

Promoting Regional Trade Agreements May Undermine the Progress in Multilateral Trade System

Baima Caicuo

Australian National University, Canberra, Australia

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Abstract: Establishment of the World Trade Organization has helped in promoting trade and investment around the world. However, increasing number of regional trade agreements may affect the progress in world trading system and generate trade barriers between countries. Promoting multilateral trading system is the best long-term strategy for both developed and developing countries to develop their trade and investment.

1. Introduction

The theory of liberalising trade for promoting the economic growth of nations can be traced back to the eighteenth century when Adam Smith noted that free trade may help in creating and accumulating the wealth of nations. In 1947, there were 23 countries signed the General Agreement on Tariff and Trade (GATT) for reducing tariffs and promoting global trade. This had helped in promoting the global integration and economic development of nations. GATT was replaced by the World Trade Organisation (WTO) at the end of twenty century for providing a better platform for liberalising trade, settling trade related disputes and resolving trade related problems between member countries. The establishment of the WTO has helped in reducing trade barriers by the reduction of tariff rates on thousands of items and the number of WTO member countries has increased to 159 by the year 2013. However, the proliferation of regional trade agreements (RTAs) tends to undermine the progress in global trading system, and the deadlock of Doha Round has further slowed down the progress in multilateral trade system. This essay will argue that RTAs would undermine the progress in WTO toward removing barriers to trade and investment, and the essay will also give some recommendations on how to promote multilateral trading system instead of promoting the development of regionalism.

2. Background

2.1 The Characteristics and Nature of RTAs

European Economic Community (EEC), the most well known RTA, was established in 1957, and RTA has become the recognisable feature of world multilateral trading system with the decades of the development of regionalism. There are three identifiable waves of regionalism. The first wave started with the establishment of EEC in the late 1950s and the second wave of regionalism started around the mid 1980s and this wave lasted till the 1990s. The second wave of regionalism was called new regionalism and generated various US FTAs with different countries. A full customs union among the countries in the Latin America was also established during the period of new regionalism, and some RTAs were also established among African countries as well as in some Asian countries. The third wave of regionalism appeared underway with many Asian countries moving from multilateralism toward regionalism in the last decade (Matthews 2003). It is noticed that the share of RTAs in world merchandise trade has sharply risen from 28% in 1990 to 50% by 2008 and the share of RTA is expected to continually increase with the trend of the proliferation of RTAs (WTO 2011).

The nature of RTAs is discriminatory toward non-member countries. The RTA is an exemption to the most favourite nation (MFN) principle of WTO, and initially WTO believed that RTAs may help

in strengthening trade integration among countries of WTO members and in turn help in promoting the multilateral trading system. WTO allows countries within a RTA to use preferential tariffs and provide special conditions for removing barriers to market access (Pal 2003). These special treatments are merely applicable among member countries within a RTA instead of all WTO members. Hence, the nature of RTAs is trade discriminatory to non-signatory countries of RTAs, which denies the MFN police of WTO.

Based on the data from WTO (2013), 575 RTAs had been notified to WTO till 31 July 2013, and 379 of these agreements were in force. The majority form of RTAs is free trade agreements (FTAs) which accounted for at least 90% of RTAs and the customs union is merely accounts for no more than 10% of RTAs by 2012. FTA allows free trade between two parties, at the same time, each of them has their own policy in trading with a third country. Customs Union allows free trade among members and they also have same trade policy toward a third country. RTAs include bilateral trade agreements, plurilateral agreement and plurilateral/plurilateral/country agreement. By the year 2010, at least 60% RTAs were bilateral trade agreements, which include two countries, no more than 20% of RTAs were plurilateral agreements, negotiated among several countries, and about 20% of RTAs were plurilateral/plurilateral/country agreements, negotiated between one or several RTAs which have been established (WTO, 2011). In addition, according to WTO (2011), up to 2011, 146 intra regional trade agreements were in force, 270 cross RTAs were in force at the same year, 26 trade agreements were in force between developed

and developed countries, 139 trade agreements were in force between developed and developing countries, and 288 trade agreements were in force between developing and developing country.

2.2 The Relationship between Wto and Rtas

Three rules were provided by WTO for dealing with RTAs. I will respectively discuss each of the rules of dealing with RTAs. One is the Article 24 of GATT, and the fundamental principle of this Article is the elimination of trade related barriers among countries within FTA and CU for promoting the process of the integration of economy and the parties of FTA or CU are required to substantially reduce the trade barriers or duties on all sectors between themselves (Leal-Arcas 2011). At the same time, the establishment of customs union (CU) or free trade areas (FTAs) should not increase the restriction or raise barriers on trade to the outsiders. Article 5 of GATs is dealing with the agreements on the economic integration of trade in services. The Article requires that agreements should cover substantial sectors in terms of the trade volume, sector numbers and supply modes of the trade (Leal-Arcas 2011). The Article 5 also states that the RTAs of liberalising trade in services should not create new barriers in the regional economic zone. In addition, enabling clause is also a specific rule under the framework of WTO for dealing with RTAs. The Enabling Clauses is one of the significant achievements of the Tokyo Round, and which enables developed countries to provide more favourable treatment to developing and least developed countries and the clauses also requires substantially reducing trade barriers of all sectors among the countries within RTAs, and without raising trade barriers on the third countries.

