds, institutions to set standards, dispute resolution mechanisms);
- improvements of communications and transportation infrastructure to facilitate increased trade and factor mobility;

- harmonising legal regulation of product and factor markets (e.g., anti-trust law, commercial law, labor relations, financial institutions); and
- Monetary union—establishment of a common currency and completely integrated monetary and exchange rate policy.[10]

Arguments in favour of new regionalism:

- Progress on a range of issues impossible to achieve via the multilateral system
- Involves 'deeper' integration issues which countries are more prepared to grant and agree on regionally.
- Promotes development for instance, Cotonou agreement.
- Helps to promote more amicable relation with the neighbouring countries
- A better means to attract FDI, as compared to old regionalism
- Gives countries greater negotiating power in the hemispheric or global for a, to negotiate as a group
- can further multilateralism
- Better than non-reciprocal preferences (e.g. GSP, EBA) which
    1. exclude the products of greatest interest to LDCs
    2. may reinforce sectors where LDCs do not have a comparative advantage and hence slow the process of industrialisation

On the other hand the typical arguments that go against regionalism are:

- It creates trade diversion and investment diversion
- WTO does not provide an adequate discipline over RTAs, and these are undermining the multilateral system
- Increasing 'fragmentation' as a result of overlapping FTAs, and restrictive Rules of Origin may become highly distortionary and restrictive.
- The costs to some developing countries for moving away from a system of non-reciprocal preferences to symmetric regional preferences may be high
- The continued high protection of agriculture and the role of special interest groups in many RTAs
- A world of three RTAs may be more protectionist
- May promote wasteful competition for FDI

Although, there exists a significant body of work with regard to RTAs, it is mostly evident in old trade theories, hence explaining old regionalism. These theories seem insufficient to analyse the impact new regionalism, where the state of knowledge is in a flux. There is an urgent need to address this situation, calling for both theoretical and empirical work.

3. Trade Creation and Trade Diversion Effects of RTAs

Discriminatory tariff reductions lead to trade creation and trade diversion. The traditional economic approach to regional trade integration assumes perfect competition in markets and is concerned with the implications of forming a region for the allocation of resources

10 Burfisher, M et al ; Regionalism : Old and new, Theory and Practice

in a static sense. This static analysis distinguishes between the trade creation and trade diversion effects of regional trade integration.

When a country (the home country) eliminates trade barriers with its regional partners but maintains them on trade with third countries it may lead the home country to switch its source of import supplies. If the partner country is already the low-cost supplier, then preferential trade liberalisation leads to the same trade creation effect as is in the case for unilateral trade liberalisation. Trade creation takes place when preferential liberalisation enables a partner country to export more to the home country at the expense of inefficient enterprises in that country. But preferential liberalisation, by maintaining tariffs against the rest of the world, may cause enterprises in the home country to switch supplies from the rest of the world to higher-cost suppliers in the partner country. The partner country again increases its exports to the home country but this time at the expense of exports from third countries. Trade diversion occurs when imports from a country which were previously subject to tariffs are displaced by higher cost imports which now enter tariff-free from partners. While trade creation contributes positively to welfare in the home country, trade diversion results in a welfare loss. The consumer gain on the volume of imports previously imported from third countries is less than the tariff revenue lost by the government (because, if the partner country is a less efficient supplier, the domestic price in the home country does not fall to the world price level).

A third effect comes into play in the traditional analysis if the RTA is large in world market terms, so that a change in its demand for imports influences the price at which those imports can be purchased. If, as a result of the formation of an RTA, the demand for imports in competitive markets is switched from third countries to a partner country, this leads to a decline in the price of third country imports and improves the union's terms of trade vis-à-vis the outside world. In imperfectly competitive markets, there may be collective gains if regional integration makes it possible to shift rents away from third countries. Rents exist if firms in the Rest of the World (ROW) can exercise market power and price above marginal cost. Forming an RTA increases the amount of competition in the market and this affects not only domestic firms but also ROW firms which will find their ability to extract these rents eroded. Consumers and the RTA, as a whole, gain from the movement in the terms of trade in their favour.

Not only market power but also bargaining power can be increased by forming an RTA. To the extent that an RTA increases the joint bargaining power of its members, it may be more successful in obtaining tariff reductions from its trading partners (or avoiding the imposition of trade sanctions such as 'Super 301' threats). This assumes that the countries making up an RTA have a sufficient economic size relative to the third countries with which they must negotiate, and this requirement limits the relevance of this argument in the case of developing countries. A nice example (though based on regional cooperation rather than a regional trade arrangement) is noted by Schiff and Winters (2003). They point out how the Organisation of Eastern Caribbean States (OECS) wanted to impose waste disposal charges on cruise ships to prevent ocean dumping of solid waste which was threatening the fragile ecosystems on which the tourist revenue of the islands depends.

The cruise lines warned the OECS governments that any island that imposed waste disposal charges would lose cruise tourism because the lines would move their business to other islands. However, by acting together (and, it should be noted, with some arm-twisting by the World Bank and other donors) the islands were able to face down the cruise lines and a pollution charge was introduced.[11]

Trade Creation and Trade Diversion

	Country A	Country B	Country C
Supply price	50	40	30

Case – Alpha: If A imposes a tariff of 100% on both B and C, only A's own producers will be in the A's domestic market.

Case – Beta: If A imposes a tariff of 50% on both B and C, only C will be the supplying country in A's market.

Case – Gamma: If A forms customs union with B, but retains the 50% duty on C => B will be the supplying country in A.

If Alpha was the initial condition, moving to Gamma will be considered as trade creation, welfare enhancing for A.

If Beta was the initial condition, moving to Gamma is an example of trade diversion with adverse consequences on welfare of A.

Box 1: Trade Creation and Trade Diversion

3.1 The WTO and RTAs

RTAs represent a fundamental departure from the core WTO principle of non-discrimination. Nonetheless, the WTO affords its members a large degree of flexibility in entering new RTAs. The mandate of the WTO provides that countries may join agreements by meeting the requirements of the General Agreement on Tariff and Trade (GATT) Article XXIV covering the formation of customs unions and free trade areas in merchandise trade; the General Agreement on Trade in Services (GATS) Article V on agreements in Service; or the Enabling Clause (the 1979 decision on Differential and More Favourable Treatment, Reciprocity and fuller participation of Developing Countries) dealing with trade in goods between developing countries.

