



## STRENGTHENING THE GLOBAL TRADE SYSTEM



### **Regional Trade Agreements: Development Challenges and Policy Options**

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December 2013

E15 Expert Group on  
Regional Trade Agreements and Plurilateral Approaches

**Overview Paper**

Co-convened with



Inter-American Development Bank

# ACKNOWLEDGMENTS

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## Published by

International Centre for Trade and Sustainable Development (ICTSD)  
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Tel: +41 22 917 8492 – E-mail: [ictsd@ictsd.ch](mailto:ictsd@ictsd.ch) – Website: [www.ictsd.org](http://www.ictsd.org)  
Publisher and Chief Executive: Ricardo Meléndez-Ortiz

World Economic Forum  
91-93 route de la Capite, 1223 Cologny/Geneva, Switzerland  
Tel: +41 22 869 1212 – E-mail: [contact@weforum.org](mailto:contact@weforum.org) – Website: [www.weforum.org](http://www.weforum.org)  
Co-Publisher and Managing Director: Richard Samans

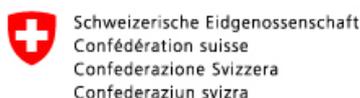
## Acknowledgments

This paper has been produced under the E15 Initiative (E15). Implemented jointly by the International Centre for Trade and Sustainable Development (ICTSD) and the World Economic Forum, the E15 convenes world-class experts and institutions to generate strategic analysis and recommendations for government, business and civil society geared towards strengthening the global trade system.

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**Citation:** Estevadeordal, Antoni, Kati Suominen, and Christian Volpe. *Regional Trade Agreements: Development Challenges and Policy Options*. E15 Initiative. Geneva: International Centre for Trade and Sustainable Development (ICTSD) and World Economic Forum, 2013. [www.e15initiative.org/](http://www.e15initiative.org/)

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ISSN 2313-3805

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# ABSTRACT

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Regional trade agreements (RTAs) have proliferated around the globe in the past decades. There has been an intense debate about their implications for the world trading system. By now, the evidence seems to point out that most RTAs have been trade-creating. The question is more about whether and how RTAs can be additive to the global trading system. In this sense, RTAs have emerged as incubators of new trade and trade-related rules. In some of these areas, RTAs are unquestionably more advanced and sophisticated than the multilateral system. RTAs have also been found to impart benefits that go well beyond traditional analyses on static gains from trade. The challenge ahead is how the WTO system and RTAs can be most synergistic and help deepen and improve each other. Various measures can be pursued. As a multilateral organization, the WTO is uniquely placed to provide dedicated "RTA Exchange" where all matters related to RTAs could be discussed among all WTO members. This exchange would enhance RTAs' transparency and facilitate multilateralization of RTA disciplines and best practices. The RTA Exchange could be complemented by a dedicated forum for discussing complementary policies to RTAs to facilitate trade, such as physical infrastructure improvements. Multilateralization would further be enabled by reforms in WTO's negotiation.

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# LIST OF ABBREVIATIONS

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ADB	Asian Development Bank
ASCM	Agreement on Subsidies and Countervailing Measures
ASEAN	Association of Southeast Asian Nations
BITs	bilateral investment treaties
CACM	Central American Common Market
CAFTA-DR	Dominican Republic-Central America-United States Free Trade Agreement
CAN	Comunidad Andina
CRTA	Committee on Regional Trade Agreements
EFTA	European Free Trade Association
EU	European Union
FDI	foreign direct investment
FTA	free trade agreement
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GSP	Generalized System of Preferences
IDB	Inter-American Development Bank
IIRSA	Initiative for the Integration of Regional Infrastructure
ITA	Information Technology Agreement
LAIA	Latin American Integration Association
MERCOSUR	Southern Common Market
MFN	most favored nation
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Co-operation and Development
OP	outward processing
PTAs	preferential trade agreements
RoO	rules of origin
RTAs	regional trade agreements
SPARTECA	South Pacific Regional Trade and Economic Co-operation Agreement
TRIPS	Trade-Related Aspects of Intellectual Property Rights
TRIMs	Agreement on Trade-Related Investment Measures
TRQs	tariff rate quotas
TPP	Trans-Pacific Partnership
US	United States
WTO	World Trade Organization

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# EXECUTIVE SUMMARY

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Regional trade agreements (RTAs) have proliferated around the world in the past two decades alongside and independent from the General Agreement on Tariffs and Trade (GATT)/World Trade Organization (WTO) system. By now, two parallel systems, multilateral and regional, are in place.

The rich debate over the past several years about the implications of RTAs to the world trading system has mostly centered on the discriminatory effects toward outsiders. The conventional analysis has reflected concerns that RTAs could be trade-diverting and antithetical to the multilateral trading system. There have been various inquiries and efforts by the GATT/WTO system to somehow regulate the depth and speed of tariff liberalization in RTAs, as well as the implications of these agreements for third parties. Such concerns have grown as each WTO Member has found itself an outsider to further agreements. However, multilateral efforts to regulate RTAs have also been toothless, not least because all WTO Members are jealous of their own RTAs.

The debate about RTAs' trade effects is by now mostly moot--most RTAs are largely found to be trade-creating. Besides, RTAs have also helped keep the liberalizing momentum going in the world trading system when multilateral talks have frozen and some protectionist practices emerged during the 2008-09 global financial crisis. Moreover, uni- and multilateral trade liberalization, the proliferation of RTAs, and the creation of trading areas such as the Trans-Pacific Partnership (TPP) Agreement, which encompass parties with multiple RTAs with each other, have tended to reduce the preferential edge that any one RTA confers. This also means that the "spaghetti bowl" problem, where firms will have to comply with different RTA provisions in each bilateral relationship, may be attenuating. Besides, further efforts to regulate RTAs top-down are unlikely to be effective, as WTO Members are jealous of their RTAs.

RTAs are largely found to be good cholesterol for global commerce. The question today is less about whether they undermine the global trading system than about whether and how they can be add to it. RTAs have emerged as incubators of new trade and trade-related rules in such areas as services trade, investment regulations, customs procedures and trade facilitation, environment, intellectual property rights, and e-commerce. In some of these areas, RTAs are unquestionably more advanced and sophisticated than the multilateral trading system. This is most often because of the ease of negotiating agreements among a smaller and more like-minded group of nations than at the multilateral level. RTAs have also been found to impart benefits that go well beyond traditional analyses on gains from trade, such as propelling export-oriented, efficiency-seeking investment flows among members, encouraging cooperation among them on customs and infrastructure integration, and helping relax the political economy constraints to multilateral trade talks in their member nations.

The WTO should not shun RTAs, but use them to inform multilateral trade negotiations and aid multilateral trade liberalization where possible. Similarly, RTA negotiators should ensure RTAs adhere to the WTO's most favored nation (MFN) principle. The question is how the WTO system and RTAs can be most synergistic and help deepen and improve each other. Some of the key issues, besides ensuring that RTAs are non-discriminatory, include enhancing their transparency; reducing undue transactions costs for nations dealing on multiple RTA fronts at once; and enabling useful RTA disciplines and regulations to scale globally.

Various measures can be pursued. As a multilateral organization, the WTO is uniquely placed to provide dedicated "RTA Exchange" where all matters related to regional trade pacts, their rules, and their practices could be discussed among all WTO Members. The Exchange would enhance RTAs' transparency and facilitate multilateralization of RTA disciplines and best practices. The RTA Exchange could be complemented by a dedicated forum for discussing, with a broad set of stakeholders, complementary policies to RTAs to facilitate regional and global trade, such as infrastructure improvements. Such an effort would go beyond the rather narrow discussions on ways to converge RTA rules to reduce the transactions costs of RTA members. Multilateralization would further be enabled by reforms in WTO's negotiation modalities--a shift from unanimity and single undertaking rules to plurilateral agreements among coalitions of the willing.

# INTRODUCTION

As multilateral trade talks have stagnated, regional trade agreements (RTAs) have moved to the forefront (including free trade agreements [FTAs], customs unions, and common markets). Overall, more than 200 RTAs have been notified to the World Trade Organization (WTO), and the total number of agreements hovers around 300 (Figure 1). In addition, there are numerous agreements that cover only trade in services. Almost all countries are member of at least one RTA, and most countries belong to two or more agreements at once (Figure 2).

The implications of RTAs on the multilateral trading system have been subject to policy debate for decades. The 1948 General Agreement on Tariffs and Trade (GATT) allows member countries to grant each other preferential treatment under FTAs or customs unions as long as certain conditions are met. These conditions are defined mainly in GATT

Article XXIV. The proliferation of RTAs in the past three decades has created a sense of urgency among GATT/WTO Members to assess RTAs' compliance with these provisions and address them in a more rigorous fashion--after all, while each member is party to numerous agreements, each is now also an outsider to an ever-growing number of RTAs. In the Doha Round, WTO members elevated FTAs to a "systemic issue," or one that affects the entire world trading system and requires to be addressed as such. However, efforts to deal with RTAs have been narrowly focused on market access provisions (like Article XXIV). They have over time proven to be rather toothless, as WTO members tend to be jealous of their own RTAs and their prerogative to negotiate RTAs.

