T.C.
YEDITEPE UNIVERSITY
GRADUATE INSTITUTE OF SOCIAL SCIENCES

REGIONAL ECONOMIC INTEGRATION AND GLOBALIZATION

by

Hatice Kerra GELDİ

Submitted to the Graduate Institute of Social Sciences
In partial fulfillment of the requirements for the degree of
Doctor of Philosophy in Economics

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LIST OF ABBREVIATIONS

ACP	Africa, Caribbean and Pacific
ADF	Augmented Dickey Fuller
AFTA	Association of Southeast Asian Nations Free Trade Area
AIC	Akaike Information Criteria
ANZCERTA	Australia New Zealand Closer Economic Relations Trade Agreement
APEC	Asia-Pacific Economic Cooperation
APTA	Asia Pacific Trade Agreement
ASEAN	Association of Southeast Asian Nations
CACM	Central American Common Market
CAN	Andean Community
CAP	Common Agricultural Policy
CARIFTA	Caribbean Free Trade Association
CARICOM	Caribbean Community and Common Market
CEFTA	Central European Free Trade Area
CEMAC	Economic and Monetary Community of Central Africa
CER	Closer Economic Relations
CET	Common External Tariff
CGE	Computable General Equilibrium
CI	Complete (Political) Integration
CM	Common Market
CMEA	Council for Mutual Economic Association
COMECON	Council for Mutual Economic Association
COMESA	Common Market for Eastern and Southern Africa
CPI	Consumer Price Index
CRTA	Committee on Regional Trade Agreements
CTD	Committee on Trade and Development
CTG	Council for Trade in Goods
CTS	Council for Trade in Services
CU	Customs Union
CUSFTA	Canada-US FTA
DOLS	Dynamic Ordinary Least Squares
DOT	Direction of Trade Statistics
EACM	East African Common Market
EC	European Community
ECO	Economic Cooperation Organization
ECOWAS	Economic Community of West African States
ECSC	European Coal and Steel Community
EDC	European Defence Community
EEA	European Economic Area

EEC	European Economic Community
EFTA	European Free Trade Association
EIA	Economic Integration Agreement
EMU	Economic and Monetary Union
EPA	Economic Partnership Agreement
EPC	European Political Community
EU	European Union
FDI	Foreign Direct Investment
FMOLS	Fully Modified Ordinary Least Squares
FTA	Free Trade Agreement (Area)
FTAA	Free Trade Area of Americas
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GLS	Generalized Least Squares
GMM	Generalized Method of Moments
GNP	Gross National Product
GSP	Generalized System of Preferences
IBRD	International Bank for Reconstruction and Development
IFS	IMF Financial Statistics
IID	Independent Identically Distributed
IMF	International Monetary Fund
IPS	Im, Pesaran and Shin (1997)
IT	Information Technology
ITO	International Trade Organization
LAFTA	Latin American Free Trade Area
LAIA	Latin American Integration Association
LLC	Levin, Lin and Chu (2002)
LSDV	Least Square Dummy Variable
MAI	Multilateral Agreement on Investment
MERCOSUR	Mercado Común del Sur (Southern Common Market)
MFN	Most Favored Nation
MUSFTA	Mexico-US FTA
NAFTA	North American Free Trade Agreement
NAFTA	New Zealand Australia Free Trade Agreement
OECD	Organization for Economic Cooperation and Development
OEEC	Organization for European Economic Co-operation
OLS	Ordinary Least Squares
OLS_{FE}	Ordinary Least Squares with Fixed Effects
OPEC	Organization of the Petroleum Exporting Countries
PAFTA	Pan-Arab Free Trade Area
PECS	Pan-European Cumulation System
PTA	Preferential Trade Agreement (Area)
RIA	Regional Integration Agreement
RMSE	Root Mean Squared Error
RoO	Rules of Origin
RTA	Regional Trade Agreement

SAARC	South Asian Association for Regional Cooperation
SACU	Southern African Customs Union
SADC	Southern African Development Community
SAFTA	South Asian Free Trade Area
SAPTA	South Asian Preferential Trade Arrangement
SEA	Single European Act
SPARTECA	South Pacific Regional Trade and Economic Cooperation Agreement
TRIMs	Trade-Related Investment Measures
TRIPs	Trade-Related Aspects of Intellectual Property Rights
UNCTAD	United Nations Conference on Trade and Development
WAEMU	West African Economic and Monetary Union
WB	World Bank
WTO	World Trade Organization
WWI	World War I
WWII	World War II

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ABSTRACT

The GATT/WTO system has been founded on the fundamental principle of non-discrimation. However, the system has also allowed exceptional cases to this principle through several arrangements. The leading examples of these cases are Regional Integration Agreements (RIAs). While RIAs imply liberalization for member countries, they imply discrimination for non-member countries. This situation has caused to question the compatibility of regional economic integration and globalization. To this end, the history of both regional integration and globalization and the main motives for the formation of RIAs will be studied. This analysis will be further supplemented by the study of the effects of these agreements on member and non-member countries, as well as on the multilateral trading system. Moreover, through an empirical analysis that derive from the gravity model, the effects of the EU , NAFTA, MERCOSUR and AFTA on bilateral trade flows will be analyzed for the period of 1980-2008.

The historical development of regional integration and the related evaluation of RIAs suggest that this phenomenon has gained its importance after the establishment of the WTO. The motives for the formation of RIAs, on the other hand, are not limited to the economic concerns only. Both political considerations and the inefficient regulation of the GATT/WTO system also contribute to the process of regional integration. While discrepancies among the member countries result in internal problems for the regional group, non-member countries are likely to suffer from the increased external protection. The empirical analysis, on the other hand, suggests that trade effects of RIAs on members and non-members differ significanlty for each RIA.

ÖZET

GATT/WTO sistemi temel prensip olarak ayrımsızlık ilkesi üzerine kurulmuştur. Fakat, bu temel ilkenin yanında birçok istisnai durum da çeşitli düzenlemeler ile sisteme kazandırılmıştır. Bu istinai durumlardan en önemlilerinden biri Bölgesel Entegrasyon Anlaşmalarıdır. Bu anlaşmalar üye ülkeler için ticari liberalleşme getirirken, üye olmayan ülkelere karşı ayrımcılık yapılmasına neden olur. Bu durum bölgesel ekonomik entegrasyon ve küreselleşme arasındaki uyumun sorgulanmasına neden olmaktadır. Bu nedenle, hem küreselleşmenin hem de bölgesel entegrasyonun tarihi ve bölgesel entegrasyona başvurmanın temel amaçları incelenecektir. Bu analiz bu anlaşmaların üye olan ve olmayan ülkeler üzerindeki etkileri ile çok taraflı ticaret sistemi üzerindeki etkilerin incelenmesi ile desteklenecektir. Çekim modelini temel alan ampirik analiz ile de EU, NAFTA, MERCOSUR ve AFTA'nın iki taraflı ticaret akımları üzerindeki etkileri 1980-2008 dönemi için ölçülecektir.

Bölgesel entegrasyonun tarihsel gelişim süreci ve bu anlaşmalara ilişkin değerlendirmeler, söz konusu kavramın Dünya Ticaret Örgütü'nün kurulmasından sonra daha önemli hale geldiğini göstermektedir. Ayrıca, bu anlaşmaların arkasındaki temel amaçlar sadece ekonomik sebeplere dayalı değildir. Politik sebepler ve GATT/WTO sisteminin yetersiz yönetimi de bölgesel entegrasyon sürecine katkıda bulunmaktadır. Üye ülkeler arasıdaki farklılıklar bölgesel grup içinde problemlere sebep olurken, üye olmayan ülkeler artan dış koruma nedeniyle zarar görür hale gelmektedir. Ampirik analiz ise bölgesel entegrasyon anlaşmalarının üye olan ve olmayan ülkeler üzerindeki ticaret etkilerinin her anlaşma için önemli ölçüde değiştiğini göstermektedir.

CHAPTER 1 INTRODUCTION

The contemporary world has been experiencing a paradoxical situation such that while the non-discrimination principle constitutes the hard-core of the multilateral trading system, approximately all World Trade Organization (WTO) members are participating in at least one of regional economic integration. Besides outlawing non-discrimination principle, regional integration agreements (RIAs[1]) which are the engines of regional economic integration further dilute the multilateral trading system through increased protection raised against non-member countries. Hence, the dual nature of RIAs implies the existence of both liberalization (within the integrated area) and protectionism (for the outside of integration).

The major motive of "Regional Economic Integration and Globalization" is to investigate the relationship between regional economic integration and globalization from the perspective that whether they are complementary or rival of each other. The New World Order governed by the Bretton Woods Institutions has been designed so as to increase the depth of globalization throughout the world. As one of the constituents of this reconstruction, the General Agreement on Tariffs and Trade (GATT, 1947) has been introduced to the system as a set of rules governing the international trading system[2]. However, the GATT has brought also several exceptions to the so-called multilateral trading system. Through these exceptions, regional economic integration concept has been legalized within the jurisdication of the GATT system. Hence, the main concern of this study is what these exceptional cases mean for the globalization process, that is to say, for the multilateral trading system. In order to find possible answers to this question, regional economic integration concept will be studied on different grounds.

[1] These agreements are also called as Regional Trade Agreements (RTA) or Preferential Trade Agreements (PTA).

[2] International Trade Organization (ITO) was one of the planned institutions of Bretton Woods Conference (1944). As the formation of ITO was not approved by the US, instead of this institution, the GATT had been introduced.

In order to compare the concepts of regional integration and globalization, it is necessary to clarify the meaning of regional economic integration. For this purpose, Chapter 2 gives major definitions related to this concept. The analysis starts with the meaning of regional economic integration (regionalism), and then continues with studying the types of RIAs. Differences arising from the structural forms of RIAs constitute the next topic covered in this chapter.

Chapter 3 surveys the literature related to regional economic integration. For this analysis, three main sections are included. In the first section, the literature that contributed to the theoretical underlyings of the effects of RIAs are examined. These studies like Lipsey (1960), Dam (1963) and Cooper and Massell (1965) mainly derive from Jacob Viner's "The Customs Union Issue" (1950) that introduced trade-creation and trade-diversion concepts to the welfare analysis of regional integration. The second section, on the other hand, tries to survey studies that focus on the effects of regional economic integration on the multilateral trading system or on the multilateral tariff liberalization. Some of the leading studies of this section include Baldwin (1993), Bhagwati (1993), Levy (1994), Grossman and Helpman (1995), Bagwell and Staiger (1998), and Krishna (1998). Final section of this chapter examines some of the literature on the effects of RIAs from the viewpoint of members and non-members.

As the main concern of this study is to make comparison between regional economic integration and globalization, Chapter 4 will study the history of these concepts. In the first section, brief history of globalization will be presented as the first wave of globalization (1870-1914) and the second wave of globalization (1945-). In the first wave, the main driving forces of globalization were the industrial revolution, the hegemonic power of Britain, the colonial relationships of the leading powers, international gold standard system, and the advances in transportation and in communication. On the other hand, the second wave of globalization has been realized through the attempts of the Bretton Woods Institutions and backed up by the advances in high-tech communication and aircraft transportation. When the increased number of countries together with the increased subject matters of the international trading system raised several concerns about the GATT system, the need for reform in the trading system had been realized through the establishment of

the WTO (1995) at the end of the 8-year long Uruguay Round. Hence, the GATT/WTO system constitutes the important part of the second wave of globalization.

The second section of Chapter 4, on the other hand, focuses on the brief history of regional integration which dates back to the 16th century. In order to study RIAs in connection with the GATT/WTO system, this chapter divides the history of regionalism into two as the before the GATT system and the GATT/WTO period. The first section depicts that preferential agreements signed to assure colonial trade links of the leading countries and the politically-oriented agreements in Europe were the initial examples of RIAs. On the other hand, in the inter-war period, the Reciprocal Trade Agreement Act (1934) of the US significantly increased the number of RIAs in this period. Prior to the analysis of the history of regional integration prevailing in the GATT/WTO period, the remarks on the key principles of GATT and on the first exception to these principles, namely Article XXIV, will be given in the second section.