Despite the potential dangers of regionalism to the MTS, from its inception the GATT - and now the WTO - has allowed member countries to conclude customs unions and free-trade areas as an exception to the fundamental principle of non-discrimination set out in

11 Drawn on http://www.fao.org/docrep/004/y4793e/y4793e05.htm#TopOfPage

the most-favoured-nation (MFN) provision of Article I. Conditions to be met for trade in goods in RTAs are set out in GATT Article XXIV. During the Uruguay Round, Article XXIV was clarified to some extent and updated by an Understanding on its Interpretation. For trade in services, the conclusion of RTAs (referred to in GATS as economic integration agreements, EIAs) is governed by GATS Article V. Preferential trade arrangements on goods between developing country members are regulated by an "Enabling Clause" dating from 1979.

Non-reciprocal preferential agreements involving selected developing and developed countries require WTO members to seek a waiver from WTO rules. Examples of such agreements which have received a waiver include the US-Caribbean Basic Economic Recovery Act, Canada's offer of non-reciprocal duty-free access to most Caribbean countries, the US - Andean Trade Preference Act and the Cotonou Agreement between the EU and the ACP countries.

Proposed RTAs are examined to determine their compatibility with these rules. During the GATT years, the examination of RTAs was conducted in individual working parties. In order to ensure consistency in their examination, the General Council established in February 1996 a single Committee to oversee all RTAs, the Committee on Regional Trade Agreements (CRTA). The mandate of the CRTA is to carry out the examination of agreements referred to it by the Council for Trade in Goods (agreements under Article XXIV of the GATT 1994), the Council for Trade in Services (agreements under Article V of the GATS) and the Committee on Trade and Development (agreements notified under the Enabling Clause). The Committee is also mandated to develop procedures to facilitate and improve the examination process and to ensure that the reporting on the operation of the regional agreements is adequately carried out by the parties to the agreements. In addition to examining individual regional agreements, the Committee is also charged with considering the systemic implications of the RTAs for the multilateral trading system and the relationship between them.

Main requirements of the WTO rules on RTAs can be summarised as follows:

The neutrality of trade restrictiveness requirement: For trade in goods, Article XXIV: 5(a) provides that, with respect to a customs union, the "duties and other regulations of commerce imposed at the institution of any such union ...in respect of trade with contracting parties not parties to such union or agreement 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...". With respect to a free trade area, Article XXIV: 5(b) makes the same requirement for the trade policy of each of the countries which are party to such an agreement.

The 1994 understanding made clearer the methodology to be used to judge this requirement in the case of a customs union. With respect to tariffs and duties, the evaluation should be based on an overall assessment of weighted average tariff rates and of customs duties collected. The calculation is done by the WTO Secretariat based on import statistics for a previous representative period on a tariff-line basis using the methodology used to compute the tariff offers in the Uruguay Round negotiations.

Importantly, it is specified that the duties and charges taken into consideration should be the applied rates of duty. For non-tariff measures, individual examination to assess the fact should be undertaken whether their overall trade restrictiveness has increased or not.

The substantial coverage requirement: Article XXIV: 8(b) specifies that duties and other restrictive regulations of commerce, except as otherwise permitted under GATT rules, should be eliminated on substantially all the trade between the constituent territories. Article 5:1 of the GATS has similar language that an agreement should have substantial sectoral coverage, which is defined in terms of the number of sectors, the volume of trade affected and modes of supply. Specifically, to meet this condition, agreements should not provide for the a priori exclusion of any mode of supply.

The reasonable time requirement:. Article XXIV: 5(c) requires that any plan to form a customs union or FTA must show that it will be completed within a reasonable length of time. In the 1994 Understanding, this is defined as not exceeding 10 years except in exceptional cases. The GATS does not contain an equivalent provision with respect to a regional agreement covering trade in services.

The compensation requirement: If, in forming a customs union, it is necessary for a Member to raise a bound rate of duty, other Members have a claim for compensatory reductions in bound tariffs on other goods. The 1994 understanding specifies that, in calculating the amount of compensation required, due account should be taken of reductions of duties on the same tariff line made by other parties to the customs union upon its formation. The idea of compensation is not provided for in the GATS with respect to RTAs covering services. However, Article V:6 does provide that nationals or firms of any WTO Member which engage in substantive business operations in the territory of parties to a regional agreement are entitled to whatever special treatment is provided for in that agreement. There is no reciprocal obligation on third countries which benefit from a reduction of duties following the formation of a customs union, or from more liberal market access under an EIA services agreement, to offer any tariff or other concession to its members.

Special and differential treatment for developing countries: With respect to trade in goods, the Enabling Clause permits "regional or global arrangements entered into among less-developed contracting parties for the mutual reduction or elimination of tariffs and... non-tariff measures, on products imported from one another". Two aspects of this provision can be highlighted. First, it allows for preferential trade agreements which fall short of either an FTA or a customs union. That is, it does not require the elimination of duties, nor does it require that substantially all trade should be liberalised. Second, the only constraints on the operation of preferential trade arrangements between developing countries are that: (i) they shall be designed to facilitate and promote the trade of developing countries and not to raise barriers or to create undue difficulties for the trade of any other contracting parties; and (ii) they shall not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a MFN basis. This language is less demanding than the corresponding injunction in Article XXIV that the post-agreement trade policies shall not be more restrictive than the trade policies in force in the constituent countries prior to the formation of the agreement. Finally, there is no requirement for any indicative timetable for such liberalisation with respect to trade in goods.

With respect to trade in services, where the Enabling Clause does not apply, Article 5:3 of the GATS provides special and differential treatment for developing countries, in two dimensions. First, where developing countries are party to an EIA involving services, flexibility can be shown, particularly with respect to the requirement that substantially all discrimination must be removed in the service sectors covered by the EIA, in accordance with the level of development of the countries concerned, both overall and in individual sectors and sub-sectors. Second, in the case of EIAs involving only developing countries, more favorable treatment may be granted to juridical persons owned or controlled by natural persons of the parties to such an agreement.

The notification requirement; All RTAs concluded by WTO Members require notification. RTAs involving developed countries are sent to the CRTA for examination, while RTAs among developing countries under the Enabling Clause are notified to the Committee on Trade and Development. Some WTO Members argue that the Enabling Clause is not appropriate to deal with RTAs which take the form of either a customs union or FTA which should be covered by Article XXIV. According to this view, the Enabling Clause should be confined to PTAs which stop short of an FTA or customs union.[12]

3.2 Building blocks Vs Stumbling blocks

Notwithstanding the motivation behind the formations of RTAs, it is also essential to throw light on the different stands taken on the RTAs. There are two distinct schools of thought on that regard. In the existing literature, RTAs have been hotly debated and there are two schools of thought. The first school of thought, which holds RTAs to be building blocks towards multilateral trade, is led by Larry Summers13. The second school of thought that argues that RTAs are stumbling blocs to multilateral trade liberalisation is led by Jagadish Bhagwati14. Some other economists, however, have chosen to remain neutral.