The WTO has made good progress in this direction. In December 2006, Members issued a "Transparency Mechanism for Regional Trade Agreements," which requires them to provide an "early announcement" of their involvement in RTA negotiations and promptly notify a newly concluded RTA. This, in turn, puts forth a schedule for the RTA's examination by the WTO Secretariat (WTO 2011). Parties to a new RTA are required to submit certain data to

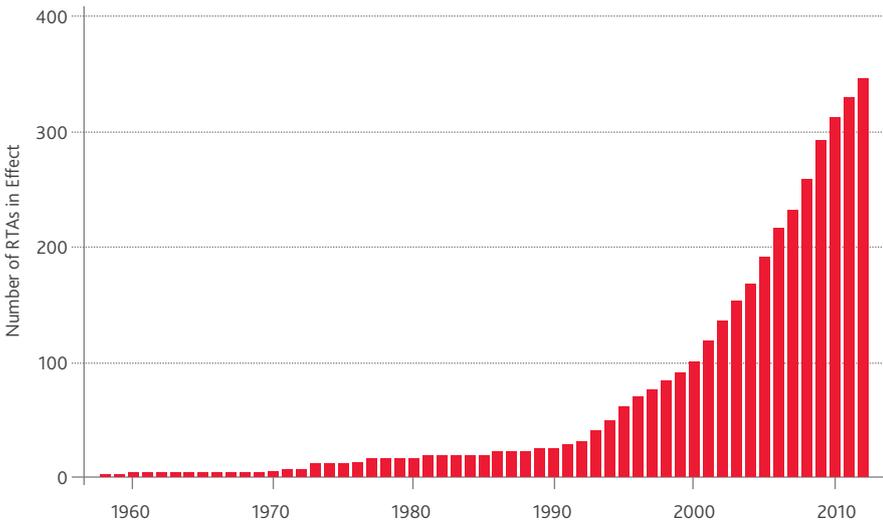


FIGURE 1:

Regional Trade Agreements in Effect Over Time

Source: Authors' calculations based on WTO.

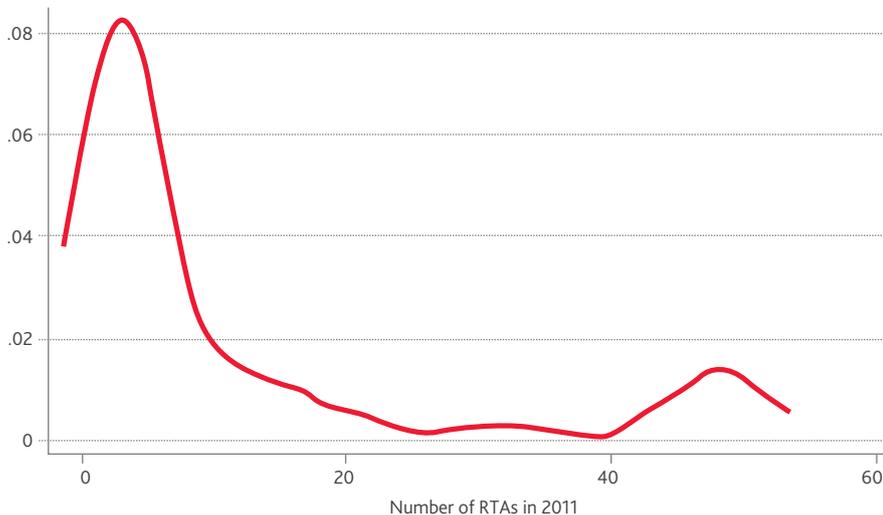


FIGURE 2:

Distribution of Number of RTAs in which Countries Participate in 2011

Source: Authors' calculations based on WTO.

the WTO, such as on the RTA's tariff concessions and rules of origin, and their MFN duties and import statistics. After this, the Committee on Regional Trade Agreements (CRTA) is supposed to prepare a detailed survey of the contents of the RTAs.<sup>1</sup> The CRTA is also to perform legal analyses of WTO provisions pertinent to RTAs; draw comparisons across RTAs; and examine the economic aspects of RTAs. The resources for the WTO to perform such analyses are, however, limited, and there are also political sensitivities that curb the ambition of these studies.

This may not matter. The longstanding concern that RTAs might balkanize the global trading system into exclusive blocs are moot--RTAs have proven to be more trade-creating than trade-diverting. The question today should not be whether RTAs undermine the multilateral trading system, but whether and how they can be additive to the WTO system. RTAs have emerged as incubators of new trade and trade-related rules in such areas as services trade, investment regulations, customs procedures and trade facilitation, environment, intellectual property rights, and e-commerce. RTAs have also been found to impart benefits that go well beyond traditional analyses on gains from trade, such as propelling export-oriented, efficiency-seeking investment flows among the members; encouraging cooperation among the members on customs and infrastructure integration; and helping relax the political economy constraints to multilateral trade talks in member nations.

It is not practical or even desirable to force RTAs into a certain mold. Rather, trade policymakers should focus on whether and how RTAs can be additive to the global trading system, and help deepen and enhance multilateral commitments. The purpose of this paper is to seek answers. One answer revolves around multilateralizing RTA disciplines and best practices. However, it may require changes in the World Trade Organization's (WTO) negotiation modalities for that to occur--a shift from unanimity and single undertaking rules to plurilateral agreements among coalitions of the willing. More generally, as a multilateral organization, the WTO is uniquely placed to act as a dedicated clearing house and forum where all matters related to RTAs and their rules and their practices could be discussed among all WTO Members. Such a forum alone would also help transfer best RTA practices from one RTA to another. It can readily draw on the countless datasets and analyses that have been produced around the world for years in row.

Section 2 reviews the economic and political drivers of trade regionalism, and examines RTAs' compatibility with the GATT and WTO Agreements related to them. Section 3 discusses the various multilateral efforts to deal with RTAs. Section 4 examines RTAs' benefits beyond market access in goods in areas such as services, customs procedures, and investment. Section 5 discusses the evolution of the RTA "ecosystem," while Section 6 puts forth policy proposals for building a new relationship between RTAs and the multilateral trading system.

## REGIONALISM VS. MULTILATERALISM: A FALSE CHOICE?

RTAs have been forged for centuries. The first modern-day RTAs were launched in the late 1950s. But it is since the 1990s that RTAs have spread like wildfire around the world. The wave started with the formation of sub-regional pacts, such as the Southern Common Market (MERCOSUR) forged in 1991 between Argentina, Brazil, Paraguay, and Uruguay; the consolidation of the European Union (EU), including the launch of the single market in 1993; the deepening of the Association of Southeast Asian Nations (ASEAN) throughout the 1990s; and, perhaps most notably, the formation of the North American Free Trade Agreement (NAFTA) between the United States (US), Canada, and Mexico in 1994.

Bloc formation was followed by prolific bilateralism. The EU forged numerous FTAs with Eastern European countries on the verge of becoming its members, while the US negotiated FTAs with Chile and Central America, and Latin American countries signed agreements with each other. The RTA wave subsequently engulfed Asia. The latest RTAs are transcontinental, with such partners as the US and Morocco, Mexico and Japan, and Chile and the EU recently forming bilateral agreements, among numerous others.

After being reticent until the 1990s to form preferential agreements, the US has become one of the most prolific integrators, signing 14 agreements in little over a decade with partners in the Americas, Asia, and the Middle East, and currently pursuing the rather ambitious TPP agreement with several Pacific Rim nations. Other particularly keen integrators include Mexico, Chile, Peru, Singapore, Canada, and the EU.

Integration schemes have mushroomed, and their content has become more complex and encompassing. Most agreements go beyond market access in goods to address trade in services and so-called behind-the-border issues, such as investment, intellectual property rights, competition policy, government procurement, and e-commerce. RTAs come in many flavors, but they also have clustered into distinct "families," particularly around key trading nations such as the US, EU, and Singapore. US agreements and the many agreements tailored after them in the Americas are particularly encompassing, as are the EU's agreements. Some sub-regional pacts have taken collaboration even further to issues ranging from macroeconomic cooperation

1 | See <http://docsonline.wto.org/DDFDocuments/t/WT/L/671.doc>.

to labor mobility and coordination of members' positions in multilateral trade negotiations.

Remarkably, GATT and WTO Members have been forming RTAs all the while, concluding seven multilateral trade rounds, establishing the WTO in 1994, and, since 2001, negotiating the Doha Round agreement. There are countless theories on why practically all the 154 WTO Members pursued regional integration alongside multilateral liberalization processes. Some focus on interest group pressure by exporter, importer, and investor lobbies, others on political leadership, and still others on strategic considerations in the world economy and politics and the dynamics of the multilateral trading system.<sup>2</sup> For example, RTAs can offer their members international bargaining power; insurance against external shocks or trade wars; and cooperation beyond trade in such areas as investment and infrastructures. For several WTO members and prolific trading nations such as Chile, Peru, and Mexico in Latin America, or India and the ASEAN countries, regional and bilateral agreements are now the preferred and most important means to conduct economic exchange with their trading partners. The world's largest traders--the US, China, the EU, and Japan--are on the same path.

## DO RTAS "COMPLY" WITH MULTILATERAL TRADE RULES? THE BUILDING BLOC--STUMBLING BLOC DEBATE

Whether trade regionalism is driven by politics or the expansion of intra-regional economic ties, RTAs are a very prominent part of the world trading system and the global economy, and they cover nearly half of global trade flows. RTAs have essentially proliferated alongside, yet uncoordinated by, the GATT/WTO system. Two parallel systems, global and regional, are now in place.

The conventional policy question surrounding RTAs has been whether they help or hamper the global trading system and MFN treatment. This is an important question both from a legal, formal point of view and from an actual, economic point of view-- incompatibilities between RTAs and the multilateral trading system could be associated with violations of international trade law and could seriously distort global trade flows, production patterns, and economic growth. It is also a big question that has troubled GATT and WTO Members for decades.

From the beginning, the GATT system allowed member countries to grant each other preferential treatment under free trade areas or customs unions, as long as certain conditions were met. These conditions were defined mainly in GATT Article XXIV, but also in the General Agreement on Trade in Services (GATS), other WTO Agreements, and the so-called Enabling Clause, which exempts developing countries from MFN obligation for RTAs they form with each

other. GATT Article XXIV stipulates that Members notify their RTAs to what is now the WTO, and that RTAs liberalize "substantially all trade" among Members "in reasonable length of time" and not introduce new "restrictive rules on commerce."<sup>3</sup> The article also demands open regionalism--that RTA members do not raise barriers to third parties.

Concerns that RTAs are protectionist instruments have, since the early 1980s, prompted three major efforts in the GATT/WTO system to somehow regulate them.<sup>4</sup> However, WTO Members have practically never debated or agreed whether

2 The literature is huge, so only some representative studies are highlighted here. For more exhaustive literature reviews, see, Winters 1996; Baldwin 2008; Bhagwati 2008; Mansfield 1998; World Bank 2000; Schiff and Winters 2003; Esteveordal and Suominen 2009.

