Overview

The proliferation of regional trade agreements (RTAs) is fundamentally altering the world trade landscape. The number of agreements in force now surpasses 200, and it has risen sixfold in just two decades. Today more than one-third of global trade takes place between countries that have some form of reciprocal RTA.[1] The European Union (EU) and United States are playing a prominent role in this proliferation (figure 1).

This report addresses two questions:

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

Identifying What Works: Open Regionalism

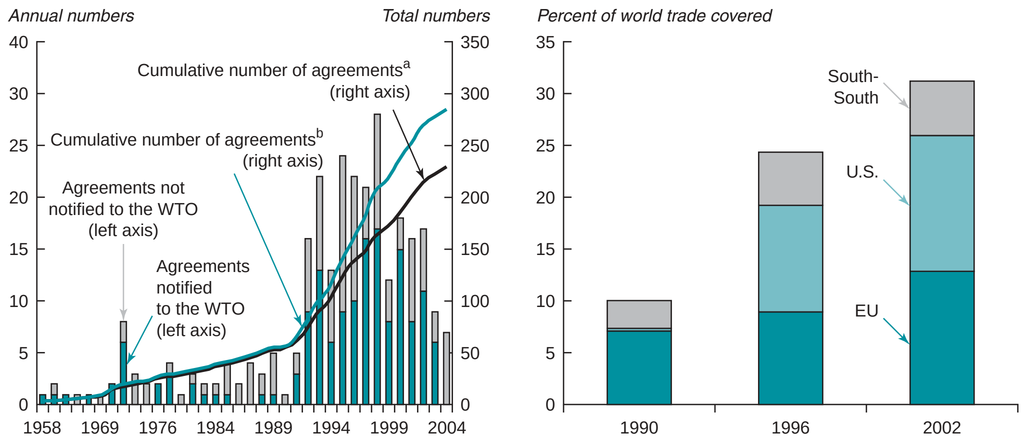
RTAs are often one component of a larger political effort to deepen economic relations with neighboring countries.[2] As such, they can create opportunities to expand trade through joint action to overcome institutional as well as policy barriers to trade. At a basic level, it is often easier to motivate reciprocal reductions in border barriers when the participants are fewer and the policymakers feel more in control of outcomes. Moreover, RTAs have the flexibility to pursue trade-expanding policies not addressed well in multilateral trading rules. Trade agreements therefore usually go beyond slashing tariffs to include measures to reduce trade impediments associated with standards, customs and border crossings, and services regulations—as well as broader rules that improve the overall investment climate. Finally, these agreements often form cornerstones of larger economic and political efforts to increase regional cooperation. RTAs can help motivate and reinforce broader reforms in domestic policy; they can be designed to contribute to a political environment that is more conducive to stability, investment, and growth.

Not all agreements create new trade and investment. Those RTAs with high external border protection are particularly susceptible to the adverse effects of trade diversion (figure 2). In fact, a statistical analysis based on findings from several econometric studies suggests that many agreements cost the economy more in lost trade revenues than they earn, because they discriminate against efficient, low-cost suppliers in nonmember countries. Of course, this finding does not take into account the potential dynamic gains, the positive effects associated with services liberalization, or any of the benefits from adopting new regulations. But it does underscore the point that regional agreements carry risks that merit close scrutiny by would-be participants.

Figure 1 Regionalism spreads

a. The number of RTAs exploded in the 1990s

b. EU and U.S. agreements were most important



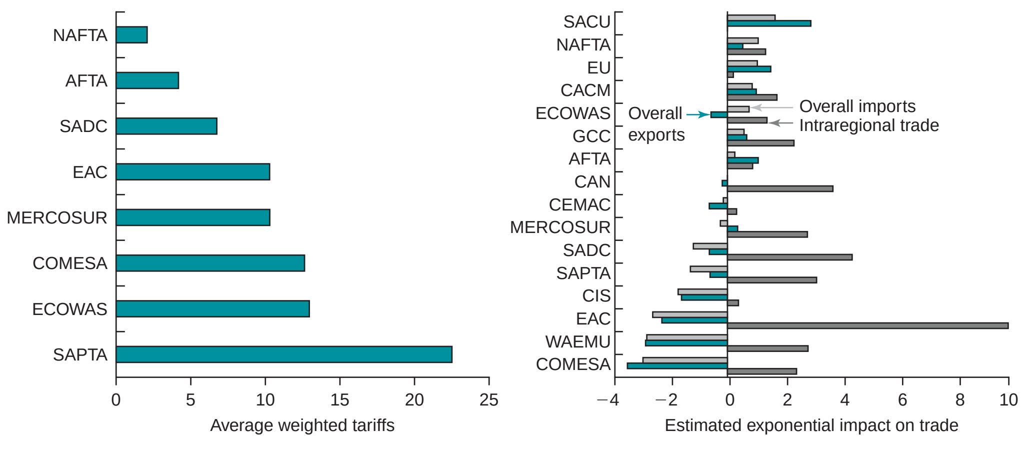
a. EU-25 counted as single country.
b. EU-15 counted as single country.