Regionalism also has a tendency to beget regionalism as outsiders attempt to minimise the costs of trade diversion by becoming insiders. This has given rise to the new phenomenon of overlapping RTAs which increase their complexity and their relationship with the MTS. One highlighted issue is the negative effects on trade of differing rules of origin, and the way in which rules of origin can be designed to have a protectionist impact. There is also the danger that, as countries pursues deeper integration within RTAs, dispute settlement provisions contained in the 'new generation' RTAs could build jurisprudence conflicting with that of the WTO.

12 This section on RTAs & WTO is been drawn heavily from www.fao.org/docrep/004/y4793e/y4793e08.htm#TopOfPage

13 Former Treasury Secretary of the USA and currently President of the Harvard University

14 Professor of Economics at Columbia University

The positive view of the relationship between RTAs and the MTS is based on a number of arguments. First, it is argued that RTAs, by moving at a faster pace than WTO rules, while sharing its goals, represent a way of strengthening the latter. Second, smaller regional groupings may be more effective in tackling new areas such as services, investment, intellectual property protection, cooperation in competition policy, technical standards and government procurement compared to multilateral rule-making. By acting as laboratories to try out alternative rules and strategies to encompass these issues, it is argued that they can ease the reaching of agreements on these issues at the multilateral levels.

Third, despite the fears of trade diversion, the empirical evidence suggests that trade-creating effects dominate in major RTAs thus enhancing world welfare. A study conducted by the WTO Secretariat showed that there had been a definite trend toward broader as well as faster market access liberalisation on non-tariff measures in RTAs, in parallel to developments in the MTS (WTO, 1995). Also, although on a simple static analysis third parties may be disadvantaged by trade diversion, this is less obvious in a dynamic context if overall growth, and hence the demand for imports, is increased as a result of the integration process (Crawford and Laird, 2000). Fourth, it is argued that RTAs have had a positive effect by facilitating the integration of developing countries into the world economy.

4. North- South versus South-South RTAs

A trade relation between a developed and a developing country/region is referred to as North-South RTA, and that between two Developing regions is known as South-South regionalism. The new regionalism *inter alia*, stresses that schemes of North-South integration are likely to be more beneficial to developing countries. The *first* argument is that because industrialised countries are likely to be among the more efficient global suppliers, the costs of trade diversion (switching from cheaper global to more expensive partner imports) will be minimised. Schiff and Winters (2003) qualify this conclusion by pointing out that even small cost disadvantages for Northern firms can be costly for Southern partners because of the large amount of trade which will be involved. Also, if the Southern partner continues to import from the rest of the world over significant tariff barriers, prices in its market will not fall to the Northern partner price. Instead, there will be a substantial transfer of rents from Southern consumers to the Northern exporting firms.[15]

A *second* argument favoring North-South RTAs is based on credibility. If developing countries want to establish the credibility of their policy reforms, locking these in through agreements with a Northern partner may be more convincing to investors (both domestic and foreign). The argument assumes that the costs of backsliding in the case of a Northern partner will be greater than for Southern partners. Again, the premises behind this assumption may not stand up to examination. While the Northern partner may have the market power to wield credible sanctions, it may not have the will (for instance, the

15 Ibid

public relations problems for the EU if it were to withdraw market access from a traditional African supplier because the latter introduced some discriminatory economic policy) or the motivation (the market of the Southern partner may be so insignificant that the Northern country has no material interest in retaining access to it).[16]

North-South RTAs have been seen as more likely to result in gains to developing countries as compared to South-South RTAs, on the grounds that they minimise trade diversion costs and maximise the gains from policy credibility. Closer examination of these arguments, however, suggests that the assumptions on which they are based may not always stand up. Positive economic outcomes will depend on the deliberate design of these agreements, and cannot simply be assumed.

The growing propensity of RTAs to include aspects of policy integration also poses a challenge for developing countries. Although these aspects are most common in RTAs involving high-income countries, a growing number of North-South agreements now have broad integration objectives. The removal of NTBs which act to segment markets can be potentially beneficial, but whether this turns out to be the case in practice will depend on the nature of the policy integration. The costs to developing countries of harmonising inappropriate policy regulations may exceed the benefits of encouraging greater market access.

A case in point may be that of the EU-ACP Economic Partnership Agreement (EPA). These partnership Agreements diverge radically from the past trading relationships. Previously, the Lome Conventions had governed the EUs trade, aid and political links with the ACP countries, the EU's former colonies. Under these Conventions, the EU gave unilateral trade preferences to all ACP countries so they had better access to EU markets than their developing and developed country competitors. The Conventions also allowed ACP countries to protect their markets from EU competition. In Cotonou, in June 2000, a new agreement was signed to succeed the Lome convention. This was the Cotonou partnership Agreement, and was concerned with supporting the economic development of ACP countries and recognised their sovereign right to make their own decisions regarding their Economy and Development. The Agreement stipulated that by September 2002, the EU and the ACP countries must begin talks to negotiate EPAs between the EU and regional country groupings such as Economic Community of Western African States (ECOWAS).

The previous Lome Agreements were characterised by non-reciprocal trading relationship, this meant that ACP countries could protect their domestic markets from EU imports, while they had better access to EU markets for their exports compare to their competitors. However, EPAs mark a radical departure from this because the EU is choosing to negotiate the agreements under the strict WTO rules that govern reciprocal (FTAs), requiring ACP countries to open their markets to '*substantially all*' EU imports over a limited period of time. The EU policy shift from a non-reciprocal to a reciprocal trading relationship with ACP countries has been pushed by: the

16 Supra

EU's demand that EPAs be compatible with their interpretation of WTO rules; the lack of development gains secured by ACP countries from preferential treatment in EU market access; and the EU's pursuit of its own 'aggressive market access strategy' . Given this many governments, trade negotiators and civil society organisations (CSOs) in the ACP countries have raised concerns over EPAs.