3 For the purposes of Article XXVI, a customs union is understood as "the substitution of a single customs territory for two or more customs territories, so that (i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and, (ii) ... substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union." A free trade area is "a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories."

4 As early as 1983, the GATT Director-General created an independent group of seven eminent persons to study and report on the problems facing the international trading system. The Leutwiler Report issued in March 1985 concluded that multilateral "rules permitting customs unions and free-trade areas have been distorted and abused" and that "the exceptions and ambiguities which have thus been permitted have seriously weakened the trade rules, and make it very difficult to resolve dispute to which Article XXIV is relevant."

During the 1986-1994 Uruguay Round, a group of countries that included Australia, India, Japan, New Zealand, and Korea--nations that at the time had not set out to form numerous RTAs but did worry about the discriminatory impact of emerging agreements--called for toughening the language of Article XXIV (WTO 2011). India proposed reviewing the requirement that duties and other restrictive regulations be eliminated on "substantially all trade" between the RTA partners (Croome 1995). Japan called for improving the consultations before and after preferential agreements were reached, and for improved procedures for examination of such agreements, proposing for the establishment of special procedures separate from the GATT dispute settlement system aimed at discussing compensation for damages to outsiders to RTAs (Croome 1995). The Members that opposed Japan's proposal suggested that RTAs be analyzed under the newly-created Trade Policy Review Mechanism, which assesses WTO members compliance with their multilateral trade commitments.

The grievances did result in the Understanding on Interpretation of Article XXIV, which helped clarify "reasonable length of time" as 10 years into an RTA's lifespan and fine-tuned paragraph 5 to call for multilateral assessments of "the general incidence of the duties and other regulations of commerce applicable before and after the formation of a customs union." The Understanding also establishes procedures in cases where non-members to a customs union be compensated if the common external tariff applied by the customs union is above the level of the tariff applied by any of the members prior to its forming. It also posits that concerns related to Article XXIV could be submitted to dispute settlement (Croome 1995). Despite initial opposition by the EU, India, and Yugoslavia, the Understanding was adopted and became part of the Uruguay Round agreements (WTO 2011). A further important outcome of the Uruguay Round was the inclusion of a provision on the regulation of regional and bilateral agreements on trade in services in GATS.

any one RTA breaches multilateral trade rules, let alone the revised Article XXIV--multilateral, top-down regulation of RTAs has not worked. This is hardly surprising. WTO Members are jealous of their agreements, and unlikely to agree to any multilateral rules that would curb their ability to negotiate bi- and plurilateral agreements or force them to modify their existing agreements. Moreover, since all WTO Members with the exception of Mongolia belong to at least one RTA, all Members are reluctant to challenge the RTAs of other Members as discriminatory, let alone take another Member to the dispute settlement body, as the challenger could be next called out. As such, the dispute settlement body has dealt with RTAs on only a handful of occasions.<sup>5</sup>

Yet WTO Members have been concerned about the systemic implications of RTAs. In 1996, the WTO General Council established the CRTA as a means to examine individual RTAs and consider their systemic, cross-cutting implications for the multilateral trading system. Members that were eager to engage in the debate included Australia, Hong Kong China, India, Japan, Korea, New Zealand, and Pakistan, while the EU and the US, both of which were increasingly engaged in negotiating RTAs, were reluctant. The committee remained dormant, not issuing any examinations in 1996-2001.<sup>6</sup>

Have WTO Members complied with Article XXIV? The answer is negative in the sense that numerous RTAs among developing countries are exempted. But it also depends on how exactly the multilateral disciplines governing RTAs are interpreted.<sup>7</sup> WTO Members' interpretations of the Article vary widely (see Estevadeordal and Suominen 2009). For example, "substantially all trade" has at least four interpretations--a quantitative approach geared to a statistical benchmark, such as a percentage of trade between RTA parties, most commonly suggested as 90, 85, and 80 percent; and a qualitative approach stipulating that no sector (or at least no major sector) should be kept from liberalization, with definitions of "sector" varying widely.

Empirically, most agreements do attain some of these most common interpretations of "substantially all trade" and "reasonable length of time"--liberalization of 90 percent of tariff lines and about the same amount of trade by year ten into the agreement (Estevadeordal and Suominen 2009). However, there are also a number of outlier RTA parties (in general developing countries) that are too many, and do not want to single out product categories (particularly sensitive sectors such as agriculture, textile and apparel, and footwear) that have prolonged tariff phase-outs and/or non-tariff barriers.

There also is no clear agreement as to what constitutes "other restrictive regulations of commerce." RTAs carry several rules that can qualify the extent of market access that tariff liberalization provides, such as tariff rate quotas; special safeguards; anti-dumping regulations; non-tariff measures; and rules of origin (RoO). Such disciplines are often put in place due to political reasons--governments may be more willing to engage in deep tariff liberalization in RTAs

when defensive instruments are also available. However, the distortionary impact of these instruments can be significant and accentuate over time, as such rules tend to remain in place even after preferential tariffs have been phased out. For example, by tying final goods producers to using intra-RTA sourcing even if it is inefficient, stringent RoO can at the extreme augment intra-RTA final goods producers' production costs to the point where compliance costs exceed the benefits that RTA tariff preferences confer.<sup>8</sup>

RTA members' compliance with the prohibition against raising barriers to third parties is also disputed. Indeed, economists have long engaged in a contentious debate on whether RTAs are "building blocs" or "stumbling blocs" to multilateral trade liberalization. The building bloc camp argues that RTAs fuel the liberalizing logic of the multilateral system; help advance global trade talks; and serve as laboratories for new trade rules that could eventually be multilateralized. The stumbling bloc camp maintains that RTAs are discriminatory instruments that lead to trade diversion and deviate governments' attention from multilateral trade talks.

While a priori both views find support in the empirical literature, overall available evidence can be considered to favor the building bloc thesis. Limao (2006) and Karacaovali and Limao (2008) analyze the impact of preferential trade liberalization on multilateral trade liberalization at the Uruguay Round in the US and EU, respectively, and find that liberalization was less in products where preferences were granted. More specifically, Limao (2006) concludes that the US cuts in MFN tariffs were small for products imported under preferential trade agreements (PTAs) relative to similar products imported only from non-members. The subsequent study by Karacaovali and Limao (2008) shows that the EU reduced its MFN tariffs on goods not imported under PTAs by

5 | The main one is *Turkey--Textiles*, the WTO Appellate Body held that the burden of establishing that an RTA meets the requirements of Article XXIV falls on the respondent WTO Member if it invokes the RTA to justify a discriminatory measure.

6 | One of the reasons was that WTO Members were reluctant to provide information or agree to conclusions that could later be used or interpreted by the WTO's dispute settlement panel. The process was also stifled by the disagreements over the terminology of Article XXIV, and the lack of specific multilateral language on such provisions as preferential rules of origin. Also views on whether the CRTA or the dispute settlement body should deal with RTAs remain divided. Others hold that the examination of the consistency of RTAs ought to be reserved solely to the CRTA. One notion is that GATT and WTO rules applying to RTAs are of less relevance today in the light of the fact that trade diversion is reduced as a result of multilateral tariff reductions. The empirical evidence on RTAs' positive welfare effects, and that they are different from WTO agreements lie in that they cover more trade-related disciplines (Mavroidis 2010). As such, the Transparency Mechanism should become the de jure new forum to discuss RTAs within the multilateral trading system.

7 | Indeed, the very design of Article XXIV was not immune to politics. It was sponsored in the 1940s by the US, a staunch advocate of multilateralism and non-discrimination, as a means to address customs unions, but it was extended to allow for the formation of FTAs to accommodate the imminent US-Canada FTA that was under secret negotiations but failed to materialize (Chase 2006).

almost twice as much as it did on PTA goods. The implication of such a negative relationship between multilateral and preferential trade liberalization is that these large countries offer preferences on a unilateral basis to extract concessions from the recipients in non-trade areas. So they tend to resist liberalization to prevent erosion of preferences. Limão and Olarreaga (2006) make a similar finding in the case of import subsidies provided to RTA partners by the US, EU, and Japan.

The studies referred to above concentrate on large and developed countries. Related papers considering developing countries include Baldwin and Seghezza (2007), Estevadeordal et al. (2008), and Calvo-Pardo et al. (2009). Baldwin and Seghezza (2007) find that these tariffs are complements, not substitutes, since margins of preferences tend to be low or zero for products where nations apply high MFN tariffs. They argue that the positive correlation between MFN and preferential tariffs might be caused by sectoral vested interests that (co-) determine both types of tariffs. Estevadeordal et al. (2008) conclude that regional trade liberalization has had a complementary effect on general trade liberalization in Latin America, particularly in countries that are not members of customs unions.<sup>9</sup> On the same lines, Calvo-Pardo et al. (2009) find that preferential tariff liberalization caused external tariff liberalization in ASEAN countries. Agreements in Latin America and Asia can therefore be seen as forces that operated in favor of broader liberalization.

More generally, the divergence in results for developed and mostly developing countries might be traced back to prevailing preferential tariffs. Thus, preliminary evidence in Ludema et al. (2012) for Latin American countries suggests that when preferential tariffs are above zero, external and internal liberalization are complementary, but they become substitutes after those tariffs reach zero. The rationale would be that in the absence of flexibility in preferential tariffs when they hit zero, only external tariffs remain to accommodate political economy forces.