In the final section of Chapter 4, history of regional integration that covers the period after the initiation of GATT will be studied. Up to 1980s, regionalism concept was not a controversial issue for the newly developing multilateral trading system. In this period, successful examples of RIAs were limited to the European Economic Community (EEC, Treaty of Rome, 1957) and the European Free Trade Agreement (EFTA, Stockholm Convention, 1960). The other examples included agreements formed by Latin American and African countries. However, as these developing/least developed countries were mainly interested in import-substitution based regionalism, these agreements did not improve the economic conditions of these countries and they became ineffective. At the end of 1980s, however, the slow progress of regional integration turned into the opposite direction. The main contributing factors for this shift were the collapse of the Soviet Union and the prolonged negotiations of the Uruguay Round. Ex-communist countries of Central and Eastern European countries tried to adapt to the capitalistic system through several RIAs signed among themselves and with the economic power of Europe, namely the European Community (EC). On the other hand, long-lasting Uruguay Round negotiations significantly affected the US' attitude on regionalism. As the hegemonic power of the second wave of globalization, the US has started to pursue its trade policy on both

multilateral ground and regional ground. The other countries have followed the leader, and consequently, the number of RIAs has significantly increased since the establishment of WTO.

Chapter 5 analyzes the main underlying reasons for countries to form or to participate in RIAs. The first section covers the economic motives for membership in regional integration. These motives include several factors like the efficiency gains arising from economies of scale and increased competition, possible investment flows (both domestic and foreign) and the secure access to the protected markets of developed partners. In the second section, the political motives that lead countries to form RIAs will be studied. These motives include using RIAs as a tool for diplomacy and for stabilizing external economies via locking these economies into reform policies. Moreover, these agreements are generally used as a reaction to other countries' regionalism policies. In the final section, on the other hand, how the GATT/WTO system canalizes countries to search for regional solutions will be analyzed. The establishment of WTO has been coupled with the increased items on the agenda of WTO rounds and the increased number of member countries. The still continuing Doha Round negotiations (2001-) and the increasing number of RIAs raise several questions about the efficiency of the WTO system.

In Chapter 6, the legal basis for the establishment of RIAs will be presented. As it is noted before, the first exception that legalized the formation of Free Trade Areas (FTAs) and Customs Unions (CUs) was the GATT Article XXIV. In the first section, the basic requirements of this article will be analyzed. On the other hand, concerns over developing countries' trade capabilities resulted in several attempts to modify the trading system in favor of these countries. While the initial attempt was the introduction of the Generalized System of Preferences (GSP, 1968) by the United Nations Conference on Trade and Development (UNCTAD), the GATT counterpart of GSP schemes was introduced to the system through the Enabling Clause in Tokyo Round (1979). The Enabling Clause has legalized the formation of RIAs that involve only developing countries as members. Hence, in the second section, the requirements of this clause, which are looser than the ones of the GATT Article XXIV, will be studied. As one of the by-products of Uruguay Round, the General Agreement on Trade in Services (GATS) has been introduced to the

trading system. In line with this development, the third section tries to study GATS Article V that specifies the conditions for forming RIAs covering trade in services. The following chapter, on the other hand, will study the critiques raised against these exemptions to or loopholes of the multilateral system. These critiques mainly center on ambiguity of the statements involved in these articles. In the fifth section, the Committee on Regional Trade Agreements (CRTA) which is the RIA controlling body of WTO will be analyzed. As the WTO is generally critized for its assessments and its controlling power on RIAs, this section will also include the critiques raised against the CRTA.

In Chapter 7, present situation of regional economic integration will be analyzed. In order to do this, the first section will study the general view of regional economic integration. As of March 2010, WTO data show that there are more than 270 RIAs (preferential trade agreements, free trade agreements, customs unions and economic integration agreements) that are notified and entered into force. When the notified agreements are considered, the number of RIAs increases to approximately 470. Together with the number of RIAs, this section will present the data on the percentage shares of types of RIAs. Later on, geographical distribution of RIAs will be shown. Moreover, for selected RIAs, statistics on intra-regional exports and extra-regional imports will be presented. This chapter will also include evaluation of selected RIAs in terms of member countries and structural development.

In Chapter 8, the main arguments raised against/for the effects of RIAs will be studied. This chapter will cover the effects of RIAs that are relevant to the globalization process. The first section aims to study the effects of RIAs in terms of member countries. As the development level of member countries differ for each RIA, this leads to several internal problems within the group, like the sectors to be included in tariff liberalization, determination of the common external tariff (in the case of CU), distribution of tariff revenues, etc. The second section studies the effects of RIAs in terms of non-member countries. On the non-members side, the crucial element is the increased external protection of regional integration. In this analysis, it will also be studied that how the ambiguity of related Articles on RIAs enables regional groups to impose higher tariff levels or other protection measures against non-member countries. In the third section,

relationship between regionalism and globalization will be studied by analyzing the arguments from two sides. The first side argues that RIAs are in line with the multilateral trading system. Accordingly, they are contributing factors of the multilateral trading system. On the other hand, the second side argues that these agreements are in contrast with the system and hinder the development of multilateral trading system. While the first group points out internal liberalization as a positive step in front of globalization, the second group points out increased outside protection which is governed by the special interest groups. In the final section, what the existing situation implies in the global world is to be discussed.

Chapter 9 tries to measure the effects of RIAs on bilateral trade flows through an econometric analysis. This analysis, in the related literature, is generally carried out by either computable general equilibrium model (CGE) or gravity model. As gravity model is commonly preferred model for the estimation of trade effects of RIAs throughout the literature, this chapter depends on the gravity model. While this model was originally suggested by the independent studies of Tinbergen (1962) and Pöyhönen (1963), this model has been developed in terms of the included variables and the estimation methodology. In the first section, studies that contributed to the theoretical development of gravity model will be surveyed. This section also includes some of the studies that employed gravity model in order to analyze the effects of RIAs on bilateral trade. In the second section, specification of the gravity equation employed in this study will be determined. The panel data analysis will be the main method of the analysis. The third section is on the model specification that will be used in estimating the gravity equation. The fixed effects model is the mostly applied model in the literature, so this section starts with the examination of this model. On the other hand, as the panel data unit root tests and cointegration tests are gaining importance in empirical analysis since 2000, this study will also employ panel non-stationarity and cointegration analysis. In the following section, details on the selected data will be presented. The data cover the period of 1980-2008 and include the European Union (EU), North American Free Trade Area (NAFTA), Mercado Común del Sur (MERCOSUR) and ASEAN FTA (AFTA) as the sample of RIAs. The last two sections will give estimation results and remarks on the methodology employed.

Depending on the analysis given in the previous chapters, in Chapter 10, this study tries to find answers to the following questions:

- Is the trend in regional economic integration complementary or contradictory to the globalization process?
- Do the deficiencies inherited from the GATT/WTO system further contribute to the increasing interest in regional economic integration?
- What does the gravity model estimation result in for the effects of RIAs on bilateral trade flows?

CHAPTER 2 REGIONAL INTEGRATION: MAJOR CONCEPTS

While the globalization experience of the world has been evolving, on the other side, nation-states have been searching for the opportunities that would preserve their national-interests. Membership in regional economic integration is regarded as one of such opportunities. Hence, regional economic integration is conceived as a way to gain privileged situation within the specified boundaries. As it will be studied in the following chapters, while preferential trade relations were mainly characterized by the colonial trade links in the first wave of globalization, arrangements existing in the the second wave of globalization have been supplemented by the legal environment of GATT/WTO system. In this chapter, the basic concepts related to regional economic integration will be presented. These concepts include the definition of regional integration, types of the regional integration agreements (RIAs) and the structure of RIAs.

2.1 Definition of Regional Integration

What regional integration or regionalism means in economic sense should be the starting point for understanding the overall concept of RIAs. In its dictionary meaning, regionalism can be defined as a foreign economic policy that defines the national interests of a country in terms of particular geographic areas. On the other hand, the WTO defines regionalism as actions by governments to liberalize or facilitate trade on a regional basis, sometimes through free trade areas or custom unions.

Before to study types of regional integration, remark on the concepts of regionalism and regionalization would be beneficial. Such remark will help further to clarify the meaning of regionalism. While regionalization is a process mainly driven by market forces of trade and investment flows, regionalism derives from state-led policies of cooperation and intergovernmental treaties (Gavin & van Langenhove, 2003, p.280). Differently, Ravenhill (2005, p.117) distinguishes regionalism as a formal process of intergovernmental

cooperation between two or more countries, and regionalization as the growth of economic interdependence within the specified geographical area.

2.2 Types of Regional Integration Agreements

Types of the regional integration agreements (RIAs) are mainly defined according to the different instruments which identified and limited the scope of regional economic integration. These instruments include preferential access for specified products, internal tariff elimination, determination of common external tariff (CET), free factor mobility, harmonization of economic policies and harmonization of political policies. The classification depicted in Table 2.1 shows that there is a hierarchical order between each type of regional integration agreement. For this reason, each subsequent type of the RIA covers the content of the previous type in addition to its own requirements. Accordingly, it is possible to distinguish six different types[1] of integration. These types are:

- **Preferential trade area (PTA)** which gives preferential access to certain products from the participating countries. This can be called as a limited or sector-based free trade area.
- **Free trade area (FTA)** that include the reciprocal removal of tariffs on member countries' goods. In an FTA, each member is free within the limits specified by the GATT/WTO system on deciding the level of external tariffs that will be applied to non-members. As there is flexibility on the interactions with the third countries, the members in an FTA are free to establish or join other FTAs. The leading examples are North American Free Trade Area (NAFTA), ASEAN Free Trade Area (AFTA) and European Free Trade Association (EFTA).
- **Customs union (CU)** which is a type of agreement that include determination of the common external tariff (CET), in addition to the elimination of the internal tariff rates. Generally, determination of the CET is done through taking an average of all partners' before-union tariff levels. For member countries, such cooperation

[1] While these six types depict that how regional agreements can diversify and extend its limits, this kind of classification mainly resembles to the evolution of the European Union (EU). The antecedent of the EU which is now at the level of EMU was the European Coal and Steel Community (ECSC, 1951) which can be counted as an intermediate agreement between free trade area and customs union (Dam, 1963, p.638).

in external tariffs can only be attained through the loss of autonomy in foreign economic policies. The examples include Andean Community, the CUs of EU with Andorra, San Marino and Turkey, and Southern African Customs Union (SACU).

- **Common market (CM)**, in which there is free factor mobility –capital, investment and labor– in addition to the customs union requirements that determine free flows of goods and services. This integration requires governments to employ coordinated actions in order to ensure the equal treatment for all factors in the member countries of the CM. Caribbean Community and Common Market (CARICOM) is one of the examples of this type.
- **Economic and monetary union (EMU)** which results from the enlargement of a common market with the additional requirement of the harmonization of economic policies, both monetary and fiscal. It further involves the creation of an independent regional central bank that has control over exchange rate policy and inflation rates. The only example that arrived to this level of integration is the European Union (EU).
- **Complete (political) integration (CI)** is a type of agreement which includes the harmonization of economic and political policies, and so as to become a single state. This kind of integration necessitates the loss of sovereignty and the creation of domestic institutions on the international level.

Table 2.1 Types of regional integration agreements and their coverage (Source: Savaş, 2004, p.177)

	PTA	FTA	CU	CM	EMU	CI
Preferential access to certain products	X	X	X	X	X	X
Tariff elimination		X	X	X	X	X
Common external tariff			X	X	X	X
Free factor mobility				X	X	X
Harmonization of economic policies					X	X
Harmonization of political policies						X

There is also another classification that is not referred too much. It is the "Economic Partnership Agreement" (EPA). This term is used to imply that the scope of the agreement is broader than the elimination of barriers of trade in goods (Aminian, Fung & Ng, 2008, p.10).Currently, there are more than seventy EPAs of the EU signed with the Africa, Caribbean and Pacific (ACP) countries. On the other hand, the Japan-Singapore bilateral agreement is called as the "New Age Economic Partnership" (Antkiewicz & Whalley, 2006, p.344).