By choosing to EPAs as FTAs, the EU is neglecting the WTO principle of Special and differential treatment for the less developed countries and marks a shift away from their previous thinking on development and trade. When trade is intended to reduce poverty, it is held by the developing countries such as the ACP countries that, they should be allowed to choose when and how much they can open up their markets. This is believed because conditions are necessary before a country can open its markets and benefit from trade, such as competitive domestic producers, a viable commodity sector, good physical infrastructure, and strong supply capacity and new jobs, this will only be a short term problem

In Africa, the most likely result is that many of her farmers, industries and firms will go out of business and, because access to loans and jobs in most African countries is difficult and costly, the impacts of deindustrialisation will be severe and long-term. Deindustrialisation is likely to bring with it increasing reliance on primary products as export commodities, the prices of which have been declining for years. This will exacerbate pressure on land resources as increased export volumes are necessary to maintain incomes. Food security crop farmers will be further marginalised increasing the pressure on productivity, otherwise trade liberalisation will likely lead to deindustrialisation. Due to the high levels of concentration within the industrial sectors of many ACP countries, competition is as yet not well developed in their domestic markets.

If local firms are inefficient, they can be sustained because they enjoy great market power. Opening the domestic market to foreign competition will lead to on of two things: either it will force local firms to quickly become efficient and competitive or firms will go out of business. If there is easy access to loans and new jobs, this will only be a short term problem. In Africa, the most likely result is that many of her farmers, industries and firms will go out of business because access to loans and jobs in most African countries is difficult and costly, the impacts of de-industrialisation will be severe and long-term. De-industrialisation is likely to bring with it increasing reliance on primary products as export commodities, the prices of which have been declining for years. This will exacerbate pressure on land resources as increased export volumes are necessary to maintain incomes. Food security crop farmers will be further marginalised increasing the pressure on remaining forests as they are cleared for small scale agriculture.

4.1. EPAs impact on Ghana and ECOWAS

EU is an important trading partner for Africa. It absorbs 31 percent of Africa’s exports and supplies 40 percent of its imports. With Sub Saharan Africa (excluding South Africa) having a meagre and declining share of world exports (0.3 percent in 2002), the region will be keen on not losing any existing of future export opportunities with the EU. However, EPAs are likely to have a negative economic, social, and environmental impact on Ghana and other ECOWAS countries.

EPAs are likely to have a range of impacts – largely negative – on Ghana and other ECOWAS countries, including economic, social and environmental ones. Revenue impacts are likely to be large as a result of reciprocal tariff removal on EU imports. In 2000, import revenues contributed 16 percent to the Ghana government's revenue. Predictions of the revenue impact of the EPA suggest that in the middle income scenario, Ghana would lose US$91mn in import duties, equivalent to 66 percent of total import duties and 10 percent of total government revenue. These are significant losses. Exports to the EU will have to increase significantly if such high losses are to be recovered, yet there is no guarantee that exports will grow at all in the face of such strong EU competition.

The most likely outcome is that imports of EU products will flood ECOWAS markets and push domestic products out of local markets, replicating what has already happened in several key West African agricultural sectors such as the poultry and rice sectors. Due to the tariff reductions in West Africa as a result of structural adjustment policies and the West African Economic and Monetary Union's (WAEMU) CET, there has been an eight-fold increase in the import of EU poultry products with over 30 percent of the total imports going to Ghana. In 2000, US$11mn worth of poultry products were imported, but just a year later this had more than doubled to US$26 million. These products are selling at 25-30 percent below the cost of production in Ghana due to the production and export subsidies they enjoy in developed countries.

The livelihoods of Ghana's poultry farmers are now seriously under threat and there are signs the industry is already collapsing. Abandoned poultry farms are now a common sight in Ghana as local poultry farmers are forced out of business by unfair competition from cheap subsidised EU imports. The farmers' problems have recently been exacerbated by the high price of feed which has doubled within just a few months. Poultry farmers have been forced to lay off many workers and to sell eggs for chick production at a small fraction of the price normally received. Reciprocal tariff removal will mean more producers, farmers and businesses will suffer these same consequences and be forced out of business by cheap EU imports unless ECOWAS countries are given sufficient time to develop and strengthen their competitiveness in domestic markets before opening to EU trade.

The EU's requirement for reciprocity in tariff removal on EU imports may not be consistent with already agreed regional ECOWAS policies for agriculture. The West African Agricultural Policy (ECOWAP) states that unilateral protective action at the regional level is justified where vulnerable populations may be injured. If livelihoods are undermined and agricultural sectors found to be suffering as a result of EPA implementation, it seems unlikely West African states would break EPA rules to protect its producers. If protective measures such as increased tariffs were imposed, the EU would probably force ECOWAS countries to back down, just like when IMF, World

Bank and developed country government pressure forced the Ghana government to cut import tariffs imposed to protect the country's rice and poultry farmers. It is therefore critical that the EPA is designed in a way that will strengthen rather than undermine pre-existing regional trade arrangements and agricultural policies, and also allow for countries to protect sensitive sectors important to the majority poor and to a country's own development agenda.

Tariff removal is likely to have two major effects that will impact on farmers, businesses and industry. First, imported cheap EU products will undermine local producers and industries, potentially putting them out of business if they cannot compete. This is related to trade creation where overall consumption of imported products increases as a result of lower prices, but domestic producers is displaced. Consumers benefit from reduced prices, but the negative impact of job losses is likely to undermine any gains in welfare. This will be a repeat of past experiences for Ghana: between 1987 and 1993, liberalisation in consumer imports caused employment in manufacturing to fall from 78,700 to just 28,000. There are also negative environmental impacts as food and other products are transported longer distances, thereby increasing transport-related pollution.

Europe stands to benefit greatly from EPAs so it is of no surprise it is pursuing them with such vigour. Midscenario estimates suggest the EU will benefit from trade creation and trade diversion to the value of US$46mn and US$40mn respectively for Ghana alone. For Nigeria, the equivalent estimates are US$348mn trade creation and US$229mn trade diversion. The Africa Economic Policy Centre (AEPC) estimates other figures for trade diversion. For Ghana and Nigeria, it suggests that US$102mn and US$173mn of trade value respectively will be diverted to the EU from possibly more efficient producers in non-EU countries, exacerbating the pollution effects where this substitution increases distances goods are transported.

The impact on ECOWAS countries of lost regional trade will be varied. Togo, Mali, Niger, Senegal and Guinea-Bissau will register no trade diversion and Nigeria only a limited amount from other ECOWAS countries, illustrating the low level of intra-regional trade involving these countries, and EPAs will severely limit the potential for such intraregional trade to develop in the future. By contrast, 23 percent of the trade diverted from Ghana will originate from other ECOWAS countries. This will have significant impacts for countries currently exporting to Ghana which will lose export markets and future export potential, contributing to job losses and de-industrialisation. It will also lead to damaging environmental impacts as food and other products will travel further when imported from the EU instead of ECOWAS regional neighbours. Transport-related environmental costs are externalised from international trade, distorting supposed comparative advantages. If these costs were internalised, EU products would likely remain more expensive than the ECOWAS products they will divert.