Source: World Trade Organization.

Figure 2 External protection can differ among agreements

a. Only a few agreements have low external tariffs

b. And so intraregional trade in some cases grows at the expense of extraregional trade



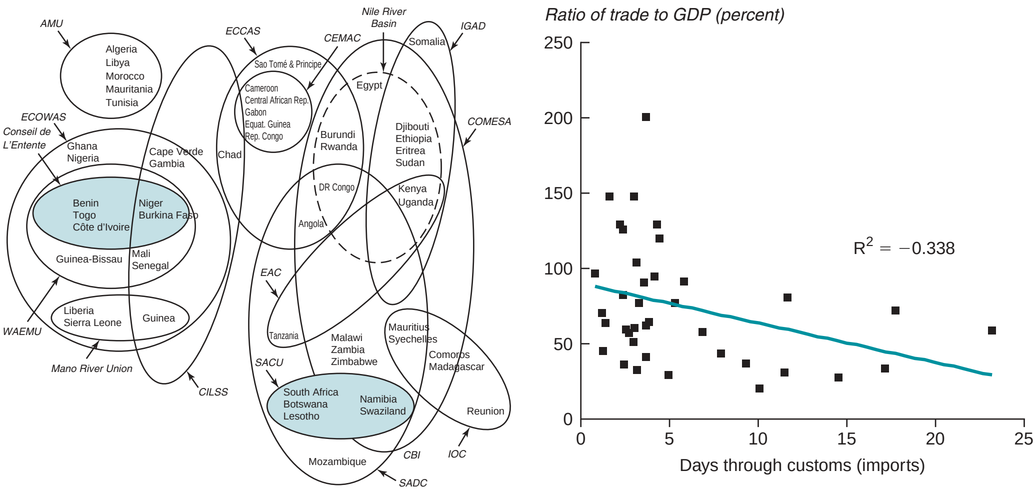
Note: In chart a, tariffs are import-weighted at the country level to arrive at RTA averages. In chart b, the bars show the magnitude of the dummy variables, capturing respectively the extent to which intraregional trade, overall imports, and overall exports differ from the "normal" levels predicted by the gravity model on the basis of economic size, proximity, and relevant institutional and historical variables, such as a common language.

Source: World Bank staff using UN TRAINS, accessed through WITS.

As agreements proliferate, a single country often becomes a member of several different agreements. The average African country belongs to four different agreements, and the average Latin America country belongs to seven agreements. This creates a "spaghetti bowl" of overlapping arrangements (figure 3). Each agreement has different rules of origin,

Figure 3 RTAs can complicate customs administration

a. African agreements are overlapping **b. More efficient customs are associated with more trade**



Sources: Chart a, Schiff and Winters (2003). Chart b, Investment Climate Surveys data and Global Trends as cited in Subramanian and others (2003).

different tariff schedules, and different periods of implementation, and together they complicate customs administration. Customs agents report that it takes longer to process goods covered by preferential arrangements, and longer processing times drive up the cost of trade. In general, the longer the delays in customs, the smaller the role of trade in GDP.

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

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

- Low external MFN tariffs,
- Few sectoral and product exemptions,
- Nonrestrictive rules-of-origin tests that build toward a framework common to many agreements,
- Measures to facilitate trade,
- Large ex-post markets,
- Measures to promote new cross-border competition, particularly in services, and
- Rules governing investment and intellectual property that are appropriate to the development context.