## WTO VS. RTAS AS TRADE-CREATING INSTITUTIONAL ARRANGEMENTS

Even if they are not free from political economy constraints, RTAs can, on the whole, be considered good cholesterol for world trade (though most studies have glazed over the complexity of RTAs, operationalizing them as a dummy variable). Frankel et al. (1997) analyze the EU, MERCOSUR, the ASEAN, and East Asia, concluding that regionalism has over the past decades been trade-creating. Soloaga and Winters (1999) find that except for Latin America, RTAs of the 1990s did not boost intra-bloc trade significantly, and also that there was trade diversion only in the EU and the European Free Trade Association (EFTA). However, Adams et al. (2003) estimate that 12 of 16 trade agreements, including the EU, ASEAN, and NAFTA, have diverted more

trade than they have created among members. The World Bank (2004) unsurprisingly finds that RTAs whose members have high external barriers, especially RTAs in Africa, are trade-diverting, while RTAs where members have reduced external barriers are trade-creating. Based on the experience of seven RTAs (EU, CAN [Comunidad Andina, or Andean Community] NAFTA, CACM [Central American Common Market], MERCOSUR, ASEAN, and LAIA [Latin American Integration Association]), Carrere (2006) concludes that these agreements have generated a significant increase in trade between members, often at the expense of the rest of the world. DeRosa (2007) shows that some of the world's major RTAs, such as the EU, NAFTA, ASEAN, MERCOSUR and EFTA, are trade-creating—even though there is trade diversion in agriculture, an unsurprising finding given the pervasive barriers in the sector around the world. Using different empirical approaches, Baier and Bergstrand (2007, 2009), Egger and Larch (2011), and Egger et al. (2011) find that trade agreements have increased members' bilateral international trade flows. Egger et al. (2008) show that in the case of developed countries, such trade volume effects are primarily associated with growing intra-industry trade as opposed to inter-industry trade. Suominen (2004) finds that while RTAs are trade-creating, restrictive RoO can cause trade diversion in inputs. Also tariff rate quotas (TRQs) in RTAs can be discriminatory. TRQs in RTAs are usually additional to TRQ entitlements under the WTO Agreement on Agriculture.<sup>10</sup> That the expansion of the quota of one supplying RTA partner can cause some erosion in the quota rents to other quota holders has raised suspicions that TRQs in RTAs are inconsistent with GATT and WTO rules.

The latest findings attest to a distinction between the "closed regionalism" of the import substitution policies in the 1960s and 1970s and the RTA wave of the 1990s and 2000s, which was embedded in a context of multilateral liberalization. However, the conventional notion has remained—that RTAs are second-best to global trade liberalization. In theory, they are—multilateral liberalization and the MFN principle are economists' panaceas. There is evidence of the benefits of multilateral liberalization. For example, Subramanian and Wei (2007) argue that the WTO system has had a massive positive impact, more than doubling world trade from their counterfactual alternative.

<sup>9</sup> Estevadeordal et al. 2009 observe that this pattern does not hold across sectors. More precisely, while in some industries, complementary effects between both kinds of trade liberalization are observed, in others no significant links are detected and—in a few cases—even substitutability seems to prevail. Variation across sectors appears to be systematically related to both import demand elasticities and countries' sectoral comparative advantages. In particular, countries are more likely to cut external tariffs once they have lowered regional tariffs in those sectors with larger import demand elasticities and where they have an overall comparative advantage.

<sup>10</sup> The Appellate Body in the dispute *Turkey—Restrictions on Imports of Textile and Clothing Products* found that a dispensation could be available in cases where it could be shown that the proposed measure is essential to the formation of the RTA, but did not set the criteria by which this condition could be fulfilled in practice.

According to their estimates, additional imports by industrialized countries were USD 8 trillion more than they would have been in the absence of the WTO. This trade-promoting role of the WTO has been, however, uneven across countries and sectors.<sup>11</sup>

At the same time, RTAs have attained far greater depth and breadth than multilateral talks. They have also had impact. Rose (2004a) contends that countries joining or belonging to the GATT/WTO do not significantly trade more with each other than outsiders.<sup>12</sup> In contrast, the Generalized System of Preferences (GSP) and RTAs appear to have played an important role in encouraging trade.<sup>13</sup> Eicher and Henn (2008) explicitly combine the various approaches to trade opening--WTO accession, reduction in tariffs abroad, and RTA formation--finding that once previously omitted variables are stacked alongside the WTO variable, the positive WTO effects vanish altogether. RTAs emerge as stars in their analysis, on an average resulting in trade creation amounting to 123 percent of pre-PTA bilateral commerce (see also Hufbauer and Schott 2008). The positive news from these dueling analysts seems to be that pulling the liberalization lever does generate greater trade flows--the debate is just what policy lever yields the biggest flow.<sup>14</sup>

## BEYOND BUILDING BLOC-- STUMBLING BLOC DEBATE: RTAS AS WTO+

Efforts at the WTO to assess, let alone regulate, RTAs have been rather narrow in focus and had scant impact. Granted, while GATT/WTO may have influenced RTA negotiations, it has never been employed to "tame" or discipline supposedly discriminatory reciprocal trade agreements (Davey 2011; Low 2008). Multilateral measures on RTAs have arguably also become less relevant--although the number of RTAs has skyrocketed, the odds of trade diversion have decreased with unilateral, preferential, and multilateral tariff cuts around the world. The WTO's ineffectiveness in regulating RTAs is also likely more positive than negative--it gives RTA negotiators elbow room to continue creating and experimenting with new trade rules that would be all but impossible to agree on across the WTO membership. Indeed, RTAs have become WTO+ laboratories of trade rules and also often entail deep, mutually beneficial integration for the parties. The following reviews RTA disciplines in investment, services, competition policy, and customs procedures.

## INVESTMENT

International investor protection and investment liberalization issues are regulated by a multilayered set of bilateral, regional, sectoral, plurilateral, and multilateral agreements.<sup>15</sup> The main multilateral instruments governing investment issues include the Agreement on Trade-Related Investment Measures (TRIMs) and the Agreement on Subsidies and Countervailing Measures (ASCM), which limit WTO Members' abilities to apply certain kinds of measures to attract investment or influence the operations of foreign investors. Also the GATS, the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), and the plurilateral Agreement on Government Procurement include provisions pertaining to investments, particularly to the entry and treatment of foreign enterprises and the protection of certain property rights. The Understanding on Rules and Procedures Governing the Settlement of Disputes contains rules for addressing conflicts that arise under these agreements.

TRIMs applies to measures affecting trade in goods. It exhorts the national treatment principles of the GATT, and bars investment measures that lead to quantitative restrictions. TRIMs also requires members to inform each other of any rules that do not conform to it. There are further TRIMs provisions that are viewed as inconsistent with GATT articles, including local content and trade balancing requirements. As compared to the extensive, in-depth coverage of investment rules in bilateral investment treaties and RTAs, TRIMs is much thinner. After a failure at the WTO's Cancun Ministerial in September 2003, the General Council in July 2004 dropped investment along with two other so-called "Singapore issues"--competition policy and transparency in government procurement. By and large, the innovation in investment rules continues to be accomplished in bilateral investment treaties (BITs) and RTAs.

11 | Industrial countries that participated more actively than developing countries in reciprocal trade negotiations witnessed a large increase in trade. In addition, bilateral trade was greater when both partners undertook liberalization than when only one partner did. Finally, sectors that did not witness liberalization did not see an increase in trade.

12 | Rose 2004b argues that GATT/WTO member do not have more liberal trade policies. Trade liberalization, when it occurred, usually lagged behind the GATT entry by many years, and the GATT/WTO often admitted new members that remained closed for years.

13 | According to Rose 2005, there is little evidence that membership in the GATT/WTO has had a significant dampening effect on trade volatility.

14 | Anderson and van Wincoop 2001 contend that the volume of trade between two countries depends on the height of the bilateral barriers between them relative to the average trade barriers each country faces with all its trading partners. Following this logic, a country can increase its trade volume both by preferential and multilateral liberalization.

15 | Bilateral investment treaties (BITs) have been found to have a significant positive impact on FDI flows (for example, Egger and Merlo 2007).

From any one country's perspective, the multilayered approach to investment rules can help signal credibility to investors. Yet, at the global level, it has forged a highly complex web of agreements. However, there is already a de facto harmonization process in place, as most RTAs feature similar main principles, such as non-discrimination, and also because the many agreements the US and EU have entered into are very similar with each other.

## SERVICES

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The GATS covers all services except those provided in the exercise of governmental authority and, in the air transport sector, air traffic rights and all services directly related to the exercise of traffic rights. The GATS has governed multilateral services rules since the Uruguay Round. It contains a number of general obligations applicable to all services, including an MFN rule and a transparency rule, but in market access each member defines its own obligations through its own schedule.

Services chapters in RTAs usually only cover Modes 1 and 2 (cross-border supply and consumption abroad), and are thus separate from RTA chapters on other forms of trade in services--investment and temporary entry of business persons. The coverage of services in these two sectors has intensified in recent US agreements with Chile, Peru, Colombia, and Panama.

How do RTAs' rules in services interact with the GATS? Roy et al. (2007) assess 28 RTAs, arguing that they have tended to provide important advances when compared to GATS schedules in three ways--RTAs are often very substantive and have helped propel liberalization in sectors that have only thin commitments in the GATS, such as financial services, and in more traditionally contentious areas such as audiovisual or education services. Countries that have used negative-list approaches in RTAs have bound at least the existing level of openness for a large majority of sectors, a measure that arguably instills predictability in a bilateral relationship and is key to attracting investment and spurring cross-border trade. Countries have submitted a high number of sub-sectors to liberalization in the GATS schedules as well as their GATS offers in the Doha Round, which they have freed in RTAs. As such, either the GATS commitments did not reflect their applied regime or, as is more likely, the improved commitments in RTAs induced actual liberalization and new commercial opportunities.

In general, RTAs in the Americas are particularly comprehensive in services and often go well beyond GATS provisions. In particular, NAFTA-inspired agreements feature a much wider schedule of commitments than is made in the GATS (see Houde et al. 2007).<sup>16</sup> The commitments of developing countries are in general shallower than those made by the developed countries. Paradoxically, far-reaching liberalization in RTAs could particularly lower developing countries' incentives to negotiate further at the multilateral

level, particularly if multilateral talks provide for limited reciprocity. Indeed, the way in which developed countries have induced developing countries to open services sectors is by offering, through RTAs, preferential treatment in trade in goods as a *quid pro quo*.<sup>17</sup>

The issue linkage is not as easy to make at the global level. The Doha Round services negotiations have proven less far-reaching and ambitious than many developed countries would have hoped. Industrial countries are looking for developing country commitments to reform "infrastructure services," such as banking, insurance, telecommunications, and air transport, while developing countries expect new opportunities to provide labor-intensive services, such as healthcare, construction, and basic information technology services (Scott 2007).