As it will be studied in Chapter 7, FTAs are dominant types of the regional economic integration. Furthermore, the experience has shown that the proliferation in the number of RIAs has coupled with changes in the legal structure of the WTO system. At the beginning there was only the GATT Article XXIV that enabled the formation of FTAs and CUs, but in time, nation-states began to ask new legal open doors for deeper integration types, like the Enabling Clause of GATT and GATS Article V. Liberalization and elimination of trade-regulatory policies and harmonization of economic and political policies have become the new topics of regional economic integration beside trade policy measures. In other words, as Tinbergen (1965) dubbed them, "negative integration" involving the removal of discrimination and of restrictions on the trade flows has been supplemented by "positive integration" that require the coordination of member countries on modifying the existing policies and institutions together with the creation of new ones within the regional integration (Robson, 2000, p.2).

Hence, rather than using the term of regional trade agreements that emphasizes trade side, tagging these agreements as regional integration agreements (RIAs) would be a correct description of the existing agreements. Thus, the term 'RIA' covers all different types of economic integration.

2.3 Structure of Regional Integration Agreements

When the configuration of RIAs is taken into account, it is seen that the increasing number of RIAs implies the networks of RIAs that include intra- and inter-continental members. It is usually the case that one member of given RIA is also a member of another RIA. This

naturally results in overlapping RIAs and makes regional integration issue increasingly more complex. The simplest form of RIAs is bilateral agreement that involves two member countries. There are nearly 155 RIAs (covering goods and services) that are in force and between two countries, recently. This number constitutes more than half of the RIAs that are in force and notified to the WTO. The plurilateral agreements, on the other hand, include more than two member countries.

In the geographical context, while in most of the RIAs, member countries of the integration are neighboring countries, some RIAs cover members locating in different continents. Examples of these inter-continental RIAs include the US-Israel FTA, Chile-Japan FTA, Peru-China FTA. Although it does not fit into the above types of integration, the Asia-Pacific Economic Cooperation (APEC) that includes twenty-one countries from four continents. The more complex type of regional integration arises if one partner is itself an RIA, like FTAs/CUs between the EU and several countries (Israel, Jordan, Mexico, Syria, Turkey, etc.). EFTA and MERCOSUR are also involved in such integration agreements. Although EFTA-SACU (2008) the only up-to-date example, it is expected that the trend would let the emergence of several RIAs that involve the other RIAs as partners. For example, the EU is negotiating the formation of FTA with MERCOSUR.

RIAs can also be classified according to the development levels of member countries as North-North, North-South and South-South agreements. In this kind of classification, while “North” symbolizes developed countries, “South” symbolizes developing countries. Hence, the first type of these agreements includes developed countries as members and its subject area, that is its scope, tends to be more comprehensive than the other two agreements. The European Community (EC) was the first example of such agreements. The US-Australia FTA that came into force in 2005 is, on the other hand, another example of North-North agreements. North-South agreements, like North American Free Trade Area (NAFTA) and the Turkey-EU customs union, include partnership of a developing country(s) with a developed one(s). South-South agreements, like Latin American Free Trade Area (LAFTA) and Southern African CU (SACU), on the other hand, cover RIAs that are established by developing countries. South-South agreements are tend to be more relax on the subject coverage and the degree of liberalization.

CHAPTER 3 LITERATURE REVIEW

The relationship between RIAs and globalization has been studied from different perspectives throughout the literature. While Jacob Viner's (1950) work on the Customs Union was the first attempt of theorizing the welfare effects of RIAs, the following studies like Lipsey (1960), Cooper and Massell (1965) were extensions of the Vinerian analysis[1]. These studies significantly contributed to the development of this analysis. In the late 1980s, with the introduction of the New Trade Theory, several studies like Krugman (1991) and Frankel et al. (1996) included new factors like economies of scale and product differentiation in order to model regional economic integration. The 1990s, on the other hand, witnessed the emergence of studies that emphasized the effects of regionalism on the future multilateral trading system, like the 'dynamic analysis' of regional integration, Bhagwati (1993). In a similar vein, the studies on the political economy stance like Levy (1994), Grossman and Helpman (1995) and Krishna (1998) provided significant insights about RIAs and their effects on multilateral tariff liberalization.

Since there is a growing literature in regionalism debate, this chapter tries to survey some of these studies through categorizing them into three subsections. The first section will present a brief summary of selected studies that contributed to the theoretical development of regionalism. The second section will try to enlist some of the literature that focused on the relationship between regional economic integration and multilateral tariff liberalization, and on the effects of regional integration on multilateral free trade. The final section, on the other hand, will survey the literature studying the effects of regional economic integration on member and non-member countries.

[1] Although classical economists like A.Smith (1776), Ricardo (1817) and McCulloch (1832) had mentioned about trade-diverting effects of of preferential commercial treaties, theory of economic integration dates back to the 1940s that include the studies of de Beers (1941), Tinbergen (1945), Byé (1950) (Robson, 2000, p.8). The study of Balassa (1961), on the other hand, was the first for the systematic analysis of this theory (cited in Halıcıoğlu, 1996, p.4).

3.1 Theoretical Studies on the Effects of Regional Integration

As it is stated, theory on the welfare effects of regional economic integration stems from Viner's (1950) "The Customs Union Issue". Prior to this study, the customs union was seen as a movement toward free trade and as a way to increase world welfare. As the father of the concepts of trade-creation and trade-diversion, Viner had showed that the formation of customs union was not necessarily a welfare-improving process. While trade-creation effect arises in the case of "one of the members of the customs union will now newly import from the other but which it formerly did not import at all because the price of the protected domestic product was lower than the price at any foreign source plus the duty", trade-diversion effect arises in the case of "one of the members of the customs union will now newly import from the other whereas before the customs union it imported them from a third country, because that was the cheapest possible source of supply even after payment of duty" (Viner, 1950, p.43). Accordingly, net welfare effect of customs union will depend on the extent of these two effects. For a customs union to operate in the free-trade direction, Viner (1950, p.51) suggests the larger economic area, the lower average tariff level on post-integration imports from non-members, the less degree of complementarity of the member countries with respect to protected industries, etc.

The analysis presented in Viner (1950) had been critized from several points, and resulted in extensions on the issue. For example, Lancaster and Lipsey (1956-57) take the Vinerian analysis as "The General Theory of the Second Best". In this theory, if it is impossible to satisfy all of the optimum conditions, then a change in some of these conditions could cause better or worse outcomes (cited in Lipsey, 1960, p.498). In addition to this, they criticize the Vinerian analysis further due to its focus on the trade shifts from one country to another and its ignorance on the effect of the substitution between commodities that derived from the changes in relative prices (ibid., p.499).

The substitution effect in consumption entered into the customs union theory through the works of Meade (1956), Gehrel (1956-57), and Lipsey (1957) (cited in Lipsey, 1960, p.501). Gehrel's conclusion in favor of the gains rather than the losses of the customs union is criticized by Lipsey (1960) because of taking into account two commodity case.

Lipsey (1960) states that in order to derive the valid conclusions on the customs union theory it is necessary to consider at least three types of commodities (domestic commodity, imports from partners, imports from the outside world). Additionally, Lipsey (1960) proposes the distinction of inter-country substitution that would embody trade-creation and trade-diversion effects of Viner (1950), and inter-commodity substitution that would derive from the changes in relative prices. His analysis together with the analysis of Meade (1956) lead Lipsey to conclude that "when only some tariffs are to be changed, welfare is more likely to be raised if these tariffs are merely reduced than if they are completely removed" (ibid., p.507). Lipsey also makes another generalization[1] that relates the gains from inter-commodity substitution to the size of expenditure on previously mentioned three classes of goods. From these generalizations, Lipsey (1960, p.508) concludes that "the sort of countries who ought to form customs unions are those doing a high proportion of their foreign trade with their union partner, and making a high proportion of their total expenditure on domestic trade".

Another extension on the Vinerian analysis came from the study of Dam (1963). Dam (1963) interpretes the Viner's trade-diversion and trade-creation effects as the model of production side and includes consumption effects to measure the overall impact of RIAs together with the production effects. Accordingly, the ratio of prices paid for domestic goods to that for partner goods and the ratio of prices paid for partner goods to that for non-member goods will be changed by the formation of FTA, and "consumers will tend to find prices of member goods cheaper, relative to the pre-free-trade area situation, than either local goods or nonmember goods" (ibid., p.626). Hence, this will result in favorable (substitution of member goods for local goods) and unfavorable consumption effects (substitution of member goods for nonmember goods). Dam (1963, p.628) concludes as "… the smaller the range of goods imported from nonmember countries relative to the range of goods imported from member countries, the smaller the unfavorable and the greater the favorable consumption effects".

The study of Cooper and Massell (1965), on the other hand, derives the pure theory of the customs union theory which is based on the Lipsey's extension of the Vinerian trade-

[1] This generalization derives from Lipsey's doctoral thesis: Lipsey, R.G., 1958, "The theory of customs unions: A general equilibrium analysis", Unpublished Ph.D. thesis, University of London.

creation and trade-diversion analysis. The study rules out the effects like terms of trade and economies of scale from the pure theory. By splitting the welfare effects of a CU into two as "tariff reduction component" and "pure trade diversion component" (ibid., p.743), authors states that the former component is the only source of any gain in consumers' welfare in the integrated union. Accordingly, this component accounts for the consumption effect introduced by Lipsey (1960) and the trade creation effect of Viner (1950). The overall effect of the union will depend on the relative magnitudes of the two components in which tariff reduction component represents the gain side, pure trade diversion represents the welfare loss side of a CU. In the welfare analysis, the study concludes that since a CU necessarily causes in trade diversion, as a result welfare loss, appropriate policy of non-preferential protection would result in better welfare effects relative to the customs union option. The authors further criticizes the Viner's analysis taking into account customs union as an acceptable policy option but not taking into account a tariff reduction policy.

The study of Arndt (1968) starts from the 'inferiority of the customs union relative to the non-preferential protection' assertion suggested by Cooper and Massell (1965) and argues that the argument is not valid due to not taking into account the effect of integration on the terms of trade. With three-country two-goods model, the study concludes that two countries acting together may gain in economic terms, relative to the case where one country acts alone, due to the terms of trade effect of the union which result in a "net improvement in welfare over any non-preferential tariff situation" (ibid., p.976). Kemp and Wan (1976), on other hand, emphasizes the importance of the design of RIAs on the expected outcomes. The study shows that the optimal tariff constructed so as to leave non-members' trade unaffected would improve the welfare of member countries as well as the welfare of world. The argument raised in Cooper and Massell (1965) is also critized by Wonnacott and Wonnacott (1981). The study suggests that small countries can gain from the formation of regional integration in the presence of transport costs.

With the advance of the new trade theory, the concepts of imperfect competition, economies of scale and product differentiation has become important determinants of international trade. In this vein, Krugman (1991) studies the model consisting B identical blocs and N identical countries, each producing one differentiated product. While transport

costs are not taken into account, the model is further based on the concept of natural trading partners which states two countries as natural partners in case of high initial volumes of bilateral trade and low distance between them. According to this setting, as the number of blocs declines through further integration, each bloc starts to consume from the share of the other blocs. The study finds the maximum number of blocs as three.

The extension of Krugman (1991) model comes from Frankel, Stein and Wei (1996). The study emphasizes the role of transportation costs on determining the desirability of RIAs and includes transport costs to the model of Krugman (1991). Accordingly, the magnitude of these costs will determine the optimal level for the extent of regional integration.

On the other hand, Panagariya (1998) offers an example in which the formation of a PTA with a distant partner is superior relative to the one with proximate partner. The author states that the studies like Wonnacott and Wonnacott (1981) and Frankel et al. (1996) that emphasize the importance of proximity or transport costs on the formation of PTAs are misleading due to their highly specific assumptions and/or selected variables of the simulations. Accordingly, all sources of cost (transportation costs, costs arising from differences in technology/factor endowments) have equal significance for the trade flows.

Goto and Hamada (1999) study the effects of regional integration under the assumptions of constant tariffs and asymmetric bloc formation as an extension of the Krugman (1991) framework which assumes symmetric blocs. The study states that welfare first increases with the expansion of the bloc, but when approximatley half of the world is participated into this bloc, welfare starts to decrease with new members.