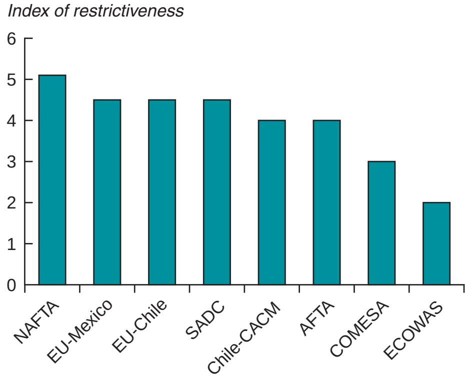
Low external tariffs and wide coverage minimize the risks of trade diversion, while nonrestrictive rules of origin allow for increased trade. The practice of excluding many agricultural products is common, and it can limit development payoffs. Trade facilitation measures, though worthwhile in and of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

Well designed agreements are of limited value if they are not implemented, and many RTAs have more life on paper than in reality. Weak implementation often afflicts South-South agreements. Monitoring mechanisms are often inadequate and do not receive the sustained high-level political attention necessary to drive institutional improvements in, for example, adherence to tariff reduction schedules, customs, and border crossings.

Against these benchmarks of success, it is difficult to give universally high marks to any single category of agreement. In general, North-South agreements score better on implementation than South-South agreements. Because North-South agreements can integrate economies with distinct technological capabilities and other different factor proportions, and because they usually result in larger post-agreement markets, the potential gains are usually greater. However, tighter rules of origin, more restrictive exclusions for particular sectors (such as agriculture), and a preoccupation with rules not calibrated to development priorities can undercut these benefits (figure 4). North-South agreements, particularly those with the United States, have been more effective in locking in new services liberalization; they have pressed intellectual property rights beyond World Trade Organization (WTO) rules; and expanded the sphere of investment protections; but they contain few provisions to liberalize the temporary movement of labor.

Some South-South agreements are better at focusing on merchandise trade, minimizing exclusions, adopting less restrictive rules of origin, and lowering the border costs. For example, the Caribbean Community (CARICOM) and the Common Market of Eastern and Southern Africa (COMESA) have had some success in reducing border costs. But in general, South-South agreements have not adhered to implementation schedules, and they suffer from their small market size and economic similarity. And like the North-South agreements, South-South agreements rarely provide for the temporary movement of labor.

Figure 4 Rules of origin in North-South agreements are more restrictive than in South-South agreements



Note: Higher values of the index equals to more restrictive rules of origin derived from Estevadeordal and Suominen (2004).

Consequences for the Multilateral System

The development consequences of RTAs are not limited to their effects on members—they also have cumulative effects on the multilateral system. In one sense, RTAs are a step toward greater openness in the whole system, by promoting more trade and generating new domestic constituencies with an interest in openness. Moreover, some regional trade policies are effectively nondiscriminatory, such as measures to improve customs, speed transactions at ports or border crossings, or in some cases open services markets. These measures can complement unilateral and multilateral policies.

However, this view overlooks the effects that RTAs can have on excluded countries. Preferences for some countries mean discrimination against others. Indeed, the General Agreement on Tariffs and Trade (GATT), borne out of the sad experience of discrimination in the prewar years, was founded on the principle of nondiscrimination. Today, the adverse consequences for the excluded countries are much less severe than at GATT's inception, because tariffs and other barriers have come down sharply, mitigating the exclusionary effects of regional arrangements. The exception—and it is not trivial—is agriculture. Another mitigating factor is that many countries excluded by trade agreements between the United States and the EU enjoy some degree of preferential access through voluntary preference schemes, such as the Generalized System of Preferences (GSP), America's Growth and Opportunity Act (AGOA), and the EU's Everything But Arms (EBA) program. To be sure, these programs lack the certainty of market access that MFN agreements and RTAs provide, because preferences are voluntary and subject to political whim, but they do mitigate the effects of exclusions for selected, very low-income countries. Finally, some developing countries—the spokes in the hub-and-spoke analogy—are signing bilateral agreements with each other and with other hubs.

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

RTAs can also undercut the incentives of governments to press for multilateral liberalization, which would improve global trade rules. This study finds little evidence that major players in the current WTO negotiations have changed their negotiating positions or retreated from the multilateral process, even as they avail themselves of regional trade deals. However, as the discussions become politically difficult, the risk is ever present that even they will abandon multilateralism in favor of "satisficing regionalism." One consequence of the spread of regional agreements is that many poorer developing countries have diverted scarce negotiating resources to regional negotiations at the expense of more active participation in the Doha discussions. The average developing country belongs to five separate RTAs and is negotiating more all the time. In the future, will countries that now enjoy preferences fight multilateral liberalization, or even oppose further regional liberalization, to keep their privileged market access? A few small developing countries are indeed likely to lose advantages in preferential markets, and they may scuttle a deal if their legitimate concerns are not addressed.