Above analysis shows that all three rules for dealing with RTAs provide an exception of MFNs to RTAs under strict criteria which RTAs should meet. RTAs are qualified to be set up by meeting two specific criteria. RTAs should help in removing trade barriers among member countries for promoting the trade flow within a RTA, which is one of the two criteria for the qualified RTAs. Another criterion for the qualified RTAs is the establishment of RTAs should not set new barriers on trade with the outsiders. RTAs allowed to be set up under the framework of multilateral trading system by meeting these two specific criteria for promoting the trade integration among countries across the world. Hence, according to WTO rules, *ideally* the establishment of RTAs should complement the multilateral trading system instead of threatening it.

3. The Impact of Rtas on Multilateral Trading System

Although RTAs initially were established as complementary agreements for helping in promoting the world multilateral trade liberalisation, empirical analysis indicates that RTAs may undermine the

progress in multilateral trading system toward eliminating trade and investment barriers because of the following reasons.

3.1 Preferential Rules of Origin

Discriminatory nature of RTAs may create conflict between non-discriminatory principle of WTO and RTAs, and result in trade diversion by setting complex rules of origin (RoO). Discriminatory nature of RTAs is in conflict with the non-discriminatory fundamental principle of WTO for widespread removing trade and investment barriers. Limao (2006) noted that non discrimination is one of the main pillars of WTO and embodied in Article I of GATT which was initiated in 1947. Lee (2011 p.633), among others, noted that preferential trade agreement of RTAs may greatly affect the third countries by offering special treatment to participants of RTAs and often focus on seeking interest of countries within RTAs (Lee 2011).

Complex RoO in RTAs may result in trade diversion and hinder the smooth flow of international trade and investment. Study shows that the design of RoO by WTO was for the authentication and statistical purpose (Lazaro & Medalla 2006, p. 2). However, RoO has become an instrument which is widely used by RTAs in a preferential manner to implement discriminatory policies on trade against the third countries. Generally speaking, the preferential RoO as a preferential policy is often more strict than general rules of origin. The preferential rules of origin are multifarious and different between RTAs. There are as many as 16 different standards of preferential rules of origin in the European Union, while the United States also has six (Chen 2007). It is noticed that Europe Union has used very strict RoO on some strategic industries for the purpose of preventing the competition with non-member suppliers (Lazaro & Medalla 2006, p. 6). At the same time, American RoO regimes are also complex and currently are even more complicated than in the EU. North American Free Trade Agreement has a 150 pages' blue print about the RoO (Lazaro & Medalla 2006, p. 7). These complex rules of origin may adversely affect the flow of international trade and investment. If every RTA has its own rules of

origin, this means each product exported to different RTAs will need to adapt to a different RoO. Hence, it is evident that complex RoO may greatly hinder the flow of international trade and investment.

In general, if a country implements same tariff rate to all trade partners, the most efficient supplier who provides the products at lowest price will be chose by buyers in a host country (Lazaro & Medalla 2006). However, the establishment of RTAs which apply discriminatory RoO often result in trade diversion. Trade creation means that the establishment of RTAs helps in generating new trade for the members in a RTA. Conversely, trade diversion means that the establishment of RTAs results in the switch of trade from a trade partner in outside of a RTA to a trade partner which is a member of the RTA (Lazaro & Medalla 2006). Ample evidence shows that complex RoO in RTAs often result in trade diversion instead of trade creation. Research shows that complex requirements of RoO often affect the decisions of transnational corporations (TNCs) on choosing where they buy their intermediate goods and TNCs often switch the source of their intermediate goods from an efficient supplier from a non-party of a RTA to another less efficient supplier which is from a member country of the RTA (WTO 2011,p.108).

3.2 Overlapping Rtas

Overlapping RTAs may undermine transparency of trading rules which is one of the core principles of WTO and this affect the free flow of international trade. According to WTO (2003, p.65), overlapping trade agreements in a single country may result in the difference of trade rules applying to different trading partners, which may undermine the transparency of trading system and hamper the integrity of multilateral trading system. Study shows that parallel existence in a single country of varying trade rules applying to different trading partners may represent a barrier to trade (Chen 2009). For example, there are a wide range of economic elements in the RTA between Singapore and Japan including financial services, capital flows, and the development of human resources. At the same time, RTA between Singapore and US covers the provision of environment and labour standards. These RTAs with various safeguards may lead to the mutually inconsistence of provisions and there is a risk

of increasing transaction cost of international trade by these overlapping RTAs.