3.2 Studies on the Relationship between Regional Integration and Globalization

After 1980s, the Vinerian seminal work has considered as representing the static nature of preferential trade agreements. Dynamic analysis that deals with the long-run relationship of regionalism and multilateralism has considered two time-path questions of Bhagwati (1993). While the first time-path question inserts the assumption that time-path of regional economic integration does not affect (or influence) the one of multilateral trade

negotiations, the second time-path question considers the case where there is a interrelationship between the trends of regional economic integration and multilateral trade negotiations.

The first question concerns the incentives of non-members to be a member and the willingness of the member countries to offer entry until the utmost outcome of global free trade. Baldwin's (1993) study is in line with this question. Baldwin employs the 'domino theory' that emphasizes the existence of idiosyncratic events on creating economic rationale for non-members to participate in the RIA. These events consequently bring about a multiplier effect that "knocked down bilateral import barriers like a row of dominos" (Baldwin, 1997, p.877). In his framework, Baldwin gives the US-Mexico FTA, NAFTA, MERCOSUR, the completion of the EC's Single Market and the weakening of the USSR as the examples of shocks that triggered dominos, i.e. pushed non-members to apply for membership in RIAs. From this empirical evidence, Baldwin (1993) concludes that the domino effect will eventually lead to global free trade. In response to the critiques of not taking into account the resistance of members for new memberships, Baldwin (1997, p.878) states this would not change the result and notes that "the new political economy flames may find vent in preferential arrangements among excluded countries".

The second time-path analysis of Bhagwati (1993) focuses on the determination of whether RIAs will be the 'building blocs' or the 'stumbling blocs' in front of the worldwide non-discriminatory free trade. In line with this distinction, present section will survey firstly studies that emphasize regional integration as a contributing factor to the processes of multilateral tariff liberalization and multilateral free trade. Secondly, the opposing arguments on regional integration and multilateralism are to be studied.

Ethier (1998) employs many-country, specific-factors model in order to assess the relationship between regionalism and multilateral world. The author, as a result, emphasizes that rather than threatening multilateralism, regionalism is the direct consequence of the success of of multilateral liberalization. In a similar vein, Freund (2000) employs oligopolistic model of trade with three countries import and export one imperfectly competitive good. The study concludes that as welfare gain from membership

in an RIA is greater when tariffs are low, each round of multilateral tariff liberalization should be accompanied by an increase in the number of RIAs.

Kim and Shin (2002) employ social network approach for the analysis of regionalism and globalization. Their results indicate increase in overall network density between 1959 and 1996. According to this, they conclude that world trade has been globalized. Another result that is increase in the intraregional density, on the other hand, supports the idea of regionalized trade. The authors entail this two-sided improvement in international trade to the fact that globalization and regionalism are not contradictory processes.

Woolcock (2003) by comparing the provisions of the EU-Poland, the EU-Mexico, Euro-Med, NAFTA, Chile-Canada FTA and Closer Economic Relations (CER) agreements with the provisions of the GATT/WTO states that these agreements generally are WTO-plus (or GATS-plus). As a result, Woolcock concludes that the RIAs tend to complement rather than undermine multilateral rules.

Ornelas (2005) asserts that when considering the effects of FTAs, both determination of external tariff level and participation in an FTA should be treated as endogenously determined concepts. Accordingly, taking into account endogeneity of these policies would reduce the importance of special interests in an FTA. In this set up, when members of an FTA lower their internal trade barriers, they tend to reduce their external tariffs as well. Consequently, an FTA formation would result in support for further multilateral liberalization.

Baldwin (2006a), on the other hand, studies the political economy framework for the trade liberalization by categorizing it into three mechanisms, as the ‘juggernaut effect’ for multilateral trade liberalization, the ‘domino effect’ for regional trade liberalization, and ‘race to the bottom unilateralism’ for unilateral trade liberalization. The author also states three ancillary political economy logics that are interacting with the above mechanisms. These are intra-sectoral special-interest politics, asymmetric lobbying effects and the magnification of footloose-ness. Examining the period starting with the Reciprocal Trade Agreement of 1934, Baldwin states that multilateralism, regionalism and unilateralism are

not substitutes, but complements of each other. Furthermore, the author calls the proposed political economy framework as the 'spaghetti bowls as building blocs' mechanism.

Pomfret's (2007) study examines regionalism issue from the historical perspective. The author distinguishes three waves of regionalism as the first wave covering 1950s and 60s, the second wave covering the period of 1980s until the establishment of WTO, and the third wave from the early 2000s onwards. He states that "regionalism has twice [*in the first and second waves*] appeared as a terminal threat to the GATT system but multilateralism emerged stronger ever after the Kennedy and Uruguay Rounds" (ibid., p.925). For the third wave prevailing now, he again emphasizes the strength of WTO system in the international economics. The author points out other factors like Multifibre Arrangement quotas and the use of agricultural safeguards as elements that are more important types of discrimination than RIAs. Accordingly, regionalism does not threaten multilateral trading system as significantly as it is generally announced.

There are also some studies that interpret regional integration as an impeding factor in front of multilateralism. For example, Levy (1994) forms his analysis through a median voter model in which voters in two countries are opting for membership in an FTA or sticking to multilateral liberalization. Accordingly, in a model based on the Heckscher-Ohlin framework, an FTA option can not make feasible multilateral liberalization as infeasible; it can not also make previously infeasible multilateral liberalization as feasible. However, when the model is extended to consider product differentiation, expected effects arising from the formation of an FTA change significantly. With this kind of model, a given FTA can constitute a stumbling bloc in front of the global free trade due to trade gains that result from differences in factor endowments and product variety.

Grossman and Helpman (1995), on the other hand, study the formation of an FTA in the political economy framework that emphasizes the interaction between special interest groups and governments. The study concludes that governments respond to pressures of industry special interests, but they also take into consideration the average voter. The authors state that if some industries can be excluded from the scope of an agreement, then the likelihood of signing this agreement would improve (ibid., p.687).

Krueger (1997) asserts that political economy of FTAs will lead these agreements to be stumbling blocs in front of further multilateral trade liberalization than will customs unions. This mainly derives from the fact that FTAs include rules of origins that are governed by special interest groups.

Bagwell and Staiger (1998, 2002) employ a general model that includes governments that are motivated by political and terms-of-trade considerations in order to evaluate the effects of reciprocal trade agreements on multilateral trading system; especially on non-discrimination, reciprocity and enforcement mechanism. Through politically augmented terms-of-trade approach, they show that these agreements may retard the effectiveness of reciprocity and non-discrimination. Accordingly, as free trade areas violate most favored nation (MFN) principle, the efficiency properties of a multilateral system that depends on the principles of reciprocity and non-discrimination will be damaged. For the customs union case, the only multilateral-friend type is possible when all external tariffs are set to conform to the principle of non-discrimination. On the enforcement issue, the consequence of RIAs is ambiguous and depends on the time period of analysis, the extent of trade diversion and the extent of multilateral cooperation. The authors conclude that RIAs may constitute a potential threat for multilateral trading system.

Krishna (1998) employs a model of imperfect competition with oligopolistic firms producing substitutable goods, in order to study the conditions for partners' support for a bilateral agreement and the impact of FTA formation on the incentives of continuing on multilateral trade liberalization. He asserts that the more trade diverting FTA between two countries, the more likely it will be supported and more it counteracts against the multilateral trade liberalization. Hence, with certain amount of trade diversion, the initially feasible multilateral liberalization can become infeasible as a result of the special-interests-based FTA.

Bond, Riezman and Syropoulos (2004) work with a three-country general-equilibrium model to determine the likely effects of an FTA formation on the tariff and welfare levels of all countries. Accordingly, the formation of FTA may undermine multilateral trade liberalization if member countries employ optimal external tariffs. However, it is stated

that as member countries tend to lower their external tariffs after the establishment of FTA, this will improve terms of trade and welfare of the excluded country. If the member countries are sufficiently large, then trade-creation induced welfare improvement will dominate and FTA will be beneficial for the members, too. As a result, the welfare gains on both sides may undermine the attainment of global free trade.

Limão (2006a), on the other hand, uses data on the US tariffs with the distinction of PTA goods that are covered by PTA and non-PTA goods that are excluded within the integration. The study states that MFN tariffs for PTA goods of the US are higher on ninety percent of all goods than they would be in the case of not forming PTA. The study concludes that PTAs of the US constitute a stumbling bloc to multilateral trade liberalization of the US. Estimating the difference in MFN tariff reduction between PTA and non-PTA goods for the EU and the US cases, Limão (2006b) finds that PTAs of these important traders result in delay on multilateral tariff liberalization and increased discrimination via non-tariff barriers.

3.3 Studies on the Effects of Regional Integration on Members/Non-members

This section will survey the studies that consider the effects of the formation of RIAs on member and non-member countries. For example, Brada and Méndez (1985) take into account three developed (the EEC, EFTA and CMEA) and three developing country (CACM, LAFTA and the Andean Pact) integration schemes. They conclude that an effective integration is possible for both groups. They also note that while inter-member distances limit the benefits of integration in Latin America, the system and policy differences of CMEA relative to the market economies do not change the expected results. On another study, Brada and Méndez (1988) study dynamic effects of regional integration on investment levels and factor productivity growth for six integration schemes (EEC, EFTA, LAFTA, CACM, EACM and CMEA). For the period 1951-77, the study concludes that the impact of dynamic effects of integration is no more than 1 per cent of members' GNP. Hence, the dynamic effects are neither a reason of raised growth rates nor a *raison d'être* for integration for the given sample.

Shiells (1995) starting with the examination of economic and non-economic motives for the formation of RTAs emphasizes the necessity of considering the welfare gains of RTAs beside their trade-creation and trade-diversion effects. Nationalization of existing industry structures, FDI flows and dynamic gains from learning by doing, improved product quality, greater product variety are proposed as further welfare gains entailed to such agreements.

Wonnacott (1996) states that trade diversion would increase competition and specialization, beside its supply-switching effects. Overall, this process can make member of an FTA the lowest-cost source. The study also incorporates the hub-and-spoke analysis[1] to the issue of overlapping FTAs and concludes that diversion will increase as a result of this overlap and hub (center of integration) rather than spokes is the probable gainer in such a system.

Wei and Frankel (1998), on the other hand, state that in a world of increasing trade blocs, an open regionalism (defined as the reduction in barriers on imports from third countries) with a modest external liberalization can be welfare improving, but not as much as the one that will attained as a result of multilateral tariff liberalization. Moreover, as it is stated in Frankel, Stein and Wei (1996), the international trade rules should be modified to ensure welfare-improving RIAs. Rather than complete elimination of internal barriers (required by Article XXIV), the partial internal liberalization serves better results in this respect.

Cadot, De Melo, and Olarreaga (1999) use three-good, three-country model to examine the effects of regional integration on the external trade policies of member countries. The study concludes that protectionist pressures against non-member countries will increase as a result of the deepening integration and states that trade-diverting RIAs are the ones that are politically most viable.

Antkiewicz and Whalley (2006) takes into account regional trade agreements covering Brazil, Russia, China, South Africa and ASEAN as large-population and rapidly growing

[1] The hub-and-spoke analysis of RIAs is as follows if one member of the agreement has also other RIAs with a number of countries that keep trade barriers against each other, then this member becomes the hub, i.e. the preferred location, for investment flows (Schiff & Winters, 2003, p.78).

non-OECD economies. Accordingly, recent agreements covering these countries include WTO-plus subjects like intellectual property, competition policy and mutual recognition, beside their own dispute settlement procedures. For this group of countries, the study emphasizes that although the agreements are in line with WTO disciplines, they represent some kind of a response to multilateral failures like "Multilateral Agreement on Investment (MAI) and the repeated Doha Round setbacks" (ibid., p.346)[1].

Baharumshah, Onwuka and Habibullah (2007) investigates the (ASEAN-5)+3 economies (Malaysia, Indonesia, Philippines, Singapore and Thailand, plus Japan, China and South Korea) in order to find out that whether regional integration is an obstacle in front of the multilateral trade liberalization or not. For the period 1967-2000, the study tests the existence of any long-run relationship between regional and multilateral terms of trade and concludes regional trade integration does not hinder the global integration in the region. Accordingly, two forms of liberalization (preferential and multilateral) are complementary to each other for the given sample of countries.