The Importance of Doha to Open Regionalism

The policy solution to these twin concerns—the need to design regional agreements that create trade and regional agreements that have minimal exclusionary effects—comes together in the form of low MFN tariffs and other border barriers. An agreement that lowers border protection around the world promotes open regionalism by mitigating trade diversion. At the same time, it would diminish the exclusionary effects of discriminatory preferences built into regional agreements. The first order of business for the international community is to accelerate progress on the Doha Agenda and to fill in the blanks of the August 2004 framework agreement with reductions in protection, especially for products produced by the world's poor.

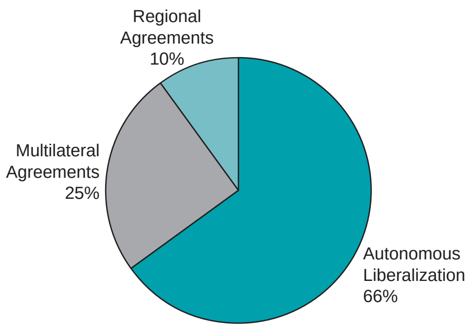
For Developing Countries, a Three-Part Strategy

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

Historically, *unilateral liberalization,* which is usually linked to a broader program of domestic reform, has accounted for most of the reductions in border protection. Most comprehensive trade reforms among large countries (Argentina, Brazil, and China in the early 1990s, and more recently, India) were primarily unilateral reforms that were undertaken to increase the productivity of the domestic economy. The same process took place in many small countries as well. In fact, of the 21 percentage point cuts in average weighted tariffs of all developing countries between 1983 and 2003, unilateral reforms account for roughly two-thirds of the reduction. Tariff reductions associated with the multilateral commitments in the Uruguay Round accounted for about 25 percent, and the proliferation of regional agreements amounted to about 10 percent of this reduction (see figure 5).

Autonomous liberalization promotes global competitiveness by lowering costs of inputs, increasing competition from imports to drive productivity growth, and integrating the national economy into the global economy. Autonomous trade reform is, ironically, more important than ever in the presence of RTAs; low border barriers minimize the risks of trade and investment diversion. Low external barriers promote trade in world markets, and this is highly correlated with increases in intraregional trade, irrespective of the presence of an RTA.

Figure 5 Share of total tariff reduction, by type of liberalization, 1983–2003



Source: Martin and Ng 2004.

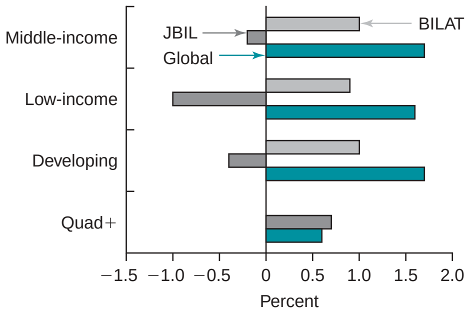
Multilateral liberalization leverages domestic reforms into increased market access around the world. Developing countries collectively stand to gain much more in the WTO arena than in any smaller regional market. Moreover, this multilateral forum is the only place that developing countries, working together, can press for more open markets in agriculture and can seek disciplines on trade-distorting agricultural subsidies and on contingent protection.

Some have argued that RTAs can be an alternative to multilateral liberalization. They are not. Gains for all developing countries from these agreements, even under the most generous of assumptions, are usually only a fraction of those from full multilateral liberalization. Of course, if one of the partner countries is a high-income, large-market economy, and if most other countries are excluded from preferential access, the countries signing the first trade agreement may benefit individually and substantially—but those benefits wither as new countries sign additional agreements. In fact, the scenarios in this study show that all developing countries would collectively lose if they were all to sign preferential agreements with the Quad (Canada, the EU, Japan, and the United States) (figure 6). Therefore, developing countries have a powerful collective interest in an effective Doha Agenda—even if they all are scrambling to gain preferential market access to the Quad.

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

Figure 6 Multilateral liberalization is far more beneficial than RTAs

Change in real income in 2015 compared to baseline



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

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

their eyes wide open. The lessons of this study (and others before it[4]) are that, much as with unilateral or multilateral policies, design and implementation determine the ultimate effects. It is important to use trade policy to leverage domestic reforms that promote growth. For South-South agreements, it is essential that the focus be on some combination of full trade liberalization behind low external border protection, greater services deregulation and competition, and proactive trade facilitation measures that together positively affect both intra- and extra-regional trade.