The AEPC estimates the EU will also benefit from substantial trade creation effects from EPAs. EU imports into the ECOWAS region will increase rapidly, benefiting particularly from strong growth in Nigeria, Ghana, Cote d'Ivoire and Senegal. Apart from Guinea-Bissau, average growth in all ECOWAS countries will be above 20 percent, with EU exports to Ghana growing by 38 percent alone. This is a deeply worrying trend because, besides the environmental impacts of the increased food and product miles, local domestic producers are going to be hit very hard. If the EPA is put in place too soon, ECOWAS producers will have inadequate time to build their competitiveness before the flood of EU imports begins. One estimate suggests that as few as 25 percent of Ghanaian industries will survive without tariff support following EPA implementation. For agriculture, the problems will be widespread, with increased food insecurity particularly in the rural regions, as farmers lose their livelihoods and are unable to access the 'cheap' EU imports due to lack of spending power. And the EU is being less than helpful with extra funds to finance the transition.

African Countries will need significant funds for investment in production and supply capacity improvements before they open to further EU competition, and to finance social and other compensatory measures which are not available due to structural adjustment, HIV/AIDs pandemic, debt and war amongst others. African countries have called on the EU to provide additional resources to assist with these EPA adjustment costs, but EU trade negotiators insist this is not part of the remit of EPA talks, and that financing is instead covered by the European Development Fund (EDF). Yet only 1.8 percent of this fund is set aside for trade development activities, hence the request for additional assistance for EPA implementation. Financing for adjustment costs and strengthening capacity had been included in the EPA 'roadmap' but the EC asked for the paragraphs on 'improvement of competitiveness' and 'capacity building' to be deleted, arguing the EDF managed those aspects. If African countries are to increase their chance of being competitive with EU products once their markets are liberalised, they must improve their domestic production capacity, and for this they need more time and financial assistance, both of which the EU seems unwilling to give.

Time is also needed to allow for debate at the regional level between ECOWAS farmers. ECOWAS countries lack a regional association representing farmers' views that could advise the EPA negotiations of the situation 'on the ground' and how specific sectors are likely to be impacted on by the agreement. Since most food in West Africa is produced by poor peasant farmers and, furthermore, the majority of West Africans are engaged in agriculture, it is crucial their voices are heard and their needs are respected and accounted for in the EPA agreement. National farmers' associations must be given the opportunity to come together for regional debate to enable discussion between ECOWAS farmers of problems, likely impacts and solutions, and allow time to find common agreement and voice their opinions at the regional level. This would be consistent with the legal commitment of the Cotonou Agreement that requires policy decisions to involve actors previously excluded from such processes, such as civil society and trade unions. Although the Cotonou Partnership Agreement stipulates the EU must provide an alternative for those countries not wanting to be part of an EPA, these alternatives have not been forthcoming. Indeed the EU has even implied it will not provide any alternatives until countries have firmly rejected the EPA.

The alternatives suggested so far have been described as second best options due to their lack of any development dimension. The UK has taken a pro-poor country stance to the

EPA negotiations, but a leaked letter revealed the EU has tried to persuade the UK government to reverse its position, condemning it as “a major and unwelcome shift”. The letter said the UK’s stance “could well make progress with EPA negotiations more difficult by reinforcing the views of the more skeptical ACP states and raising the prospects of alternatives that are, in reality, impractical”. The UK’s International Development Committee of MPs has said that development must be integral to any alternatives put forward to ACP countries, even if they are not the EU’s first choice, so that ACP countries are given real alternatives to EPAs[17].

4.2. RTAs in South Asia and Sub Saharan Africa

***The South Asian Perspective on RTAs*[18]**

The initial conditions for South Asia to embark on an RTA seem not very attractive. Limited complementarities, low intra-regional trade (4-5 percent), political turbulence, etc., are acting as impediments to embark on promoting intra-regional trade. However, there are some valid reasons for engaging in an RTA. The case for economic cooperation under an RTA can be justified from six perspectives.[19]

- Nearly 60 percent of global trade now takes place under RTAs and more than 250 RTAs in operation, so there are compelling reasons to be in an RTA, for if not formed member countries could get increasingly marginalised in the competitive world.
- It is argued that there is a large amount of informal trade that is taking place in the region and if this is added to the formal trade, the overall intra-regional trade will amount to nearly eight per cent in the SAARC. The argument is also put forward that despite intra-regional trade being put at 22 percent in ASEAN, if the re-exports from Singapore is taken into account, ASEAN intra-regional trade reduces to 12 percent. Thus it is argued that there is not much difference between SAARC and ASEAN in intra-regional trade taking into account that preferential trading in ASEAN started 20 years before SAARC.
- RTAs are not necessarily formed to increase low intra-regional trade to a higher level. In Europe, intra-regional trade was at 44 percent at the time of formation of the EC. The real objective here according to the Cecchini Report (1988) was to promote economics of neighbourhood and engage in industrial restructuring by exploiting economies of scale and specialisation. In other words, to promote industrial restructuring through complementarities and synergies.
- The cost of non-cooperation is highlighted to put forward the case for an RTA. RIS (1999) used the unit value method in a comparative static framework to work out the cost of non-cooperation in the SAARC due to sourcing of imports from non-SAARC countries. They found the cost of non-cooperation for Sri Lanka and Pakistan to be US $266 and US$511, respectively.

17 This section has heavily drawn on : ACP-EU Economic Partnership Agreements:Implications for Ghana and other ECOWAS countries

http://www.foeghana.org/trade_environment/impacts_ecowas.pdf

18 This section has drawn heavily from Adhikari, R & Kelegama, S; Regionalism debate: Re-positioning SAFTA.

19 Adhikari, R & Kelegama, S; Regionalism debate: Re-positioning SAFTA.

While the arguments for an RTA exist in South Asia, the question is how to exploit this potential. For SAFTA to be a formidable FTA, it has to cover a large portion of trade that is currently taking place in South Asia. While the case for SAFTA is straightforward, the question is a major political problem that cut across all areas of economic cooperation. Some South Asian nations being recent creations, a strong rhetoric has been built around the states and they are aided by the powers of state institutions. The mapping of the cartography of the colonial regime has eroded the foundation of regional linking. The division into nation states is strong. Since the nation-states are themselves in the process of being formed in the region, the concept of supra-national region seems novel and contradictory to the immediate task of nation building. Nation states are absolutely central and crucial for any project in South Asia. SAARC moves slowly because most nation states themselves have not been very successful.