## COMPETITION POLICY

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The GATT and WTO Agreements do not contain a standalone set of competition policy rules. However, there are a number of multilateral provisions that do address competition policy issues (see Anderson and Evenett 2006). For instance, GATT Articles VIII and IX on monopolies and exclusive suppliers, and anti-competitive practices restricting trade in services, respectively, as well as the Agreements on Safeguards bar signatories from endorsing or encouraging non-governmental measures akin to voluntary export restraints, orderly marketing arrangements, or other governmental arrangements.

TRIPS empowers signatories to act against anti-competitive practices in the licensing of intellectual property rights.<sup>18</sup> Attempts to fashion a more comprehensive multilateral framework of competition policy provisions have thus far been unsuccessful. The WTO Ministerial Conference in Singapore in 1996 created the Working Group on the Interaction between Trade and Competition Policy to study the issue; the Doha Ministerial Declaration of 2001 sharpened the group's focus to clarifying core principles, including transparency, non-discrimination and procedural fairness, provisions on cartels, modalities for voluntary cooperation, and capacity building, to support fostering competition policy

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16 Mexico, Morocco, and Singapore make complete commitments with very few reservations in their agreements with the US in sectors where they have no commitments at the multilateral level. Also the US, Australia and Japan have more commitments in their bilateral agreements than in their GATS schedules.

17 Egger et al. 2012 find that, for developed countries, the responsiveness to the respective preferences is much bigger for trade in services than for trade in goods.

18 In the meantime, the United Nations 1980 Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices, while voluntary and of limited practical relevance, iterates the importance of complementing tariff and non-tariff liberalization with non-restrictive business practices.

institutions in developing countries. However, in July 2004, the WTO General Council dropped competition policy from the negotiation agenda. Some of the reasons cited included a rejection of the proposed negotiation framework by developing countries as excessively intrusive, and a perceived lack of capacity to negotiate this area.

As is the case in investment, the deepest and most comprehensive set of competition policy rules appear to be forged in the context of RTAs (for a review of the specific competition provisions in RTAs, see Brusick et al. 2005). Perhaps encouragingly for future multilateral talks, there are broad similarities between the two most dominant competition policy models in RTAs, those of the EU and US RTAs, respectively (Baldwin et al. 2007). Moreover, RTA provisions on competition policy have tended to have solid non-discrimination clauses that “multilateralize” the RTA obligations to non-members. For instance, a US firm in Turkey has the same rights before Turkish competition authorities as a EU firm because the EU-Turkey agreement gave rise to Turkey’s competition policy framework. In other words, in some instances, RTAs have helped open up an area where prior national rules, if in place, may have been too stringent. It is in countries without explicit competition policy rules where nationality concerns, rather than non-discrimination, may arbitrate access.

## CUSTOMS PROCEDURES

RTAs’ customs procedures and trade facilitation provisions are in general compatible with three main international instruments in these areas.<sup>19</sup> They are the Arusha Declaration and the UN/EDIFACT Initiative that address the use of technology and data processing issues; the World Customs Organization’s (WCO) Revised Kyoto Convention, which addresses such areas as review and appeal, customs clearance, and uses of new technologies; and GATT/WTO trade facilitation provisions, including Article V (Freedom of Transit), Article VIII (Fees and Formalities connected with Importation and Exportation), and Article X (Publication and Administration of Trade Regulations). Indeed, trade facilitation and customs procedure measures in RTAs seem to have paralleled the development of international instruments. For instance, RTAs that entered into force after 2000 tend to include such provisions as the release of goods, automation, risk assessment, or express shipments—issues also included in the 1999 Revised Kyoto Convention.

The Doha Round negotiations on trade facilitation are relatively narrow in scope, aimed at clarifying and improving GATT Articles V, VIII, and X. The negotiations also contemplate technical assistance and capacity building for developing countries to implement future commitments. Some private sector observers think that limiting the scope of trade facilitation within the scope of these articles alone can be dangerous, as it might divert attention away from the manifold challenges surrounding the movement of goods.

RTAs provide an opportunity to mitigate such outcomes in three ways. First, unlike WCO provisions, RTA provisions are binding and enforceable via dispute settlement mechanisms. Second, given that customs procedure and trade facilitation disciplines are relatively similar across RTAs, they can facilitate and accelerate convergence in these disciplines around the world. Third, to the extent that RTAs streamline customs procedures and facilitate trade, they are inherently good for the multilateral trading system—the resulting lowered trade costs boost trade with all trade partners.<sup>20</sup>

## BEYOND STATIC GAINS FROM TRADE: DYNAMIC BENEFITS FROM THE EXPANDING SCOPE OF RTAS

Some newer RTAs are going much beyond these provisions that are more standard in RTAs. The foremost example is the TPP. The draft agreement includes various groundbreaking commitments that go much above and beyond tariff opening, such as renunciation of current manipulation and mercantilist practices; intellectual property rights protection; deep liberalized trade in services; removal of barriers to foreign direct investment/ownership; elimination of a host of other non-tariff barriers such as manipulation of standards; transparency and openness in government procurement practices; and restrictions on preferential treatment toward state-owned enterprises.

Such growing scope of RTAs means that judging them by their static trade gains is outdated. RTAs are recognized to impart significant dynamic and non-traditional gains.<sup>21</sup>

**Credibility:** As the Washington Consensus was taking hold in the 1990s, reformist interests in emerging nations pursued RTAs with major developed countries to signal their resolve not to renege on economic reforms to international investors. For example, Mexico joining the US and Canada in a legally binding, complex agreement with commitment from competition policy law to investment rules reduced its policymakers’ room for maneuver and ability to backtrack from legislative and regulatory changes related to the agreement.

19 Time associated with customs procedures can be an important barrier to trade (for example, Djankov et al. 2010; and Volpe and Graziano 2012).

20 For a review of the specific trade facilitation provisions in RTAs see, for example, UNCTAD 2011.

21 Trade policy in general and RTAs in particular can also affect countries’ specialization patterns and the spatial distribution of economic activities. Combes and Overman 2004 and Brühlhart provide useful reviews of the relevant empirical literature. For evidence on Latin American see, Hanson 1998; Sanguinetti and Volpe Martincus 2009; Volpe Martincus 2010; Sanguinetti et al. 2010.

**Dynamic effects on trade:** RTAs can also have dynamic effects on member countries' trade.<sup>22</sup> Estevadeordal et al. (2012) show that RTAs in Latin America appear to have served as an export platform. More precisely, by reducing tariffs and thereby allowing for increased intra-regional exports, these agreements seem to have fostered exports of differentiated products to Organization for Economic Co-operation and Development (OECD) markets.<sup>23</sup>

**Effects on investment:** RTAs that are particularly comprehensive help propel trade in goods and services as well as investment flows. Thus, Levy Yeyati et al. (2003) find that, on an average, regional integration contributes to attract foreign direct investment (FDI), although this is likely to be unevenly distributed across member countries. Baltagi et al. (2008) report significant positive effects of Europe agreements between Western and Central and Eastern European countries on bilateral FDI. Developing nations forge RTAs mostly to attract investment, which in turn can be channeled into building export platforms—not unlike the outcome of the NAFTA on Mexico's northern border.

**Shaping participation in global value chains:** RTAs can specifically affect countries' involvement in global value chains. For instance, Blyde and Volpe Martincus (2012) show that these agreements have had a significant positive effect on the number of foreign affiliates located in partners' territories.

**Synergies among provisions:** RTAs that yield synergies among their various provisions can accentuate positive effects. For example, simultaneous liberalization of tariffs, services, and investment can spur trade well beyond what a simple tariff lowering could. For example, Egger et al. (2012) find that the joint inception of goods and services preferences is associated with a welfare gain that is larger than the sum of those derived from an independent inception of goods and services preferences alone.

**Synergies among multiple policy interventions:** Improvements in infrastructure—regional road networks; energy transmission lines; transparent customs operations; fluid cross-border communications; services trade integration; and deep capital markets and financial integration—are key to tariff liberalization rendering the expected benefits. Thus, in 2000, 12 South American countries launched the Initiative for the Integration of Regional Infrastructure (IIRSA), which has developed 524 infrastructure projects across the region—covering transportation, energy, and communications. Beyond building physical infrastructure, the IIRSA also supports the harmonization of regulation across the region and improvements in cross-border traffic. Similarly, the Meso-American Integration and Development Project, which stretches from Mexico to Colombia, includes regional infrastructure and trade facilitation reforms. The importance of such initiatives that reduce non-tariff trade costs in general and transport costs in particular has been underscored in several studies (for example, Mesquita Moreira et al., 2008). More specifically, simultaneously acting on both the

software (policy and regulation) and the hardware (physical integration) of integration help regions make more of it—such coordinated interventions facilitate trade, drive down the costs of business, and ensure a more equitable distribution of the gains from trade, thereby increasing stability.<sup>24</sup>

**Learning by negotiating and implementing:** RTAs can also serve as training grounds for countries to negotiate and implement multilateral trade rules. For example, many Mexican officials became world-class trade negotiators after their “apprenticeship” with the US team in NAFTA talks in the early 1990s.

**Bargaining power:** RTAs can also help aggregate governments' preferences at regional levels, reducing collective action problems at the multilateral level, and leverage their bargaining power. Caribbean Community members have banded together to collectively negotiate at the WTO.

**Cross-border cooperation:** Trade agreements can serve as a focal point with real economic incentives to pursue further cross-border integration—increasingly important as regional and global cross-border externalities, such as migration, financial shocks, and environmental hazards, place an added premium on international coordination and pooling of resources for common policy responses (Devlin and Estevadeordal 2002).

22 In particular, RTAs also produce similar dynamic gains as any trade liberalization, such as sifting and sorting. However, studies in general do not take into account the dynamic effects that trade liberalization might induce, such as the sift-and-sort features of Schumpeter's “creative destruction.” The dynamic effects that trade liberalization might induce are difficult to quantify but are probably large. Differences between countries also make a difference—the most protected countries can reap much greater gains from new liberalization than relatively open ones.