Ornelas (2008) states that, in addition to endogenous external tariff formation (stated in Ornelas (2005)), if RIAs provide non-trade gains, like investment liberalization, infrastructure cooperation and harmonization of competition policies, to their members, distributive asymmetry arising from the formation of RIAs in favor of member countries could be altered, and both members and non-members could gain from regionalism.

As a final note, it would be beneficial to cite the study of Abrego et al. (2006) which relates the outcome of a given study to the model specification employed. Through computational techniques, the authors test the validity of various propositions in the literature on regional integration agreements. The study compares free trade and three-country non-cooperative (Nash) equilibria with partial cooperation regional agreement equilibria where two countries form a customs union and play noncooperatively against the non-member country. Eight propositions that are taken into consideration are as follows: 1. Both members benefit from a customs union relative to free trade. 2. Both members benefit from a customs union relative to Nash equilibrium. 3. A customs union increases world

[1] Authors call MAI and Doha Round as 'multilateral failures', for these two initiatives couldn't become effective.

welfare relative to 3-country Nash equilibrium. 4. Customs unions are a “stepping stone” to free trade (i.e. members are better off in CU relative to Nash, and members gain from free trade). 5. A customs union results in higher external tariffs for member countries relative to Nash equilibrium. 6. A customs union improves member countries’ terms of trade relative to Nash equilibrium. 7. A customs union increases member countries’ volume of trade relative to free trade. 8. A customs union increases member countries’ volume of trade relative to Nash equilibrium. As a conclusion, the authors state that the given propositions related to regional integration are not largely true and the outcomes will mainly depend on the model characteristics employed in a given study.

CHAPTER 4 HISTORICAL PERSPECTIVE ON GLOBALIZATION AND REGIONAL INTEGRATION

Regional economic integration and globalization are not new concepts to the world. History of regional economic integration is much older than the one of globalization. But, as globalization is much wider concept, in economic/political sense, than the regionalism concept, this chapter will study firstly the brief history of globalization. After studying the history of globalization, the history of regional economic integration will be covered shortly. As the main concern of this study is regional economic integration prevailing in the GATT/WTO system, this history will begin with the GATT (1947) as its inception.

4.1 Brief History of Globalization

When it is measured by the ratio of world trade to world output, the history of globalization has been generally divided into two stages or waves as the first wave and the second wave of globalization. While the first wave of globalization involved the period between the years 1870[1] and 1914, the second wave that is related to the modern world has started to develop in the 1950s and become dominant on the stage of international order since the late 1980s. Hence, this section will initially study history of the first wave of globalization, and then history of the second wave.

4.1.1 First wave of globalization

The factors behind the first wave of globalization were several. The leading contributors were as follows: the industrial revolution in the Western countries; the colonization policies of the hegemonic powers like Britain, France, Spain, Netherlands, Italy and Belgium; the technological advances in transportation and communication; the

[1] For the period 1500-1800, there were also growing trade volumes, especially in Europe, but the main reason for such an increase was the "…outward expansion of European import demand fuelled by population growth or Asian export supply rather than by market integration *per se*" (O'Rourke & Williamson, 2002a, p.426).

international monetary system of the time; the hegemonic power and 'the last resort' role of Britain; bilateral trade agreements throughout Europe and the lower tariff levels prevailing in the international trading system.

Industrialization had resulted in increase in the intensity of trade via the advances in production techniques. Industrialized countries of Western Europe exported manufactured goods and capital which in turn "fueled the growth of primary exports, such as wheat and beef from Argentina, wool from Australia, rubber from Malaya, tea from Ceylon" (Findlay, 1996, p.49). The industrial revolution had changed not only the economic patterns of the old world, but also the political balances. With increased military and industrial power, West European countries consequently started to search for new markets to dominate in the 1840s. This search eventually gave rise to the colonization period. The emergence of colonial empires at the end of the nineteenth century can be stated as a reaction to stagnant trade among European countries and "the need to expand markets in a period when protectionism on the rise" (Alesina, Spolaore & Wacziarg, 2000, p.1291).

Hence, the colonization policies of the leading countries had been the utmost factor behind the spread of globalization in the first wave. To increase their economic relationships with the colonized countries, imperialist countries had removed restrictions, be it tariffs or quotas, on their mutual trade. As a result, the first examples of preferential trade relations, i.e. RIAs, were seen in the colonial relationships of hegemonic powers.

Technological developments in transportation and communication were other contributing factors behind the growth of world trade in the first wave of globalization. Improvements in long distance transportation through completion of the Suez Canal and of the Union Pacific railroad in 1869, invention of the steamships and construction of the new railroads made cross-country transportation easier in this period. These factors together with other productivity developments on long-distance transportation led price gaps between Britain and Asia to decrease (O'Rourke & Williamson, 2002b, p.38). Transport costs, which fell significantly before 1914, but then increased sharply up to 1939 due to protectionist policies, consequently played a significant role on the upward and the downward movements of trade. The assembly of telephone and telegraph cables under the oceans, on

the other hand, had facilitated the overseas communication, as a result international trade, since 1859.

Additionally, the beginning and the end years of the first wave of globalization, i.e. 1870 and 1914, have another significant feature in the area of international economics. That period has been dubbed as the period of international gold standard. Besides being the first global monetary system, the international gold standard system depended on full convertibility of currencies to the gold and free export and import of gold. When it is taken account that "payment frictions associated with currency regime" is one of the barriers of trade, it would be easy to conclude that the natural outcome of gold standard was increased international trade (Estevadeordal, Frantz & Taylor, 2003, p.362). Hence, it has been argued that the effect of common currency explained a large portion of the change in trade volumes in the first wave of globalization. In addition to the common currency system, the Napoleonic Code, which represented a common legal coding on international trade and business, had further contributed to the development of international integration (Savaş, 2004, p.16).

The Great Britain's financial and the "lender of last resort" roles on the first wave also deserve attention. Free trade ideology prevailing in that period started with Britain's movement in the 1840s through the removal of exports and imports taxes, and the repeal of the Corn Law. Accordingly, the repeal of the Corn Law was seen as the ultimate victory of the Classical liberal economic doctrine over mercantilism (Chang, 2007, p.28). Bilateral trade agreements, initiated through steps taken by Britain, were also one of the elements of the first wave of globalization. The Cobden-Chevalier treaty of 1860 that freed trade between Britain and France was the first example of such agreements in the period[1]. The other countries had followed suit, and similar treaties had been signed all over the Europe in those years. At the same time, the newly founded countries like Germany incorporated the principle of free trade as their basic national policy. Eventually, free trade ideology had been accepted, willingly or not, by most of the remaining countries[2] through colonialism

[1] It is noted that the degree of protectionism in France was already quite low relative to the one in Britain on the eve of the treaty (Chang, 2007, p.33).
[2] The US that maintained very high tariffs was the obivous exception to the free trade trend (Chang, 2007, p.30).

and through “unequal treaties in the cases of a few nominally independent countries like the Latin American countries, Thailand [formerly, Siam], China, and the Ottoman Empire” (Chang, 2007, p.25).

The factor of low tariff levels, although promoted global integration, was not specific element of the first wave of globalization. Since the idea of free trade was dominant prior to the first wave of globalization, trade restrictions were low during the period. Among the European countries, free trade ideology had further spreaded via the colonization process and the political wars among the leading nations. On the other hand, for the leading power of Asia, namely for Japan, the ‘Meiji renovation’ had taken free trade into account as an integral part of the economic and social life. Nevertheless, the minimal role of tariffs throughout the world continued until 1914, even though this situation had been reversed after that time.

The outbreak of the World War I (WWI) had ended the first globalization period of the world. After World War I, many countries ran into severe financial disorders and rapid inflation rates (hyperinflations for some). While Britain lost its hegemony through the breakdown of its financial system, most of the countries turned into protectionist policies. The Great Depression of 1929 had further worsened the situation. Until the World War II (WWII), without any ruling power or the international institution, international order was left to its own. While the US raised tariffs via the Smooth-Hawley Tariffs (1930), Britain –the leader of the *laissez-faire* policies of the previous period– turned into tariff protection in those years. Furthermore, many of the US trading partners like Canada, Cuba, France, Mexico, Italy, Spain, Australia and New Zealand increased their tariff rates as a response to the Smooth-Hawley Tariff Act (Bagwell & Staiger, 2002, p.43). As Haberler (1964, p.7) notes: “Tariffs everywhere were raised rapidly and almost all countries introduced quotas, exchange control, import prohibitions, bilateral clearings – methods of international trading which in peacetime had literally not been known for centuries.”

For the international trading system, the conditions prevailing in the interwar period can be summarized as (League of Nations, 1942, p.101; cited in Bagwell & Staiger, 2002, p.44): “While there were frequent international conferences and committees in which

governments proclaimed their intentions to pursue 'freer and more equal trade', it is also true that 'never before in history were trade barriers raised so rapidly or discrimination so greatly practiced." Hence, in spite of the continued economic growth, due to protectionism that grew in the 1920s, trade expansion of the previous decade had turned into a trade contraction in the interwar period.

4.1.2 Second wave of globalization

After the World War II (WWII), protectionist tendencies of the past thirty years had been partly eliminated by the attempts of two powers, namely Britain and the United States. The intention was to reform the world order. The scope for change involved not only international trade, but also the financial system and the growth of national economies. Global reconstruction was concentrated on the formation of international (multinational or supranational) institutions to organize financial relations, developmental issues and international trade. One of the resulting institutions of the so-called "Bretton Woods Conference" (1944) held in Bretton Woods (New Hampshire) was the International Monetary Fund (IMF) which was supposed to provide an orderly framework for monetary relations. Another one was the International Bank for Reconstruction and Development (IBRD, later the World Bank, WB) that was formed in order to mobilize available resources for reconstruction and development.

In the international trade side, the Economic and Social Council of the United Nations (formed in 1945) was the responsible body of multilateral trade negotiations. However, the Council adopted a resolution that envisaged the formation of International Trade Organization (ITO) (Matsushita, Schoenbaum & Mavroidis, 2003, p.1). The following negotiations on this formation were held in New York (1947), in Geneva (1947) and in Havana (1948). With the Geneva meetings, it was decided to prepare a multilateral treaty that aimed to clarify the codes of international trade. As a result, the General Agreement on Tariffs and Trade (GATT) that aimed to direct the orderly conduct of trade and to promote trade liberalization had been completed by the end of 1947. However, for the formation of the ITO, the planned program did not work well. Even though being the ideological founder of the new order, the United States whose decision was vital for this formation did

not approve the legislation that would enable the establishment of ITO[1]. Hence, the ITO was dead before its birth. However, international trade should not be left alone; as a result, the establishment of ITO had been substituted by "a Protocol of Provisional Application to apply the GATT provisionally on and after January 1, 1948" (ibid., p.2).

The seeds of the second wave of globalization came into existence through these international institutions. At first sight, one big difference between the first and second waves of globalization can be noticed. It is the existence of international organizations. The role of these institutions is to arrange, when it is necessary, the smooth working of the international system on their subject area. Additionally, the role of hegemonic power –namely, the United States, at this time– and the other leading countries should also be clear in this new system. Hence, while the first era of globalization was obviously characterized by the imperialist ideology of the leading powers, the second era can also be said to be characterized by hegemonic powers, but in this case in a disguised form, i.e. via Bretton Woods Institutions and the GATT system[2].

Taking into account the ratio of world trade to world output leads the conclusion that although there has been a general trend toward freer trade after WWII, trade as a share of world output does not seem to have improved to its 1913 level until the mid-1970s (Krugman et al., 1995, p.330). Albeit it is not easy to compare two periods due to the different time-related characteristic features of the history and present, when it is looked at the statistical figures, the following comparison can be noted about the two (O'Rourke & Williamson, 2002a, p.422):

> The growth of world trade was pretty much the same in the nineteenth and twentieth centuries, roughly 3.7 or 3.8 per cent per annum. This is a surprising fact, given that world GDP growth doubled from 1.5 to 3 percent per annum between 1820-1913 and 1913-1992. Since the growth of world trade was almost identical in the two centuries, it follows that trade shares rose much faster in the nineteenth

[1] In fact, with the success of the Republicans in the 1948 election, President Truman did not send the legislation for the ITO to the Congress (Matsushita et al., 2003, p.2).
[2] During the first decade after the WWII, the US was the unique hegemonic power.

century than in the twentieth century. So far, it looks as though the nineteenth century is the canonical globalization epoch *par excellence.*

In the second wave of globalization, declining political barriers to trade and fast income growth –especially in the late twentieth century– have also been seen as a link between distant markets. Moreover, there are several new features of the modern trade relative to the past experience such as the rise of intra-trade (trade in similar industries), splitting production process into different geographic areas and the emergence of countries that have high ratios of trade to GDP (like Singapore and Hong Kong). While in the first wave, trade was mainly based on the comparative advantage (countries traded what they could not produce themselves), in the second wave, with declined transportation costs, trade in similar goods or intermediary products has become significant and resulted in increased bilateral trade ties between countries that have similar endowments. Expansion of trade in services, developments in the commercial law, increased acquaintance with doing business abroad have further contributed to the growth of world trade (Krugman et al., 1995, p.332).