Regional trade perspectives in Sub Saharan Africa

Regional Trade Perspectives:

- SSA remains weakly integrated with the global market. Although exports as a share of GDP in Sub-Saharan Africa increased in 2000, the region's exports as a share of world exports remained flat through the last decade, and are lower than in the early 1980s.
- GDP growth has also been slower than earlier decades. Many countries are dependent on a few commodities with volatile prices. Most face high transport costs and have weak institutions to facilitate trade.
- In SSA, RTAs are common and reflect an aspiration to overcome the limitations of small states. These include the South African Customs Union (SACU)—one of the oldest customs unions in the world—the CEMAC, COMESA, ECOWAS and the East African Community.
- Although average applied MFN tariffs have been cut by half since the 1990s, non-border barriers restrict internal trade. The recent RTAs have had more impact on outward looking MFN trade liberalisation, and thus on external trade, than on intra-regional trade. The economic impact of these agreements appears to have been small, especially compared to pre-independence arrangements that essentially validated existing economic links (SACU, UEMOA, and CEMAC).
- Some South-South agreements do better in focusing on merchandise trade, minimising exclusions and adopting less restrictive rules of origin—for example, CARICOM (the Caribbean Community), and COMESA (the Common Market of Eastern and Southern Africa). They have also lowered costs of crossing borders. But in general, these have fared less well in respecting implementation schedules. They suffer from the disadvantages of small market size and economic similarity, and rarely provide for temporary movement of labor.
- Many regional organisations in Africa moved aggressively to intensify trade liberalisation during the 1990s. The COMESA Treaty, signed in 1993 to replace the Preferential Trade Area, calls for a free trade area by 2000 and a customs union by 2004.

- SADC started in the 1980s as an anti-apartheid coalition, and has shifted to emphasise creating an FTA. Some observers note that African customs unions and free trade areas are as active in conflict resolution as in trade liberalisation.
- The EPAs under negotiation with the EU may reinforce an outward-looking pattern of trade integration, but they could aid Africa's own regional integration if they foster economic reform and performance.
- The extent of regional integration among COMESA members has been relatively static over the past two decades. In contrast, the share of intra-area trade has increased substantially for ECOWAS since the early 1980s and for SADC since the late 1980s.
- Different agreements are associated with different propensities for higher than "normal" overall exports. AFTA, EC, GCC, MERCOSUR, NAFTA, and SACU all appear consistently to export more than they would have without the agreement. The countries in these regional groups appear to have adopted policies that led them to be more export-oriented than they otherwise would have been.
- Delays at the main border-crossings between South Africa and Zimbabwe (Beit Bridge,as cited in the Global economic Prospects,2005) amounted to six days in February 2003, leading to an estimated loss of earnings per vehicle of US$1,750, equivalent to the costs of a shipment from Durban to the US.
- Crossing a border in Africa can equal the cost of over a thousand miles of overland transportation based on international averages; in Western Europe the equivalent is 100 miles (Arvis 2004, as cited in the Global Economic Prospects, 2005).
- Free labor movement is seen as a long-term objective of COMESA, to be accomplished by 2025. However, progress has been limited to date.

Regional Economic Prospects:

- GDP in SSA is expected to grow 3.2 percent in 2004, much faster than the 1990s, but slower than almost everywhere else. As a result, per capita incomes increased by only 1.1 percent in real terms. The region fell behind both developed and other developing economies.
- Growth in oil-exporting countries was strong at 4.4 percent, but was down substantially from the 7.9 percent pace recorded in 2003 as spare oil production capacity dried up.
- High oil revenues helped fuel a six-percent increase in personal consumption and investment demand in oil-exporting countries.
- In South Africa, which accounts for almost 50 percent of the region's GDP, growth was dampened by the 40 percent effective appreciation of the rand since 2002. As a result, exports were weak and imports strong so that despite robust domestic demand (up some five percent), GDP increased by only an estimated 2.7 percent.
- Most of the remaining countries in the region are oil-importers and poor. These countries represent more than two-thirds of the population of Sub-Saharan Africa, but less than one-third of GDP. Their output rose by an estimated three percent, up sharply from 1.7 percent in 2003.

- Overall, oil-importing SSA countries suffered a 0.5 percent of GDP terms-of-trade loss, as the negative income effect of high oil prices more than offset the positive effect of higher agricultural and metal prices.
- SSA GDP growth is projected to accelerate in 2005 and 2006, rising to 3.7 percent by 2006.
- The easing of oil prices and tight capacity constraints are expected to force a slowing in the pace of output among oil exporters. Nevertheless, given still high incomes and robust domestic demand, their annual growth should exceed 3.5 percent.
- The pace and fragility of growth in the region remains a serious challenge.

In the long run, per capita GDP is projected to grow by about 1.6 percent a year, not as rapid as other regions, but an important improvement relative to the falling per capita incomes that characterised the 1980s and 1990s.[20]

4.3. Measuring the Impact of Trade

Regional Trade Agreements in Gravity Models: A meta-analysis

Meta-analysis provides a means of assessing and combining empirical result from different studies. The approach takes as individual observations the point estimates of relevance parameters from different studies. This set of observations is then used to test the hypothesis that the relevant coefficient is statistically different from zero. Here we are concern with two parameters. The first measures that impact of the agreement on total imports (which we label overall impact); a negative value for this parameter suggests that for the for the agreement concerned, the level of trade between a member and any other country is less then the normal level of trade that one could expect. Thus a negative value is evidence of trade diversion. The second parameter captures the impact of RTAs on the level of trade between partners (internal impact). In a study carried out by the World Bank staffs a total of 254 estimates of 'overall impact' and 362 estimates of 'internal impact' from 17 research studies were analysed.

Of the estimates of the overall impact, 76 percent were found statistically significant, 42 percent negative and significant and 34 percent are positive and significant. For the internal impact, 66 percent of the estimates are statistically significant, 54 percent are positive and significant and 12 percent are negative and significant. The most robust of the overall impacts were negative. The mean value of internal impact was positive. For both parameters there was a high degree of variance about the mean values. Within this analysis the estimates of 19 RTAs were assessed 10 exhibited on an average trade diversion.[21]

A General Equilibrium Model

The development of general equilibrium models (GEMs) goes back a long way in economics, both at a theoretical level and as a tool for empirical analysis. General equilibrium theory and modelling have proved to be relevant and useful for

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20 This section has heavily drawn on Sub Saharan Global Economic Prospects,2005

21 adapted from Global Economic Prospect, 2005

understanding economic interactions between markets and agents in complex modern economies and the determination of prices and quantities as a result of the latter interactions. Applied GEMs have been developed and used to address a wide range of theoretical questions and empirical/policy issues, in the fields of macroeconomics, international trade, public finance, and environmental analysis, among others. GEMs are used for many purposes, including simulation of policy changes and response to exogenous shocks, as well as forecasting (mostly macroeconomic) variables.