23 In related studies, Borchert 2010 finds that exporting a given product to the US had a positive effect on Mexican exports to third countries and that tariffs cuts associated with NAFTA had a direct positive effect on the probability to export to additional markets and a negative impact on the volume shipped, whereas Molina 2010 shows that previous export experience in a given product to an RTA has a positive effect on the probability that the same product is subsequently exported to a non-member country. Also related to this research, there are some recent papers that present theoretical mechanisms that generate systematic spatial patterns in exporting, and empirical evidence on these patterns. For instance, in Albornoz et al. 2012, firms learn about their export profitability only after engaging in exporting. Assuming that profitability is correlated over time and across destinations, their model predicts that firms that have successfully entered some market are more likely to access countries that are similar to it. In Chaney's 2010 model, firms can break into a market only if they have a contact. The probability of a given exporter acquiring such a contact in a new country is assumed to be increasing in the aggregate trade between the potential destination country and other countries that the firm was serving before. Finally, according to Morales et al. 2010, firms are more likely to enter countries that are similar to other destinations to which they have previously exported (extended gravity) because they have already completed part of the costly adaptation process (for example, identification of a distributor, product customization to adapt it to local tastes or to make it fulfill legal requirements imposed by national consumer protection laws, and so on).

24 See the Inter-American Development Bank's (IDB) Sector Strategy to Support Competitive Global and Regional Integration (2011).

**Liberalizing logic of RTA system:** RTAs have an internal liberalizing logic—their spread gives outsiders incentives to form new RTAs or to join existing ones, lest they see their market access erode (Baldwin 2006). This built-in logic of the RTA system will eventually culminate in a system ever closer to global free trade. In addition, RTAs are also an antidote to “free-riding,” the unhealthy flip-side of the MFN principle (Ludeman and Mayda 2009). While MFN wards off discrimination, it also enables slower liberalizers to enjoy the benefits of market opening by others and do less on their own. Countries that choose to free ride on the WTO system are increasingly left out when it comes to writing trade rules and enjoying access to foreign markets.

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## PENDING CHALLENGES AND OPPORTUNITIES: CONVERGENCE, MULTILATERALIZATION, AND OTHER INNOVATIONS

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RTAs address standard market access issues, but also several trade-related issues that are only partially addressed at the WTO, and an array of behind-the-border regulations, most of which have yet to be addressed at the multilateral level. As such, RTAs conceptually pose three distinct potential challenges to the global trading system—discrimination, transactions costs, and inefficiency.

### DISCRIMINATION

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Thus far, much of multilateral discussion has been on the potential discrimination that can result to non-members from RTAs' market access rules. This debate is increasingly found to be moot—most RTAs are found to be trade-creating. The very proliferation of RTAs, or new agreements between current insiders and outsiders, attenuates the discriminatory edge—Mexico's preferences in the US market are at least somewhat diluted by US FTAs with Chile, Colombia, and Peru.

To be sure, this does not mean that assessing and measuring discrimination is misguided—more can be understood about the trade effects of rules in different sensitive sectors and about more opaque rules such as RoO. RTAs' tariff preferences would also become a more prominent issue if the

preferential margins suddenly became higher—if emerging markets and developing nations with substantial “water” between their applied and bound tariffs were to raise their applied tariffs. Moreover, there can be discriminatory effects beyond market access provisions, such as from regulatory harmonization among RTA members that locks them into a certain regime and complicates accessions to further RTAs with different rules (WTO 2011).

The point is that RTAs are about much more than market access, and the discriminatory effects of market access rules should not be the sole or even the primary focus of policy discussions. Besides, if history is a guide, policy recommendations flowing from such exercises are likely to go unaddressed by the WTO membership.

### TRANSACTION COSTS: TOWARD CONVERGENCE?

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The debate on RTAs needs to focus increasingly on transaction costs and coherence. Take transaction costs first. The end game of the current RTA frenzy could be competitive liberalization, whereby all countries have an RTA with each other. Without this, the RTA system remains an internal paradox. RTAs can and are designed to lower the costs of cross-border business, and they can provide for more efficient supply, production, and distribution networks. Yet, the spaghetti bowl of multiple overlapping RTAs can also contain internal frictions that create transactions costs to companies operating across various RTA “theaters” simultaneously. These costs could be above and beyond what they would be if operating under a single set of trade rules.

This is critical in today's world economy. Unlike integrated production activities that were internalized in a company and centered in a few locations, today's production is segmented and spread over an international network of production sites. As a result, a growing share of global trade consists of intermediate goods shipped from one country to another, and many household items from cars to computers contain parts hailing from multiple countries. The explosion of intermediate trade has been particularly striking in Asia, where parts and accessories constitute about a quarter of all trade.

The RTA spaghetti raises transactions costs for companies that operate global supply chains. RoO protocols are a case in point. Studies by the Inter-American Development Bank (IDB) and Asian Development Bank (ADB) indicate that some 60 percent to 80 percent of large companies in diverse countries, such as Peru, Singapore, Thailand, and Mexico, would much prefer a world with a single agreement with a common set of rules of origin, or at least with regional mega-agreements, rather than today's world where they have to comply with multiple and overlapping RTAs (see Estevadeordal et al. 2009). The complexity is also troublesome to customs officials for verifying RoO in countries with multiple agreements, such as Chile, Mexico, Singapore, Thailand, the US, and Vietnam.

Erasing some of the transactions costs through forging larger integration zones can yield major economic gains, particularly for smaller countries. In a study of the Paneuro system, a vast system of cumulation implemented in 1999 across all bilateral FTAs the EU had with various Eastern European nations, cumulation increased trade between Eastern European spokes by between 7 percent and 22 percent, and the increase was between 14 percent and 72 percent for the benefiting sectors (see Augier et al. 2005, 2007). Harris and Suominen (2008) take the idea further to examine the effects of cumulation zones over the past 50 years, finding that adding partners representing 10 percent of world output to a "cumulation zone" was associated with

a 3 percent increase in the bilateral trade of small countries. Importantly, this is a net effect, including any reduction in trade due to trade diversion.

Some groups of countries are making concrete efforts to converge their bilateral and plurilateral RTAs with each other into broader integration blocs—to use a gastronomic analogy, to build "lasagna plates" from the "RTA spaghetti bowl" (Figure 3). Such convergence processes are independent of the WTO, but complementary to the aim of building larger economies of scale and reducing the transactions costs that are by and large inherent to the spaghetti bowl.

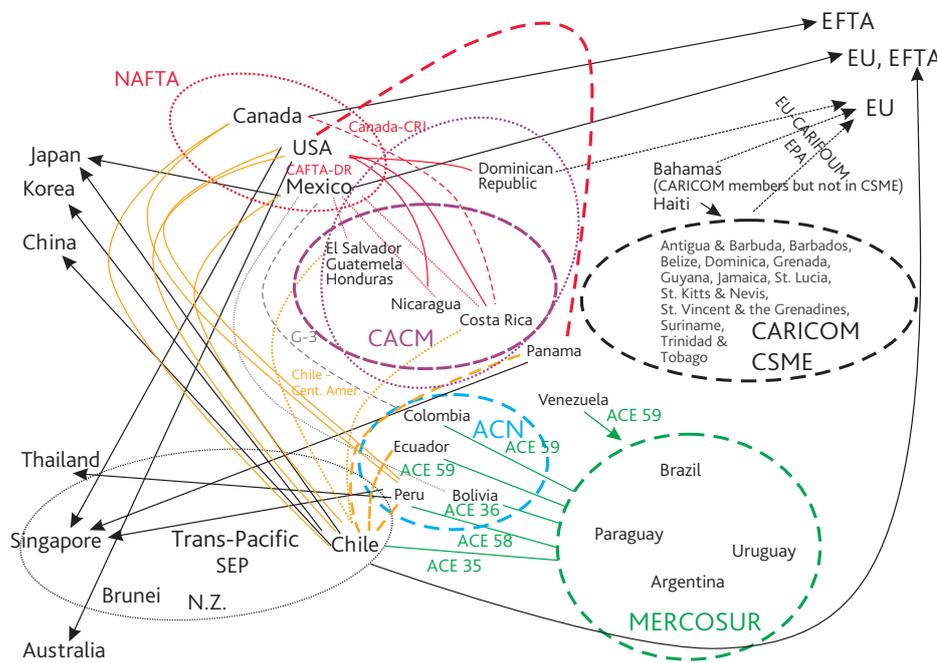


FIGURE 3:  
The Spaghetti Bowl and Lasagna Plates  
Spaghetti Bowl

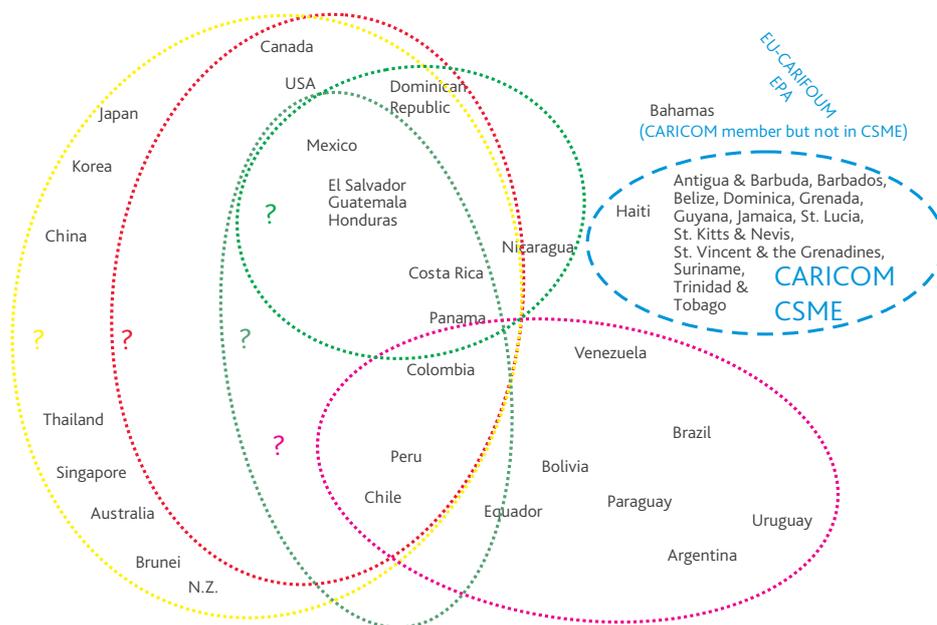


FIGURE 3:  
The Spaghetti Bowl and Lasagna Plates  
Lasagna Plates

The most prominent example of convergence was accomplished in Europe in 1999, when the EU created the Paneuro system. The system essentially substituted all the bilateral FTA commitments between the EU and the Eastern European nations for a single agreement, and in particular created a uniform RoO protocol covering all agreements. This was rather easy—the various bilateral FTAs were very similar in design. The Paneuro RoO have subsequently been transposed to the EU's extra-regional FTAs.