High-Income Countries and Development

High-income countries, in order to realize their broad development objectives, must intensify their efforts to realize the development promise of the Doha Agenda. This has the potential to open up trade, particularly in agriculture, in a way that would benefit low-income groups around the world. Because the high-income countries are the large players in the system, they have a special interest in—and responsibility for—using effective multilateral reforms to discipline the discretionary aspects of the regional agreements.

Allowing developing countries to concentrate scarce negotiating resources on the multilateral agenda may require that high-income countries decelerate their efforts at expanding RTAs. Irrespective of the pace of new agreements, high-income countries could consider the following rules of thumb when designing agreements to promote development. First, reducing the extensive exclusions for agriculture would transfer the income gains to rural areas in participating developing countries. Second, adopting more common and nonrestrictive rules of origin across agreements would reduce the administrative barriers that often undermine agreements and that increase the burden on customs administration. Third, working with prospective partners to ensure that new regulations regarding investment and intellectual property are appropriate to the level of development would reduce risks of undue enforcement costs. Finally, providing trade-related technical assistance, not only in the implementation phase but also in the negotiating phase, would promote greater liberalization of services and lower MFN tariffs.

Acting Collectively to Mute the Effects of Discrimination

To minimize the discriminatory effects of RTAs at the multilateral level, all countries must assume greater responsibility for maintaining the multilateral system. The international community, working through the WTO, should revisit Article V of its charter. If the stated disciplines cannot be enforced in the near term for collective political reasons, then increasing transparency and information should become a priority. At present, the WTO collects little if any information updating specific provisions, their implementation, and the trade consequences. It even fails to take advantage of extant public monitoring efforts in specific regions, which could inform their data collection effort. Collecting and publishing specific information on RTAs would allow members that find themselves excluded to challenge these agreements in the court of public opinion. Even the more modest goal of transparency will require building a new consensus and providing the staff of the WTO with more resources than they have currently available.

Nonetheless, WTO members should consider enhancing the existing rules to ensure that regional agreements have positive development and systemic outcomes. This could include (based on a modest tightening of current practice) setting quantitative indicators that define "substantially all trade." It could include efforts to simplify and harmonize the rules of origin that are applied to both developed and developing countries. These items are on the Doha Agenda and may be ready for action.

Organization of This Study

As is customary, chapter 1 of this study presents the World Bank's view of the global economy. The short-term section analyzes the main forces shaping the global outlook and the implications for developing countries; the long-term analysis focuses on structural changes in the global economy that will affect poverty rates and the prospects for attaining the Millennium Development Goals. A novel feature of this year's report is the introduction of a companion online feature (see www.worldbank.org/prospects), where the reader can find additional information on regional trends and commodity prices, and tools to design scenarios to his or her own specifications.

Chapter 2 introduces the issues associated with regional trade agreements and provides an overview of regional trading trends. Subsequent chapters focus on the content and consequences of regional agreements for trade creation (chapter 3), trade facilitation (chapter 4), and services, investment, intellectual property rights, and labor mobility (chapter 5). Chapter 6 returns to the issue of making regional agreements more compatible with a nondiscriminatory multilateral system.

Notes

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

2. See Devlin and Estevadeordal (2004) and Schiff and Winters (2003), among others.

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

4. See Schiff and Winters (2003).

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Abbreviations

ACP	African Caribbean and Pacific states
ACPEU	African Caribbean and Pacific states European Union
AFTA	ASEAN Free Trade Area
AGOA	African Growth and Opportunity Act
ANZCERTA	Australia-New Zealand Closer Economic Relations Trade Agreement
APEC	Asia Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BITS	Bilateral investment treaties
CAFTA	Central America Free Trade Agreement
CARICOM	Caribbean Community
CEC	Commission for Environmental Cooperation
CEMAC	Economic and Monetary Community of Central Africa
CEPR	Center for Economic and Policy Research
CGE	Computable general equilibrium
CIS	Commonwealth of Independent States
COMESA	Common Market for Eastern and Southern Africa
CRTA	Committee on Regional Trade Agreement
EAC	East African Community
EBA	Everything but arms
EC	European Community
ECO	Economic Cooperation Organization
ECOWAS	Economic Community of West African States
EEC	European Economic Community
EFTA	European Free Trade Association
EPAs	Economic Partnership Agreements
EU	European Union
FDI	Foreign direct investment