An important feature of this model is that it takes into account linkages between markets, both product and factor markets (including feedback to the original market). To investigate the impact of regional integration and trade facilitation, this study adopts a computable general equilibrium (CGE) methodology. This model has been widely used in trade policy analysis due to; *inter alia,* their ability to capture economy wide interactions. Some of it findings are given below:

Incorporation of trade facilitation improvements are also observed to at least triple the welfare gains compared to the scenario without trade facilitation, thus pointing to the substantial gains to be realised by Middle East and North Africa regions (MENA) countries in addressing existing inefficiencies in trade facilitation, in particular those arising from high indirect trade transactions costs. It would appear that significant gains could be reaped from streamlining cumbersome custom procedures including customs valuation and import requirements on standards and technical regulations. Modernising customs and adhering to WTO disciplines on customs valuation, import licensing, technical barriers to trade (TBT), and Sanitary and Phyto-sanitary (SPS) standards may be a first step in this direction.

B. Partial Equilibrium Model

It is a part of the general economic equilibrium, where the clearance on the market of some specific goods is obtained independently from prices and quantities demanded and supplied on other goods' markets. In partial equilibrium analysis, the determination of the price of a good is simplified by just looking at the price of one good, and assuming that the prices of all other goods remain constant. The Marshallian theory of supply and demand is an example of partial equilibrium analysis. Partial equilibrium analysis is adequate when the first-order effects of a shift in, say, the demand curve do not shift the supply curve.

Moreover this model focuses on one sector at time; neglect interactions between markets; and useul if second order effects are likely to be small. This model has its advantages of being simple; tranparent (rely on a few key parameters); and add realism in the specific sector.

C. Gravity Model

The gravity model in international economics, similar to other gravity models in social science, predicts bilateral trade flows based on the economic sizes of (often using GDP measurements) and distance between two units. The model was first used by Walter Isard in 1954. The basic theoretical model for trade between two countries (i and j) takes the form of:

$$F_{ij} = G * \frac{M_i * M_j}{D_{ij}}$$

Where F is the trade flow, M is the economic mass of each country, D is the distance and G is a constant. Using logarithms, the equation can be converted to a linear form for econometric analysis. The basic model for such a test results in the following equation (note: constant G becomes part of α): ln(Bilateral Trade Flow) = α+βln(GDPCountry1)+βln(GDPCountry2)-βln(Distance)+ε

The model often includes variables to account for income level (GDP per capita), price levels, language relationships, tariffs, contiguity, and colonial history (whether Country1 ever colonised Country2 or vice versa). The model has also been used in international relations to evaluate the impact of treaties and alliances on trade, and it has been used to test the effectiveness of trade agreements and organisations such as NAFTA and the WTO. Importantly, gravity model does not estimate welfare effects. An example of Application of Augmented Gravity Model is *Trade Potential in SAFTA* by Mustafizur Rahman; Wasel Bin Shadat, and Narayan Chandra Das.
The augmented gravity model was developed in the above mentioned study to identify trade creation and trade diversion effects originating from SAPTA and other nine RTAs.

- It was found that there is approximately proportional relationship between bilateral export flows and size of the economy (either exporter or importer) indicting that potential high economic growth of south Asian counties (particularly for India, Bangladesh and Sri Lanka) may boost their trade flows.

- Interestingly, openness of importing country is associated with a significant surge in bilateral exports. This indicates that it is highly possible that reduction in tariff barriers within the SAFTA region may raise intra-regional trade in the region. However, impact of devaluation of domestic currency on bilateral export flows was found to be low. This indicates that a devaluation of domestic currency may not be an effective tool to increase exports of a country.

- It has also been found that Bangladesh, India and Pakistan are expected to gain from joining the RTA, while Nepal, Maldives and Sri Lanka are negatively affected. Among these three countries Nepal and Maldives are enjoying LDCs status and by utilising the S&D treatment accorded under the SAFTA these two countries can reap benefits from the SAFTA.

- Reduction in tariff barriers and NTBs within the region as well as introduction of favourable RoO could raise intra-regional trade in the SARRC region.

- Elimination of trade barriers and structural rigidities originating from adverse political relationship could lead to substantial increase in intra-SAARC trade. Measures to stimulate investment flows from intra-regional and extra-regional sources could also boost intra-SAARC trade by providing preferential access to the produced goods.

D. Global Trade Analysis Project (GTAP)

GTAP works on providing data, standard model (general equilibrium model) and software to enable the analysis of global trade patterns. The data base contains: detailed bilateral trade, transport and protection data characterising economic linkages among regions, linked together with individual country input-output databases which account for intersectoral linkages among 50 sectors within each region (45 geographical regions covered in current version of model).GTAP has its own limitations, for instance some sectors in some countries could be characterised by imperfect competition and economies of scale, absence of the variety effect, not appropriate to look at issues related to the composition of public expenditures, labour market issues cannot be dealt with properly.

According to the authors studies based on the partial equilibrium *Gravity Model* to estimate the welfare gains from RTAs are methodologically flawed. The left hand side of the *Gravity Equation* is the bilateral trade not the welfare. Also, the impact of the RTA is captured by introducing the dummy variables in the equation which is a very weak methodology. Furthermore, *Gravity Models* are partial equilibrium analysis, not a general equilibrium analysis. Therefore, they fail to take into consideration the inter-sectoral and inter-regional linkage effects. Therefore, gravity models can not actually estimate the *trade creation* and *trade diversion* impacts of RTAs.

Findings using the GTAP model are given below:

- Amongst the RTA initiatives only the SAFTA has become operationalised. With respect to different bilateral FTAs no significant progress has been achieved so far.
- It appears that a full implementation of SAFTA will lead to welfare gains for India, Sri Lanka and rest of South Asian countries, though Bangladesh suffers from welfare loss. Bangladesh’s welfare loss is mainly driven by the negative trade diversion effect.
- Bangladesh and other LDCs in South Asia will have to raise their export share into the Indian market substantially in order to increase welfare through positive terms of trade effect. Export diversification in this regard is very important.
- South Asian LDCs should reduce tariff on the import of (at least) raw materials from India, which will have positive impact on LDCs welfare.