There are various examples of cumulation that do not fully reach the Paneuro-type diagonal cumulation in the Asia-Pacific, Latin America, and among US agreements.<sup>25</sup> Still another and more current prominent examples of convergence-like process is somewhat distinct, they include the TPP in the Asia-Pacific, which currently encompasses 11 nations, which in turn have more than two dozen pre-existing RTAs with each other. Once formed, the agreement would essentially form a single agreement among these various nations; however, most likely the various bilateral FTAs would remain in force—essentially enabling the TPP member to choose among two distinct channels. In the Americas, Chile, Colombia, Peru, and Mexico, which have trade agreements with each other, are pursuing the Pacific Alliance that has freed 92 percent of products and harmonized rules of origin, among other measures. Costa Rica and Panama are observer members.

For the multilateral system, convergence processes can be positive as long as they are based on open regionalism and do not introduce stringent RoO. They may also help aggregate their member countries' disparate preferences for multilateral bargaining. Convergence is also at least conceptually a feasible process—the target and the end result are clear (such as region-wide cumulation of production); trade and foreign policy benefits ought to be greater than in any one bilateral FTA; and a single large regional hegemonic actor, such as the EU or the US, may be able to propel the process unlike so far accomplished at the global level. To the extent that differences across pre-existing RTAs produce transactions costs to firms operating on two or more RTA fronts simultaneously, such convergence areas can also help member country firms diversify their export markets and lower the potential for distortive hub-and-spoke patterns.

A further advantage of convergence zones is that they almost inherently entice their members to go beyond the provisions in bilateral agreements. For example, the TPP would not only knit together several nations and agreements; but also stand out for holding the potential for a transformative "gold standard" trade agreement that charts the path for future trade agreements that are more comprehensive than current WTO-based ones and have stronger enforcement mechanisms.

However, there are several major considerations that would have to be addressed in any convergence process. First and foremost is the co-existence between a new set of converged rules and the rules of the other RTAs, and the actual

contents of the resulting rules—which would ideally be more liberalizing than those of any of the component agreements. The most likely scenario is one of overlapping agreements (bilateral and plurilateral) rather than plurilateral agreements that automatically swallow the pre-existing agreements among members.

## INEFFICIENCY: MULTILATERALIZING REGIONALISM?

Recent RTAs have addressed behind-the-border issues from intellectual property to competition policy and product norms in a very robust fashion. This is where the innovation in RTAs is occurring, and it is an area where the multilateral trading system lags well behind. Indeed, RTAs have gone so far beyond multilateral disciplines and mere tariff liberalization that they should be viewed as a distinct from the WTO system, not as a parallel, let alone a competing or conflicting system. The typically cited tension is one between the principle of subsidiarity, whereby common rules should be addressed at their lowest level of governance to be well-tailored for the needs of the parties, and efficiency, whereby other jurisdictions should also accede to the rules, especially if and when such rules have spillover effects on them and yield public goods.

More concretely, it is perfectly reasonable for two or more RTA members to forge rules that are tailored to their idiosyncratic circumstances and purposes. The more complex question is what such rules do—whether they are discriminatory effects against outsiders; whether they lock in the insiders into a certain regime; and, as above, whether they increase transactions costs for the parties that need to deal with multiple RTA fronts at once. Evidence thus far seems to indicate that trade effects of various RTA rules to third parties are positive. For example, the EU's single market appears to have increased access at least as much for firms from third parties (Mayer and Zignago 2005).

25 In the South Pacific Regional Trade and Economic Co-operation Agreement (SPARTECA), Australia and New Zealand allow members of the South Pacific Forum islands to cumulate among themselves and still receive preferential treatment. The Canada-Israel PTA permits cumulation with the two countries' common PTA partners a set of countries which includes the US and no other. This extension of cumulation most likely accommodates existing integration of Canadian industry with US suppliers. US agreements with Israel and Jordan also have some cumulation. Singapore has pursued innovative mechanisms in its PTAs that, while not extending cumulation in the conventional sense of the term, do allow for greater participation of non-members in the production of originating goods. The main mechanism is outward processing (OP), which is recognized in all of Singapore's PTAs. OP enables Singapore to outsource part of the manufacturing process, usually the lower value-added or labor-intensive activities, to neighboring countries, yet to count the value of Singaporean production done prior to the outsourcing activity toward local, Singaporean content when meeting the RoO required by the export market. There are as yet only limited efforts to carve cumulation areas within the Americas. The Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR) between the US, Central America, and the Dominican Republic contains provisions for cumulation of inputs from Canada and Mexico in the production of garments of woven fabric (HS Chapter 62).

Moreover, given that regulations in RTAs are tailored to the parties' needs and political economy circumstances, expanding them to third parties is not necessarily easy. Also broad-based or quick multilateralization can be complicated—RTAs are inherently motivated by their members' interests to deepen their multilateral commitments, and negotiating similar rules at the multilateral level is practically impossible. There thus seems to be an inherent division of labor between RTAs and the WTO. However, it is entirely plausible that there would be efficiency gains for the global trading system from expanding the scope of parties with common regulations or even mutual recognition—that is, from multilateralizing certain RTA disciplines.

Multilateralization has been discussed quite intensely over the past five years, and the most often cited examples of the mechanics by which it might work is the Information Technology Agreement (ITA), which in 1996 brought tariffs of IT goods to zero among the original 14 WTO members (the then 15-member EU counted as one member). Only interested WTO Members that were genuinely committed to signing the ITA took part in the negotiations; however, further parties joined, and the agreement now has 46 of the largest WTO Members, such as the US, the EU, Japan, and China. ITA-type plurilateral deals are now advocated as a potential future negotiation modality in the WTO (see Hufbauer and Suominen 2010). The post-Uruguay Round agreements on basic telecommunications and financial services are two cases in point. RTAs can play a powerful role in this process. Asia-Pacific Economic Cooperation (APEC) has made an attempt to encourage commonalities among the various RTAs among its members through its Best Practices for PTAs.

Gradual, bottom-up multilateralization will be likelier than top-down WTO-mandated multilateralization. Indeed, in some disciplines, multilateralization may be occurring by default—for example, RTA provisions on competition policy tend to be multilateralized through non-discrimination clauses. Similar de facto multilateralization may be occurring in services, as RTAs' RoO for services trade are generally quite loose. In most cases, third-country service providers can free-ride on the preferences provided by an RTA by establishing an investment presence in one of the partner countries.<sup>26</sup> More generally, while there is marked variation across RTAs in terms of their coverage and content of the various disciplines, there are also important RTA clusters of main world regions and traders, such as the US and the EU. There is also clear "borrowing" of RTA models from one region to another. For example, the Chile-Korea FTA's market access provisions are a striking copy of the disciplines in the US-Chile FTA—which in turn is modeled quite extensively on the NAFTA.

However, for WTO Members to promptly multilateralize RTA disciplines in the multilateral system would require a return to plurilateral agreements, which were a permitted modality in global trade talks before the consensus and single undertaking rules were adopted. In a plurilateral agreement,

only a coalition of the willing would accede to an agreement, receiving all the rights and accepting all the obligations. The benefit of plurilateralism over multilateralism is speed, as those who do not want to accede are left out and do not constrain the talks. Moreover, since Members self-select into agreements, compliance will be easier. Further, it is far from certain that plurilaterals would be narrow-based. The incentives are substantial—accession to any one deal, while requiring policy adjustments, would also mean more hospitable practices by as many as 153 trading partners abroad.

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## POLICY RECOMMENDATIONS

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RTAs have transformed global commerce, and mostly for the better. There is by now an important body of literature that attests to the value added of RTAs to the global trading system. At their best, trade agreements can serve as engines of liberalization; focal points of inter-state cooperation; incubators of new global trade rules; and testing grounds for mechanisms to adjust to an open trading environment. They enable countries to craft provisions to suit their idiosyncratic circumstances; help aggregate national and global pro-trade forces to lobby for further liberalization; and can deepen trade disciplines. It may also be the case that a critical mass of trade agreements can create the dynamics conducive to global trade liberalization, perhaps well beyond what could be accomplished through multilateral negotiations alone.

There have been several proposals and attempts to ensure that RTAs are non-discriminatory, including strengthening the WTO's legal framework applicable to RTAs and accelerating unilateral and multilateral trade opening. There have also been ideas to address, both at the regional and multilateral levels, potential transactions costs and inefficiencies entailed by RTAs. These include a norms-based, "soft law" approach to regulating RTAs; converging RTAs into broader integration zones; and multilateralizing RTA disciplines, such as can be done by transposing their "WTO+" features to the GATT and WTO agreements (Davey 2011; Low 2010; Sutherland Report 2005; Warwick Commission Report 2007; WTO 2003).