In addition to these, although they do not represent complete diversion from the elements of the first wave of globalization, there are some significant factors that contributed to the integration pace of the second wave (Savaş, 2004, p.31-35). First of all, the adoption of floating exchange rate system instead of fixed exchange rate system has changed the working of underlying principles in international economics. Secondly, "import substitution" strategy in which states apply domestic protection on vulnerable sectors has been substituted with the "export promotion" strategy that emphasized the place of openness and trade for economic development. Thirdly, advances in information technology have resulted in increase in the speed of capital mobility. Technological innovations, trade and capital account liberalizations are the integral parts in both waves of globalization. While in the first wave technological developments depicted themselves in railroads, steamships, and the advances in communication, developments in the airfreight and advances in the information technology that skyrocketed via computers, mobile phones, and internet have been the primary technological advancements of the second wave. The technological and organizational innovations in the production system, i.e. changing the pattern of production from "fordism" to "post-fordism", have also

significantly facilitated international integration. Moreover, while there had been both trade and capital liberalization mainly as an end result of colonialism in the first wave, in the second wave, related liberalizations are either employed unilaterally, or enforced by the international institutions.

Beside gradual decreases in the level of trade restrictions through the successive "rounds" of the GATT and advances in production systems, afterwar period has also witnessed rapid increase in the number of countries. While in 1920, there were 69 countries in the world, the number increased to 89 in 1950 and 192 in 1995 (Alesina et al., 2000, p.1292). Now, there are approximately 200 countries in the world[1]. But this rise in the number of countries does not represent the increased participation to the global management of international trade, finance or politics. It cannot be said that it is the game of equals. Throughout the world, 'triadization' that emphasizes the dominance of Japan and the newly-industrialized states in the South and South-East of Asia, Western Europe and North America on the process of technological, economic and socio-cultural integration is another fact of the second wave of globalization (Adriana, 2008, p.315).

4.2 Brief History of Regional Integration

Regional integration agreements (RIAs), either formed for economic reasons or for non-economic reasons, have been on the stage of international trade for hundred of years. To be able to study the brief history of these agreements, a good starting point would be the establishment of the GATT system, because with the introduction of the GATT system RIAs gained their legal legitimacy. After giving some remarks on the history of regional integration prior to the GATT system, the next section will study the key concepts of the GATT system, together with the underlying rationale for the introduction of the GATT Article XXIV, which is the first legal clause governing RIAs. On the other hand, in the final section, history of regional integration that spans from the initiation of GATT to the present day will be studied.

[1] Due to political considerations, the number of countries tends to change according to the various sources. For example, the US accepts 194 countries, the inclusion of countries like Northern Cyprus, Taiwan, etc., brings this number to 200 (and even more).

4.2.1 Before the GATT system

Prior to the first wave of globalization, there were several examples of RIAs. For example, a customs union (CU) of the provinces of France was proposed in 1664 and commercial union among Austria, Bavaria, Spain and some German principalities was formed in 1665. Austria had also signed free trade areas (FTAs) with five of its neighbors during the 18th and 19th centuries. In 1823, another two countries of Europe, namely, Great Britain and Ireland established a customs union. CUs were also precursors to or were embodied in the creation of new states like Germany (the Zollverein, 1833), Italy, and the United States. In 1854, the US and his neighbor Canada signed a Reciprocity Treaty that removed all import taxes on national products. In Africa, there were also similar attempts of regional integration. The examples were South African CU formed in 1910 and the CU between Kenya and Uganda formed in 1917.

In that period, as it is stated earlier, the main driving force behind the formation of RIAs was the colonial relationships. The colonial empires were based on preferential trade arrangements. While the industrial and technological developments advanced in the hegemonic powers had created the impetus for the first wave of globalization, the liberal ideology of the previous decades had slightly changed its way of expression. The colonization experience, that enabled the formation of RIAs between colonized and imperialist countries, was a key to liberalize international trade.

When the liberalism ideal of the nineteenth century slowed its pace with the outbreak of WWI, the Great Depression of 1929 further retarded the international integration. It has been argued that fragmentation into closed blocs had caused inefficiency and made recovery from the Great Depression harder (Schiff & Winters, 2003, p.4). Consequently, national economies had turned into more protective policies by imposing high tariff barriers until the end of the WWII.

While protectionism was increasing all over the world, hegemonic power of the time, that is the US, decided to intervene to this trend in order to enhance international trade links. Hence, this concern came out via the US Reciprocal Trade Agreements Act of 1934 and

resulted in the initial discussions for the coordination of international trade. The main objective of the Act was to offer tariff concessions to other countries as a way of lowering these countries' tariff levels and thereby promoting exports and employment of the US (Kreinin & Schmidt-Levine, 1996, p.35). What is more, the underlying principles of the US attempts for this Act can be stated as the ideological basics of the GATT. Accordingly, the 1934 Act "switched the US from a unilateral tariff setter to a reciprocal trade talker" (Baldwin, 2006a, p.1475). The architect of this change in trade attitudes of the US was the US Secretary of State Cordell Hull who saw international trade as a way to worldwide economic recovery. In order to fulfill this aim, Hull emphasized the necessity of bilateral trade-policy negotiations. The main approach of the 1934 Act had mainly covered two-fronts (Bagwell & Staiger, 2002, p.45):

- On the one side: import tariff reduction as "concessions" in exchange for reciprocal reductions in the imports tariffs of a foreign trading partner [that is the reciprocity principle of the GATT system],
- On the multilateral side: non-discriminatory extension of bilateral negotiations to all trading partners of the US [that is the non-discrimination principle of the GATT system].

Hence, the Reciprocal Trade Agreements Act was the first incidence in which the principles of reciprocity and non-discrimination had been emphasized for the US trade policy (Rhodes, 1993, p.56). Moreover, when it is noted that the US had made approximately twenty-five agreements depending on the above act, its effectiveness on the US trade policy would be clear.

4.2.2 GATT system and regional integration

The WWII had been followed by global reconstruction of the world on several grounds. On the international trade side, the successful outcome of the Reciprocal Trade Agreements Act in the 1940s led the US search for a multinational entity that would depend on the essential components of this Act (Bagwell & Staiger, 2002, p.46). When the attempts to establish ITO failed, this made the GATT be the center of international trading

system. Hence, to be able to understand the history of RIAs in the post-GATT period, it is necessary to emphasize the basic principles of the GATT.

Partly in response to the experience of the 1930s, and partly under the influence of the U.S. idealism and internationalism, the equal treatment of all partners (non-discrimination) has been taken as a fundamental principle of the post-WWII trading system. The system depends also on the key principles of reciprocity and transparency, beside the cornerstone of non-discrimination. Another crucial element that helps to strengthen the above key principles is the enforcement mechanism of the GATT system. The other underlying principles of the system are trade liberalization, safeguard provisions, and encouragement of economic development[1].

The content of the principle of non-discrimination has two components; Most Favored Nation (MFN) principle and national treatment. While MFN clause ensures non-discrimination between trading partners of a country, national treatment ensures non-discrimination between domestic and foreign products in a national boundary. Of the other key principles, transparency guarantees intervention as a visible kind of action by making countries' trade rules clear. Reciprocity, on the other hand, confirms reciprocate concessions between contracting parties. While reciprocity principle neutralizes the world-price outcomes of a country's trade policies, the principle of non-discrimination complements this by ensuring that all externalities are directed through the world price (Bagwell & Staiger, 1998, p.1176). Hence, the GATT system is founded on strong principles for creating free, reciprocal and non-discriminatory system of international trade.

However, in a somehow paradoxical way, the GATT system also allows loopholes that will lessen the strength of these principles. The first and the most important exception to the principle of non-discrimination was introduced through the inclusion of Article XXIV that enabled countries to form trade blocs–FTAs and CUs. Before studying the reasons

[1] While trade liberalization or freer trade principle is introduced to the system in order to lessen the existing trade barriers through multilateral negotiations, safeguard provisions of the GATT system are legalized to use restrictive import policies when the possible threat towards the national economy is perceived.

behind the introduction of GATT Article XXIV, it should be noted that the preferential trade agreements with colonial countries were taken into account differently from FTAs and CUs. The pressures coming from ex-imperialist powers like Britain, France, Belgium and Netherlands consequently resulted in these agreements to be set out of the scope of the MFN clause. Hence, preferential ties with colonies were exempted from the MFN principle by grandfather clause[1] to GATT Article I (non-discrimination principle). The general agreement permitted these preferences but prohibited any increase in the margin of preferences.

The essential concern for the introduction of Article XXIV loophole to the GATT system is worded in the Preamble of GATT. While the Preamble states "raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods" as the main objectives of the contracting parties, it also further verbalizes that "reciprocal and mutually advantageous arrangements, [i.e. RIAs] directed to the substantial reduction in tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce" would contribute to the realization of these objectives (Bagwell & Staiger, 2002, p.47).

In this approach, RIAs are seen as the stepping stones or the complementary parts of the international trading system. It can be stated that this kind of reasoning is similar to the customs union perception of the period prior to the Viner's contributions on welfare implications of the formation of a CU. This tradition states that "free trade maximizes world welfare; a customs union reduces tariffs and is therefore a movement toward free trade; a customs union will, therefore, increase world welfare even if it does not lead to a world-welfare maximum" (Lipsey, 1960, p.497).
What was the underlying reason behind such an exception that would result in discrimination against non-member countries? The reasons for the adoption of GATT Article XXIV that enabled the formation of FTAs and CUs were generally stated as:

[1] As the US followed a negative attitude towards imperial preferences since WWI, under the American pressure the signatory countries agreed the necessity of eliminating colonial preferences (Viner, 1950, p.17-18).

- the fear that Britain and other developing countries would end multilateral trading system which was in its infancy and
- the US' favoritism on the formation of a unified Europe

For the Bretton Woods negotiators, the main aim was to introduce the measures/institutions that would help global integration of national economies. Any reaction running against this aim would cease all of the efforts. So some privileges demanded by other countries were discardable for the ultimate aim of multilateralism. Moreover, the US was also supporting the introduction of such an open-door, especially for the case of Europe. Accordingly, an integrated Europe would be a safeguard against the possible Soviet Russian threat. The US supported this formation even if the customs union would lead discrimination against American exports, especially in agricultural products (Kreinin & Schmidt, 1996, p.35). Hence, political considerations surpassed economic ones in the case of the introduction of the Article XXIV.

Moreover, according to Chase (2006), the reason for the inclusion of free trade area privilege, on the other hand, is not the one that announced publicly. Rather, Article XXIV loophole for free trade areas had been inserted to the trading system through the attempts of US policymakers who wanted to "accommodate a trade treaty they had secretly reached with Canada" (ibid., p.3).

Whatever the original rationale was, the system that would work on the behalf of the entire world showed its first deficiency with the inclusion of Article XXIV that derived from the self-interests of a few leading powers. As a result, as Krueger (2009, p.40) calls it, "the clash between economics and politics" resulted in the introduction of Article XXIV into the GATT system as an exception to the key principle of non-discrimination. Here, the irony that stems from the statement of "as an exception to the key principle" should be emphasized. If there is an escape opportunity, then why it is called as the key (cornerstone) principle. This question did not raise much concern until the late 1980s, as it will be studied in the subsequent subsection.