5. Views on RTA’s Impacts on Non-member Countries

It has been controversial whether the regional arrangements help or hinder multilateral liberalisation. It is generally claimed that in RTAs the higher the level of protection that member countries apply against imports from non-members, and the lower the impact that the agreement has on growth rates, the more serious the trade diversion effects and the negative economic consequences on non-members' exports. Below are the few studies that have tried to highlight the effect of RTAs on non-members:

- Baldwin (1995)[22], among others, suggests that the formation of a trade bloc can have a "domino effect". As regional integration increases, excluded countries will lose competitiveness and seek to join the bloc. If the bloc enlarges, the cost to the non-members increases since they face a cost disadvantage in an even greater number of markets. This second round effect will lead to further enlargement of the regional trading bloc.
- Krishna (1998),[23] however, employs an oligopolistic model to show that when regional blocs foster trade diversion, in which efficiently produced goods from outside blocs are replaced by inefficiently produced goods inside, each member of the bloc will undermine its incentive to liberalize trade with the rest of the world.
- Many, including Bhagwati (1993)[24] and Nagarajan (1998)[25], attribute the negative side of regional trade blocs on non-member countries to ambiguity of the rule governing regional arrangements of the WTO. Article XXIV of the GATT requires that when a group of WTO members form a regional arrangement among themselves, the arrangement must not raise the tariffs "applicable" on imports from third countries. It is not clear, however, whether the term "applicable" refers to "bound" or to "applied" tariff rates. Because of this ambiguity, according to Nagarajan (1998), Mexico was able to raise applied tariffs within bound ceilings on imports from non-member countries as a reaction to the peso crisis, while tariffs on imports from other NAFTA countries were not affected.
- In order for regional arrangements to help greater multilateral liberalisation, two concepts have been proposed. The concept of "open regionalism" was introduced during the APEC discussion. Although the precise definition was not provided, it suggested, according to Jeffrey and Wei (1998)[26] that any outside country could choose to join the bloc as long as it satisfies the entry criteria and the benefits of a regional arrangement should be extended to non-member countries.

22 Baldwin, R, P.Haaparanta and J.Kiander (eds.), "A Domino Theory of Regionalism", in Expanding European Regionalism: The EU's New Members, Cambridge University Press, 1995.

23 Krishna, Pravin, "Regionalism and Multilateralism: A Political Economy Approach," Quart. J. of Econ., 113:1, pp. 227-251, 1998.

24 Bhagwati, Jagdish N. (1993), "Regionalism and Multi lateral ism: An Overview," in J. de Melo and A. Panagariya (eds.), New Dimensions in Regional Integration, Cambridge University Press, Cambridge.

25 Nagarajan, Nigel (1998), "Regionalism and the WTO: New Rules for the Game?" Economic Papers No. 128, June, European Commision.

26 Frankel, Jeffrey and Shang-Jin Wei (1998), "Open Regionalism in a World of Continental Trade Blocs," IMF WP/98/10, International Monetary Fund.

- Closely related to open regionalism, McMillan (1993)[27] also proposed changing Article XXIV of GATT to require that there be no decrease in trade volume between member and non-member countries after the formation of a bloc. The imports by members from non-members, especially, are required to be the same as before the formation of blocs.
- Moreover, the classical model of regional integration economics generally posits that the global welfare effects of such arrangements may be determined by examining whether they are net trade-creating or trade-diverting, as defined by Jacob Viner. If there is increase of trade among members that exceeds the level of trade lost with non-members, then there is a net positive global economic welfare effect. If level of lost trade with non-members exceeds the increase in trade among members, then there is a net negative global welfare effect.

Yet, despite these well-known consequences of regional agreements on third countries, most of the literature recommend that regional agreements can and should be strengthened and deepened for the benefits of the member countries. As noted above, the higher the level of tariffs applied to imports from non-members, the higher the likelihood that a trade agreement will produce trade diversion and discrimination. Most developing countries still have relatively high average tariffs and therefore, trade agreements that include them most usually harm non-members (World Bank 2006).

One estimate provided by an often-cited study by Bayoumi and Eichengreen (1997)[28] found that the formation of the EC (European Community) countries reduced the annual growth of members' trade with other industrial countries by 1.7 percentage points per year. Cumulating the decline over the period 1957-1973 puts the loss to the rest of the world exports at US$24bn in the latest year.

Researchers have also uncovered several cases of discrimination against developing countries' exports from integration agreements of industrial countries. Goto (1996)[29] for example, analysed the accession of Greece, Spain and Portugal to the EC to determine whether there had been changing patterns of agricultural and manufactured trade flows before and after enlargement. He found that in all three cases, there was an important increase in regional agricultural trade but at best minor changes in the patterns of manufactured trade flows. He concluded that these differences should be attributed to the ECs structure of protection that is heavily biased towards agriculture increasing trade diversion effects when enlargement to new countries was agreed.

27 McMillan, John (1993), "Does Regional Integration Foster Open Trade? Economic Theory and GATT's Article XXIV," in K. Anderson and R.Blackhurst (eds.), Regional Integration and the Global Trading System, Harvester-Wheatsheaf, London.

28 Bayoumi, T. and B. Eichengreen. 1997. Is Regionalism Simply a Diversion? Evidence from the Evolution of the EC and EFTA, in T. Ito and A. Krueger (eds.), Regionalism versus Multilateral Trade Agreements, NBER-East Asia Seminar on Economics, Vol. 6, University of Chicago Press.

29 Goto, J. 1996. Regional Integration and Agricultural Trade, Policy Research Working Paper No. 1805, The World Bank: Washington DC.

The creation of NAFTA also offers examples of export losses by third countries. Nogués (2004)[30] shows several product-specific examples of how creation of this agreement in 1994 was followed by declining import shares from Argentina and Brazil in Mexico that were compensated by higher shares from Canada and the US. For example, one case of loss from the formation of NAFTA is that of sunflower oil exports from Argentina to Mexico. As compared with 1991, Mexico's imports from Argentina reached a peak and thereafter declined rapidly from US$82.4mn to only US$3.6mn in 2000. The figures also show Mexico's imports from the US increasing fast to more than double the value registered in 1991.

There are other ways by which trade agreements can harm non-members, including:

- through price effects and terms of trade deterioration
- by reducing the likelihood of making progress in multilateral trade negotiations.

Both of these factors have been found to produce worrying negative effects on non-members (Schiff and Winters 2003)[31], which are not well reflected in several of the other documents. In sum, regional agreements do produce trade discrimination and this should be of concern to a multilateral trading system.

30 Nogués, J. 2004. Agricultural Exporters in a Protectionist World: Review and Policy Implications of Barriers Against Mercosur, INTAL-ITD Working Paper No. 16, Inter-American Development Bank: Washington DC.

31 Schiff, M., and L.A. Winters. 2003. Regional Integration and Development, World Bank and Oxford University Press.

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