The key policy question addressed in each of these areas is whether and how the WTO system and RTAs can be and be

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<sup>26</sup> See, for example, Fink and Jansen 2007. Baldwin et al. 2007 cite the NAFTA-style telecommunications provision as an agent of multilateralization due to the sheer number of countries adhering to it, and because harmonization to a single regulatory regime for telecommunications frees trade in the same way that adoption of an international standard liberalizes technical barriers to trade—a common set of rules that governments apply to private firms in many nations tends to foster competition and trade.

made most synergistic and help deepen and improve each other. The focus is shifting in the right direction, away from a narrow focus on RTAs' coverage and trade effects and futile, top-down efforts to standardize or harmonize RTAs. These approaches will now need to be deepened, with the end consumer in mind—companies engaged in global commerce. Three approaches should in particular be considered.

## RTA EXCHANGE TO SHARE BEST REGIONAL PRACTICES

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The WTO is uniquely placed to act as a dedicated clearing house and forum where all matters related to RTAs, their rules, and their practices can be discussed among all WTO Members. This type of an "RTA Exchange" could feature an annual forum where the Members regularly share practices and challenges from building RTAs, as well as an informative and interactive website on RTAs, their rules, the various research findings on them, the practical experiences in negotiating and implementing them, and the various ways in which regional governments have sought to complement them through further regional cooperation. For example, many nations could learn from the efforts made in the NAFTA to harmonize standards after regional tariff liberalization was complete. Asian and Latin American nations have much to learn from the experiences and failures of the EU nations in deepening their regional arrangement. To prevent the RTA Exchange from being diluted to long-winded political statements, both the annual forum and the website should include independent outside analysts.

This type of forum would raise the level of debate on RTAs, systematize it, and make it more applied than earlier policy discussions on RTAs. It would automatically enhance RTAs' transparency, and it could help bring together analytical work that is already being generated around the world. The Exchange should be complemented by an interactive website filled with data, information, and fresh ideas for policymakers, companies, and analysts.

## NEW NEGOTIATION MODALITY FOR MULTILATERALIZING REGIONALISM

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Unlike the 1940s, multilateral trade talks now tackle multiple issues among a record 154 Members. For multilateralization of RTA regulations to occur effortlessly, changes would be required in the WTO's negotiation modalities—a shift from the unanimity rule and single undertaking principle to enable faster deals among a critical mass of members. Such a critical mass can, for the sake of simplicity, be defined as coalitions of the willing; though such a coalition would need to encompass at least some of the large trading nations to have a meaningful impact. The multilateralization process could start out much as the ITA did, as a plurilateral

agreement, whereby a subset of WTO Members commit to a set of rules that is binding among them and can be enforced in the WTO dispute settlement system. The Members left outside would not access the benefits or need to adhere by the obligations until acceding to the agreement. The process is fully voluntary, but discussion on multilateralization can be encouraged, both through the RTA Exchange and in specific, topical forums, such as on e-commerce or competition policy.

## TRADE FACILITATION WITH RULE CONVERGENCE

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Convergence of RTA provisions such as complex RoO can be desirable, but they cannot be forced. For convergence to occur and be meaningful, a larger actor, such as the US or the EU, would need to press for it with its several FTA partners. None of the larger players has much to lose from seeking convergence (apart from resistance from protectionist interests against any further trade concessions), and could have something to gain. However, since these "hub" nations also have relatively similar rules with all their various FTA partners, it is the "spoke" nations that would likely gain most from harmonized trade rules, as showcased by the Paneuro system.

However, it is not always clear that the perceived benefits of convergence would so significantly outweigh the costs that various nations would be prepared to seek it. There are attempts in the Americas and APEC region that speak to the difficulties of such an enterprise. And convergence of rules is not everything. Indeed, assessing how and whether to somehow converge or multilateralize RTAs should avoid leading to "RTA myopia"—excessive focus on RTA rules, when there are several other ways in which members could expand their trade and trade with outside parties. For example, trade facilitation, customs modernization, and improvements in infrastructures are also likely to generate trade gains, and potentially larger than those from convergence, and they would benefit all countries, not just RTA members. Such further measures are highly complementary and synergistic to efforts to converge or multilateralize RTA, and should be prioritized. They are also politically easier to accomplish than renegotiating existing agreements or negotiating new ones.

The RTA Exchange should be complemented by a dedicated forum that includes independent analysts, leaders of global companies, trade and economic development officials of the various member nations, and multilateral development bank officials to define measures complementary to RTAs that provide the greatest "bang for the buck." The forum's discussions should include sophisticated, technical analyses on the benefits and costs of various plausible complementary measures that facilitate and expand trade with partners in different regions.

# CONCLUSION

The WTO is at a defining moment. It faces questions about its legitimacy and effectiveness, and is surrounded by increasingly vibrant system of RTAs. RTAs have long been seen as competing with and undermining the world trading system when they should be viewed as buttressing the multilateral trading system, which is struggling to adjust to an increasingly complex global economy and constituency. RTAs have deepened trade relationships, increased trade,

and created the grounds for broader cooperation conducive to trade among their members, well beyond what can be accomplished at the multilateral level alone.

Yet RTAs are not enough—multilateralism is also critical, and global, system manager institutions plays a central role in ensuring non-discrimination and settling disputes. Even as RTAs advance the cause of open markets and provide insurance against the breakdown of multilateral talks, they are not a substitute for multilateral liberalization. The two fronts must move in parallel. The WTO is uniquely placed to provide a venue for its Members to discuss best practices in RTAs and ways to build on the RTA ecosystem for greater efficiencies in global trade.

## BOX 1:

### GATT Article XXIV: Territorial Application — Frontier Traffic — Customs Unions and Free-trade Areas

1 The provisions of this Agreement shall apply to the metropolitan customs territories of the contracting parties and to any other customs territories in respect of which this Agreement has been accepted under Article XXVI or is being applied under Article XXXIII or pursuant to the Protocol of Provisional Application. Each such customs territory shall, exclusively for the purposes of the territorial application of this Agreement, be treated as though it were a contracting party; Provided that the provisions of this paragraph shall not be construed to create any rights or obligations as between two or more customs territories in respect of which this Agreement has been accepted under Article XXVI or is being applied under Article XXXIII or pursuant to the Protocol of Provisional Application by a single contracting party.

2. For the purposes of this Agreement a customs territory shall be understood to mean any territory with respect to which separate tariffs or other regulations of commerce are maintained for a substantial part of the trade of such territory with other territories.

3. The provisions of this Agreement shall not be construed to prevent:

- (a) Advantages accorded by any contracting party to adjacent countries in order to facilitate frontier traffic;
- (b) Advantages accorded to the trade with the Free Territory of Trieste by countries contiguous to that territory, provided that such advantages are not in conflict with the Treaties of Peace arising out of the Second World War.

4. The contracting parties recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements. They also recognize that the purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories.

5. Accordingly, the provisions of this Agreement shall not prevent, as between the territories of contracting parties, the formation of a customs union or of a free-trade area or the adoption of an interim agreement necessary for the formation of a customs union or of a free-trade area; Provided that:

(a) with respect to a customs union, or an interim agreement leading to a formation of a customs union, the duties and other regulations of commerce imposed at the institution of any such union or interim agreement 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 or the adoption of such interim agreement, as the case may be;

(b) with respect to a free-trade area, or an interim agreement leading to the formation of a free-trade area, the duties and other regulations of commerce maintained in each of the constituent territories and applicable at the formation of such free-trade area or the adoption of such interim agreement to the trade of contracting parties not included in such area or not parties to such agreement shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free-trade area, or interim agreement as the case may be; and

(c) any interim agreement referred to in subparagraphs (a) and (b) shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time.

BOX 1 (CONTINUED):

**GATT Article XXIV: Territorial Application — Frontier Traffic — Customs Unions and Free-trade Areas**

6. If, in fulfilling the requirements of subparagraph 5 (a), a contracting party proposes to increase any rate of duty inconsistently with the provisions of Article II, the procedure set forth in Article XXVIII shall apply. In providing for compensatory adjustment, due account shall be taken of the compensation already afforded by the reduction brought about in the corresponding duty of the other constituents of the union.

7. (a) Any contracting party deciding to enter into a customs union or free-trade area, or an interim agreement leading to the formation of such a union or area, shall promptly notify the CONTRACTING PARTIES and shall make available to them such information regarding the proposed union or area as will enable them to make such reports and recommendations to contracting parties as they may deem appropriate.

(b) If, after having studied the plan and schedule included in an interim agreement referred to in paragraph 5 in consultation with the parties to that agreement and taking due account of the information made available in accordance with the provisions of subparagraph (a), the CONTRACTING PARTIES find that such agreement is not likely to result in the formation of a customs union or of a free-trade area within the period contemplated by the parties to the agreement or that such period is not a reasonable one, the CONTRACTING PARTIES shall make recommendations to the parties to the agreement. The parties shall not maintain or put into force, as the case may be, such agreement if they are not prepared to modify it in accordance with these recommendations.

(c) Any substantial change in the plan or schedule referred to in paragraph 5 (c) shall be communicated to the CONTRACTING PARTIES, which may request the contracting parties concerned to consult with them if the change seems likely to jeopardize or delay unduly the formation of the customs union or of the free-trade area.

8. For the purposes of this Agreement:

(a) A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that

(i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and,

(ii) subject to the provisions of paragraph 9, substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union;

(b) A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories.

9. The preferences referred to in paragraph 2 of Article I shall not be affected by the formation of a customs union or of a free-trade area but may be eliminated or adjusted by means of negotiations with contracting parties affected. This procedure of negotiations with affected contracting parties shall, in particular, apply to the elimination of preferences required to conform with the provisions of paragraph 8 (a)(i) and paragraph 8 (b).

10. The CONTRACTING PARTIES may by a two-thirds majority approve proposals which do not fully comply with the requirements of paragraphs 5 to 9 inclusive, provided that such proposals lead to the formation of a customs union or a free-trade area in the sense of this Article.

11. Taking into account the exceptional circumstances arising out of the establishment of India and Pakistan as independent States and recognizing the fact that they have long constituted an economic unit, the contracting parties agree that the provisions of this Agreement shall not prevent the two countries from entering into special arrangements with respect to the trade between them, pending the establishment of their mutual trade relations on a definitive basis.

12. Each contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territories.

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