4.2.3 GATT/WTO period

Although in the initial years of its introduction, the GATT Article XXIV concession was little used, it contributed significantly to the political reconstruction of Europe till the 1960s, as it was also aimed by the US to be so. Benelux CU established in 1947. The Council for Mutual Economic Association (CMEA or COMECON[1]) among Soviet Russia, Bulgaria, Czechoslovakia, Hungary, Poland and Romania was founded in 1949. In 1951, the precursor of European Economic Community, which is, the European Coal and Steel Community (ECSC) was established. This was followed by the formation of European Economic Community (EEC, 1957) and European Free Trade Association (EFTA, 1960)[2].

In the 1960s, a large proportion of world trade was either within or between North America and Western Europe (Baldwin, 2006a, p.1456). However, adopting the successful experience of the EEC as a role model, many developing countries involved in such kind of regionalism attempts. In Africa, the regionalism concept had gained importance with the independence of former European colonies in the late 1950s and early 1960s. For the same years, the increased interest in regionalism was also true for the Latin American countries. These developing countries mostly depended on the import-substitution industrial policies and interpreted regional integration as a tool of promoting economic growth and industrialization. At that time, theoretical studies were also in line with this kind of reasoning. According to the intellectual studies examining the effects of integration consisting developing countries, preferentially opening up trade among developing countries would help to decrease the cost of import-substitution through larger regional markets (Bhagwati et al., 1998, p.1137).

However, the import-subsitution based RIAs were generally very protectionist and interventionist as they were trying to determine administratively industrial structure and the location of production (Schiff & Winters, 2003, p.5). Nevertheless, these RIAs like the customs unions among developing countries in Latin America and Africa inevitably led to

[1] COMECON was founded by Soviet Union as an alternative to the assistance that the US provided Western European countries with the Marshall Fund (Ravenhill, 2005, p.127).

[2] Other components (not related to regional integration) of the reconstruction of Europe were the Organization for European Economic Cooperation (OEEC: OECD, later), unsuccessful European Political Community and European Defence Community (Baldwin, 2006a, p.1476).

conflict, “because each member wanted a regional market for its own inefficient industries but was unwilling to buy the expensive or poor quality import-substitutes being produced by their partners” (Pomfret, 2007, p.941). Moreover, in this integration schemes, few of the members were significant economic partners for each other. For example, “in Africa where economies had been shaped in the colonial era to produce primary commodity exports for the European market”, the share of intra-regional trade in these countries’ total exports was often less than five per cent (Ravenhill, 2005, p.126).

In addition to being very protectionist, the underlying principles of agreements were not clear at all. For example, as Dam (1963, p.656) states this was the case for LAFTA: “provisions of the Treaty of Montevideo [founding treaty of LAFTA] concerning elimination of intermember tariffs were so general and the escape clauses so broad that it was impossible to determine with any certainty what action would eventually be taken by the member states”. Another reason for the failure of such attempts in East Africa and Latin America is stated as (Bhagwati et al., 1998, p.1137): “…because these countries were wedded to planning at the time and saw trade as accommodating to a planned allocation of the import-substituting industries among the members countries, instead of letting trade decide which industry went where, thus putting the cart before the horse and killing the forward momentum.”

These unsuccessful integration agreements further exacerbated the existing inequalities between the member countries as industries tended to cluster around the most developed regions and disregarded the regions of the least developed parts. This brought about problems related to the loss of tariff revenue on which the least developed partners depend heavily and raised the disputes over the distribution of benefits from regional integration like the ‘soccer war’ between Honduras and El Salvador (former CACM members) in 1962, and conflicts between Uganda and Tanzania (former East African Community members) in 1979 (Ravenhill, 2005, p.127).

In addition to above features, it should be also mentioned that over the 1950s-1970s period, most of the RIAs were among countries that were at similar development levels. The North-South agreements that involved developed and developing countries were taken the forms of non-reciprocal preferences, i.e. the Generalized System of Preferences,

association agreements and extension of colonial preferences (Benini & Plummer, 2008, p.271).

By the late 1970s, due to the OPEC crises and subsequent recession prevailed in many countries, "regional integration no longer appeared to be a viable solution to the problems of interdependence that governments faced" (Ravenhill, 2005, p.127). It was understood that the emphasis should be given to the neoliberal stance instead of protectionist and inward-looking agreements. Hence, with the learned unsuccessful lessons of protectionism, the beginning of the 1980s could be seen as a way back to the liberal stance. This time, whether it was enforced by Bretton Woods Institutions and the GATT or not, many developing countries gave importance to unilateral trade liberalizations rather than import-substitution based RIAs.

Overall, in the history of regional integration prior to the 1980s, as non-reciprocal preferences granted by developed countries to their developing countries were inadequate due to their long list of product exclusions, rules of origin restrictions and small margins of preference, and as RIAs consisting of developing countries as partners were largely ineffective, the effective RIAs were limited to the EC and EFTA of Western Europe (Panagariya, 1999, p.480).

On the other hand, while the US was the main promoter behind the formation of the EEC that would result in a unified Europe against the communist threat, this political strategy also supplemented by the economic undertakings in the GATT for the introduction of new rounds. As Kennedy Round (1963-1967) was the response to the creation of the EEC, Tokyo Round (1973-1979) was the response to the first enlargement of the EEC with the memberships of Denmark, Ireland and the UK in 1973 (Ravenhill, 2005, p.131). These rounds were aimed to reduce overall tariff levels and, thus, the discrimination American exports would face in the European market.

Uruguay Round

From the early 1980s onwards, with the upsurge of neo-liberalism, the growing integration of goods and services markets has been supplemented by the integration in the financial markets. Together with the insistence of Bretton Woods Instiutions to do so, many national governments started to follow market-friendly policies. However, the GATT system was not able to serve this globally integrated trade effectively. Hence, when deficiencies and the limited coverage of GATT system raised the concerns of several countries, it resulted in a new round –namely, Uruguay Round– in 1986. Despite the fact that for the initial years of Uruguay Round regional integration was not a controversial issue, with prolonged negotiations and the United States' change in attitude from multilateral to bilateral/regional stance resulted in a significant increase in the number of regional integration arrangements. In that time, this change in the US' attitude was mainly used as an enforcement mechanism against the EC to continue multilateral trade negotiations of the Round. As a result, the increased interest in regional integration, in turn, gave rise to intensified concerns about the successful conclusion of the Round. Bagwell and Staiger (2002, p.117) state as follows:

> …while the failure of these negotiations to conclude at the Brussels Ministerial in December 1990 reflected the strained multilateral tensions of the time, this failure together with the subsequent increase in new preferential initiatives after 1990 were …major factors in eliciting the concessions needed to conclude the Uruguay Round in 1994, as they raised the specter that a failed Uruguay Round would lead to a world in which future trade and economic relations would be based primarily on preferential agreements.

When the Uruguay Round was ended by signing the Marrakesh Agreement in April, 1994, the outcome was the most comprehensive up-to-date agreement of the international order. It resulted in the introduction of "an immense new body of international law relating to trade"; while the basic texts of the agreement were 550 pages, the Final Act signed in Marrakesh, Morocco was more than 26,000 pages (Matsushita et al., 2003, p.6). The leading change was, on the other hand, the transformation of the informal GATT into the legal body through the formation of World Trade Organization (WTO) by January 1, 1995.

Furthermore, the Final Act includes the Agreement establishing the WTO (an umbrella agreement), together with the agreements that are annexed and classified into six main categories. The first category is the Multilateral Agreements on Trade in Goods[1]. The following four categories can be listed as General Agreement on Trade in Services (GATS), Trade-Related Aspects of Intellectual Property Rights (TRIPs), Dispute Settlement Understanding and Trade Policy Review Mechanism, respectively. The final category contains Plurilateral Trade Agrements[2].

While the WTO has been designed so as to expand GATT's agenda to service transactions, intellectual property rights (TRIPs), trade-related investment issues (TRIMs), and agriculture, all the key principles of GATT like the principle of non-discrimination between supplying countries (Most Favored Nation-MFN), the principle of equal treatment of foreign and domestic firms (national treatment) are kept in the structure of WTO. Hence, by 1995, with the establishment of WTO, a body of world trade law has emerged that centered on the non-discrimination principle, strengthened dispute resolution mechanisms, and low bound tariffs in the major economies for all goods outside agriculture (Pomfret, 2007, p.925). As the key principles have remained unchanged, Article XXIV and related articles about the formation of RIAs have also been preserved in the new system.

While the initial examples of RIAs were seen in imperialistic ties of the leading powers prior to the GATT system, the range of participant countries of such agreements has been increasing in the post-GATT period, especially after 1990s. In terms of the history of RIAs, the period after the introduction of GATT is generally divided in two, as the first period of regionalism and the second period of regionalism. The important events that characterize these periods include the collapse of the Communist bloc, the long-lasting Uruguay negotiations and the industrialization of less developed countries that followed

[1] These agreements include GATT 1994 (together with GATT 1947), Agriculture, Sanitary and Phytosanitary Measures, Textiles and Clothing, Technical Barriers to Trade, Trade Related Investment Measures (TRIMs), Anti-dumping, Customs Valuation, Preshipment Inspection, Rules of Origin, Import Licensing, Subsidies and Countervailing Measures, and Safeguards.

[2] These agreements are binding only on the countries that have accepted them. These plurilateral agreements are Agreement on Trade in Civil Aircraft, Agreement on Government Procurement, International Dairy Agreement and International Bovine Meat Agreement (in 1997, the WTO members decided to end two of these plurilateral trade agreement: the bovine meat and the dairy agreements).

liberalization policies in the late 1980s. Bhagwati (1992), on the other hand, define the first period as protection-based regionalism and the second period as open trade based regionalism trade (cited in Aminian et al., 2008, p.13).

The most significant difference between these periods is the rapid proliferation of the RIAs. While the number of notified RIAs was approximately 20 in 1985, this number has drastically increased to 470 in 2010. Although significant proliferation of the RIAs has been apparent since the end of 1980s, Pomfret (2007, p.928) argues that the numbers can not be a measure of the extent of regionalism in the second wave. Accordingly, the political changes in the international arena like breaking up of the Soviet Union have significantly affected the process and the number of RIAs; such that the main cause for the increase in the number of RIAs in the 1990s and the early 2000s was the proliferation of bilateral and plurilateral free trade agreements among countries of the former CMEA and among successor states of Yugoslavia, the USSR and Czechoslovakia. These RIAs were interpreted as a way to increase free trade among ex-communist countries. Hence, after the collapse of the Union, most of the Eastern and Southern countries have abandoned their anti-market regimes in favor of the more capitalistic policies.

However, in addition to factors stated by Pomfret (2007), factors like prolonged negotiations of the Uruguay Round, following the suit while all other countries are participating in RIAs, and fast track solutions on the regional scale rather than searching for multilateral support have significantly contributed to the increase in the number of RIAs. Hence, political reconstruction can explain part of the trend existing in regional economic integration. Moreover, in the political context, a dramatic change in the security understanding due to the end of Cold War resulted in new possibilities for regional partnerships among countries of the opposite sides of the War (Ravenhill, 2005, p.127). In Asia, for example, the end of the Cold War eliminated the previous barriers that prevented the formation of RIAs.

Another important feature existing in the second wave of regionalism is that multilateral tariff liberalization of trade in manufactured goods among several countries (especially among industrial countries) is realized successfully through the last attempts taken in the

Uruguay Round. Table 4.1 shows simple average tariff rates for manufactured goods in selected countries from 1931 to 2000.