A large part of literature has shown that overlapping membership of RTAs often results in the 'spaghetti bowl effect' which often undermines the regional integration and increases uncertainty in trade and investment instead of removing barriers on trade and investment. Afifi (2007, p.11) argued that parallel existence of trade agreements in a country may increase the risk of undermining transparency of trading rules, and especially in poor countries which lack administrative professional. Investors from foreign countries initially may be interested in countries with multi-membership of RTAs. However, the various regulations on trade which required by various RTAs may seriously affect the decisions of foreign investors on investing in a country, especially when the RTAs of a country include so many non-tariff barriers (NTBs) since NTBs often involve trade discrimination among goods from foreign countries, as well as trade discrimination between domestic goods and foreign goods (Ghoneim 2003). These complex regulations may hinder the transparency of trade which is a fundamental principle of WTO and its key element for promoting the free flow of international trade and investment. Affit (2007) also goes on to argue that overlapped RTAs may undermine the accountability of government agencies in dealing with trade affairs, especially in developing countries which lack capacity in dealing with complex regional institutions due to their difficulty in recruiting and managing officials for various institutions. Hence, overlapped RTAs in many countries, particularly in developing countries, may undermine the transparency of trade and negatively affect the commitment as well as the pace of government agencies in dealing with trade matters, due to their limitation in administrative human resource and know-how.

The lack of transparency and accountability of domestic institutions may further enhance the influence of political interest groups on domestic trade matters (Affit 2007, p.17). This would negatively affect the initial purpose of RTAs for removing trade barriers and the mass of overlapped rules could generate long lasting negative impact on liberalisation of trade and deter the foreign investors, and in turn negatively affect international trade liberalisation.

3.3 The Rise of Regionalism

The proliferation of RTAs may further promote the regionalism which would lead to the erosion of multilateralism since increasing number of RTAs may divert the negotiation resources for promoting the progress in negotiation of WTO for achieving the outcome of eliminating trade and investment barriers across the world. The widespread establishment of RTAs in both developed and developing countries may increase the risk of erosion of multilateral trading system by members of WTO, and place more stress on bilateral or plurilateral trade. Lee (2011 p.630) argued that the risk of exception of MFN principle may become a rule since over ninety percent of members in WTO have joined one or more RTAs and the number of RTAs has been dramatically increased since the 1990s. It is not free of condition for establishing trade agreements, which often involve the participation of many government officials in trade related offices to handle numerous issues in RTAs. For example, the issue of how to interact a RTA with WTO as well as other RTAs, and dealing with dispute settlement and collection of related record of the issues which rise in the process of negotiation of RTAs (Picker 2005, pp. 94-95). Thus, the establishment of RTAs in a country often increase the workload of trade relevant officials and government have to budget more on dealing with the complex issues in RTAs. In addition, dealing with several RTAs by a single country is time-consuming since RTAs include many issues with different countries which vary in terms of provisions of agreement, culture and histories of different countries (Picker 2005, pp. 97). These may divert the resources which could be devoted to the progress of multilateral trading system toward widely removing trade and investment barriers to preferential trading arrangement.

3.4 Interest Groups & Rtas

The partial trade liberalisation of RTAs may seriously affect the internal dynamics of pursuing widespread of trade liberalisation. RTAs may be hijacked by powerful interest groups which may obtain substantial interests in promoting partial liberalisation which often provide special protection for 'sensitive sectors', and the domestic producers in other sectors may also be partly satisfied by the partial trade liberalisation of RTAs (Gupta 2008). RTAs had not helped in reducing the trade barriers

in trade difficult sectors which still remain as sensitive sectors in RTAs (WTO, 2011). In general, countries often do not place stress on comprehensively eliminating trade barriers, even within customs union which often with deeper integration by applying a common tariff rate to the outsiders. The establishment of RTAs provides more opportunities for domestic interest groups, or more specifically the domestic producers of 'sensitive products' which often are agricultural or textile products, to influence the establishment and operation of RTAs by lobbying the government officials (Gupta 2008, p.263). Damuri (2009) also noted that negotiation on trade related issues in RTAs is often constrained by the political-economy interests, since governments often receive considerable contribution from some powerful interest groups which intend to influence policy formulation on trade. The powerful groups, or the industries, often provide political contributions to domestic governments due to their interests in protecting the sensitive sector by asking for favourable trade policies for the sectors (Damuri 2012). This may bring the vicious cycle of promoting partial liberalisation and preventing progress in widespread trade liberalisation which is the goal of WTO.

4. Conclusion & Recommendations

With the deadlock of Doha Round, RTAs appear to play more significant role in global trade and almost all WTO member countries have joined one or several RTAs. It is debatable whether RTAs may help in promoting the progress of WTO in terms of eliminating trade and investment barriers. This essay has argued that RTAs may undermine the progress in WTO toward removing barriers of trade and investment by leading to trade diversion, undermining the transparency of trade, diverting resources which could be used to promote the multilateral trade, and offering favourable trade policies to powerful interests group, affecting the free flow of trade. Thus, it is recommended that RoO can be more precise but simple, transparent and predictable for preventing from serious trade diversion. And both developed and developing countries should place stress on promoting the RoO to be consistent across the products and agreements for substantially removing trade and investment barriers (Lazaro & Medalla 2006). In addition, it is widely acknowledged that RTAs is just second best solution for promoting international trade. Hence, it is necessary for all WTO members, especially for those powerful developed or developing countries, to make an effort to push forward the development of multilateral trading system which benefits all countries around the world rather than push forward to the development of discriminatory trade liberalisation.

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