Table 4.1 Average tariffs for selected countries (1931-2000) (Source: Findlay and O'Rourke, 2007, p.494)

	1931	**1950**	**Early 1960s**	**1976**	**Mid-1980s**	**1990**	**2000**
European Average	**30.4**	**17.8**	**14.0**	**8.9**	**6.6**	**8.3**	**4.2**
Greece		39			7	8	4
Germany	18	26	13	9	7	8	4
Italy	42	25	13	9	7	8	4
United Kingdom		23	18	9	7	8	4
Austria	28	18		12	9		4
Portugal		18				8	4
France	29	18	13	9	7	8	4
Belgium	13	11	13	9	7	8	4
Netherlands		11	13	9	7	8	4
Norway		11		9		7	3
Sweden	24	9		6	5		4
Denmark		3		9	7	8	4
Spain	76					8	4
Finland	23			13			4
Switzerland	22			4	3		
N.American Average	**37**	**15**	**17**	**12**	**7**	**8**	**4**
Canada				13		11	5
United States	37	15	17	11	7	6	4
Asian Average			**31**		**33**	**21**	**9**
Indonesia					24	19	9
Philippines			46			20	7
Taiwan			30			10	6
Thailand						41	16
China					41	43	16
Korea						13	8
Japan			18			4	3
Other Nations							
Brazil			99		44	35	17
India					80	84	32
New Zealand						9	3
Mexico			22		17	14	17
Nigeria						36	26

While European average tariff levels was 30.4 per cent in 1931, it decreased by half in the 1960s. In 2000, it became 4.2 per cent. In North America, these rates showed similar tendency to the rates of Europe. As they were 17 per cent in the 1960s, they further declined to 4 per cent in 2000. In the Asian part, figures for Japan are in line with the ones of Europe and North America. But, for other countries in the region, these levels are slightly higher as they varied between 7 per cent and 16 per cent. For developing countries like Brazil, India and Mexico, tariff levels of 2000 are changing from 17 per cent to 32 per cent. Although these countries have experienced significant declines in their tariff levels throughout the period, their rates are at levels that developed countries employed in the 1960s.

Moreover, according to International Trade Center database, average tariffs applied on all products are 0.89 per cent for members of the EU, 2.81 per cent for Norway, 2.08 per cent for Switzerland, 4.42 per cent for Turkey, 2.77 per cent for Canada, 1.49 per cent for the US, 13.31 per cent for China, 6.55 per cent for Korea, 2.40 per cent for Japan, 11.86 per cent for Brazil, 14.40 for India and 8.32 per cent for Mexico in 2009. It should be noted that several sensitive sectors, like agriculture, textile and apparel are excluded from decreases in tariff levels.

When the structure of RIAs is examined, there exist two more variations between the first and second waves of regional integration. The first difference mainly arises from the lower tariff rates prevailing in the second wave (as shown in Table 4.1). While in the first wave, RIAs covered shallow integration that focused on the liberalization of border measures, in the second wave, in addition to reducing tariffs and quotas, the removal of other barriers is on the scope of recent RIAs. Hence, regional arrangements have started to search for a deeper integration that involves diverse economic policies beyond tariff barriers.

Secondly, South-South agreements of the 1960s that involved developing countries as the members have superseded with the North-South agreements that unite developed and developing countries in terms of economic integration (like NAFTA, EU enlargements and AFTA). In this new framework, developing countries interpreted these agreements as a

way to enhance states' involvement in the global economy, to indicate their openness in order to attract foreign investment, and to secure access to the markets of their developed partners (Ravenhill, 2005, p.128).

CHAPTER 5 MOTIVES FOR REGIONAL INTEGRATION

In 1947, negotiations to legalize the formation of FTAs and CUs were primarily focusing on the economic and political reconstruction of Europe. On the US' side, while the strengthening Europe against Soviet Russian threat was the main cause for allowing the CUs loophole in the GATT, the bilateral treaty attempt with Canada was the reason for addition of FTAs exception to this loophole. Hence, the original intention for the addition of the GATT Article XXIV was to protect discriminatory status-quo. This kind of privilege, on the other hand, constitutes a paradox when it is taken into account that steps adopted in Bretton Woods Conference were aiming to form multilateralism based trading system.

The initial examples were restricted to European countries which used regionalism option for interior development, both economic and political, of the region. Without discrimination inherited in regional integration, it was impossible to satisfy such a reconstruction in Europe. Later, following the footsteps of leading countries, the other countries have started to search for regional solutions in order to tackle with their economic/political problems. Hence, throughout time, regional economic integration concept has developed gradually and become an emergency kit that allows discrimination to outside countries in certain conditions specified by the GATT/WTO Articles.

With internal and external factors affecting this process, RIAs are now one of the controversial issues of international political economy. This chapter will try to study the factors that lead countries search for or involve in RIAs. As some RIAs are established due to solely political concerns, not only their economic underlying but also their political roots deserve attention in such a study. In the first section, the main economic motives that push countries to involve RIAs will be studied. In the second section, the principal political motives for membership in RIAs will be examined. Increase in the number of issues in the GATT/WTO agendas has also affected countries' willingness to participate in such

regional solutions. So, the last section will try to study how broadening scope of the GATT/WTO system has contributed to the increased number of RIAs.

5.1 Economic Motives for Regional Integration

Nowadays, many RIAs are not limited to only trade in goods. New arrangements include trade in services, investments, standards, intellectual property rights and competition rules, in addition to other non-trade related issues like labour and environment (Estevadeordal, Suominen & Teh, 2009, p.1). This complexity in subject matters makes motives for forming RIAs diversify. Foremost, in the economic motives side, the followings can be listed as the leading driving forces for the formation of RIAs:

- economies of scale
- increased investments (domestic and foreign)
- secure market access
- increased competition within the union and
- to protect the value of national currency

The formation of an RIA will naturally enlarge the market for the member countries of the agreement. This, in turn, will result in a more efficient production structure via exploitation of economies of scale that spread fixed costs over larger regional markets. Due to the economies of scale, firms of member countries can specialize in particular product lines rather than try to produce the entire product line. Moreover, free trade on goods and services can help countries to allocate their production to the most efficient locations within the integration. Especially for developing countries that lack necessary skilled workers, capital endowment and financial capacity, RIAs are seen as a way to improve the supply capacity of member countries by providing regional public goods and the benefiting from the specialization (Deichmann and Gill, 2008, p.5). It is also true that developing countries can use regionalism option as a way to avoid from adjustment costs of unilateral non-discriminatory liberalization.

Moreover, membership in an RIA can contribute positively to the attractiveness of a domestic economy to possible investors. This effect of regional integration on investment is accounted as one of the dynamic effects of integration schemes. Greater confidence resulted from the larger and concrete group would yield increase in both domestic and foreign investments. The rationale for the positive effect of integration on investment comes from reduced risk and the increase in the return to capital. According to Brada and Méndez (1988, p.163):

> The creation of a large multinational market reduces the risk or raises the expected return to an investment project by enabling firms to lower costs through economies of scale, by providing a larger pool of customers with heterogeneous tastes, and by enabling the firm to serve national markets with asynchronous business cycles and seasonal buying patterns.

In addition to the expected efficieny gains of the integration, foreign direct investment (FDI) flows may also increase as the multinational companies use direct investment option in the regional group instead of dealing with the tariff barriers prevailing in the regional market. Whatever the original motive for investment flows is, at the end, such flows would consequently give rise to a positive impetus on the growth of a country. For higher levels than customs union, integration scheme will further result in firms to benefit also from factor mobility. Resulting externalities of FDI like learning by doing, increased research and development, adoption of new technologies, on the other hand, will promote to the growth levels of members.

The positive effect of RIAs in an FDI formation is especially significant for the North-South agreements in which companies take advantage of lower labor costs of the Southern partner to serve all of the regional market. For example, while there was a significant increase in FDI inflows of Mexico after the membership in NAFTA, there was a similar increase in FDI inflows of ASEAN after the initialization of FTA negotiations (Ravenhill, 2005, p.125).

For developing countries, RIAs are additionally considered as a key to access to the markets of their developed partners. This motivation is especially important when there has been uncertainty about the possible improvement in the WTO negotiations, or when domestic regulation restricts the accession to a major market. This is especially one of the reasons for the increased interest of developing countries on North-South agreements. Hence, developing countries take regionalism as a ladder to by-pass the trade barriers that would be imposed in industrial countries. Two researchers from International Bank for Reconstruction and Development (IBRD), Balassa and Stoutjesdijk (1975, p.39-40) state as follows:

> … a country participating in a regional integration scheme benefits from the elimination of barriers to its exports on the part of the partner countries. This is of special importance for developing countries whose exports of manufactured goods often suffer discrimination in developed country markets. We observe that tariffs in developed nations tend to rise with the degree of fabrication, thereby discouraging the importation of foods and raw materials in a processed form. Also, tariffs are generally higher on simple manufactures than on products requiring a high level of technical sophistication developing countries do not possess. Finally, quantitative restrictions tend to be applied mostly to products originating in the developing nations, as is the case of textiles, clothing and shoes.

This market-access motive is not limited only to the developing countries. Developed countries can also use RIAs as a tool to get license for the markets of other developed countries. For example, Canada has used FTA with the US option –NAFTA– so as to reduce the effect of administrative protection on part of the US. On the other hand, the EU has used the EU-Mexico FTA in order to cover up the threat of trade diversion following the formation of NAFTA (Sampson, 2003, p.11).

Additionally, RIAs can be seen as a way to increase competition within the group. Exposure of domestic firms to increased competition with firms originating from other member countries or multinational enterprises that succeeded in to pass the tariff wall of a union would, as a result, contribute to economic growth of member countries. Hence,

regionalism in this case can provide an initial step to expose inefficient domestic sectors to international competition through necessary reforms taken at the regional level. The increased competition would, as a result, lead to positive effects like "improvements in the distribution of incomes through lowering excess profits and incentives for technical progress" (Balassa & Stoutjesdijk, 1975, p.41).

One another economic motive which leads some countries to join and establish RIAs is to protect the value of national currencies by establishing a stable exchange rate system. This purpose is significantly apparent in countries whose economies are vulnerable against exchange rate uncertainty. Eichengreen (1996, p.192) states as follows:

> For the majority of smaller, more open economies, however, the costs of floating are difficult to bear.…volatile exchange rate swings impose almost unbearable costs and are disruptive to the pursuit of domestic economic goals. As their economies are buffeted by exchange-market turbulence, these countries are likely to seek cooperative agreements that tie their currencies securely to that of a larger neighbor. This desire is already evident in Europe in the effort to form a monetary union centered on the Federal Republic of Germany. One can imagine that, with sufficient time, similar tendencies will surface in the Western Hemisphere and Asia, and that the United States and Japan will be at the center of their respective monetary blocs.

5.2 Political Motives for Regional Integration

While economic motives underlying the formation of RIAs are somehow more visible, recognition and quantification of political motives are hard to conceive. However, these political motives constitute important driving force for countries to participate in regional integration. These politically-driven reasons can be listed as follows:

- reinforcement of political relations between member nations through an RIA
- using regional integration as an enforcement to lock in unilateral domestic policy reforms

- using regionalism as a way to adapt to capitalism and to cope with non-traditional security threats
- expected increase in bargaining power in the international area by becoming a member of an RIA
- using regionalism option as a diplomatic element towards other countries and the working of GATT/WTO system
- involvement in regional integration either for following the suit or for reaction to other countries' interest in regionalism

RIAs are commonly seen as an important element of diplomacy. They are interpreted as a way to improve the relations between members and to enhance security within the integrated area. The initial example is the predecessor of the European Economic Community, that is, the European Coal and Steel Community (ECSC, 1951). As it is a well-known fact that the ECSC was seen as a way of reducing Franco-German political tensions after WWII.

This diplomatic motive is also said to be present in the formation of RIAs like MERCOSUR and ASEAN. For example, the formation of MERCOSUR helped to end the historic rivalry between Argentina and Brazil which had taken on nuclear implication prior to the formation (Bergsten, 1997, p.548). The formation of ASEAN was, on the other hand, based on two important political motives, namely to build confidence and to avoid conflict in the region that experienced armed conflicts between Indonesia and Malaysia in the period 1963-1966. One additional diplomatic motive in ASEAN was to be preserved from the threat of spreading Communism.

This motive was also present in the other continents of the world. For example, while the motive for the formation of Southern African Development Coordination Conference (1980) was stated as "to provide security to the small countries of the region against the apartheid regime in South Africa by building a military defense", the main motive for the

formation of Gulf Cooperation Council (GCC) was coordination against potential threat of Iran and Iraq (Chakraborty, 2003, p.8)[1].

Governments may also use regionalism as a tool to bind to better policies which would in turn increase the attractiveness of national economies to both domestic and foreign investors. This 'lock in policy change' motive of the RIAs was apparent in the cases of the membership of Mexico in NAFTA, the membership of Vietnam in ASEAN and the memberships of Greece, Spain and Portugal in the EU (Benini & Plummer, 2008, p.276).

RIAs can also be used as a defensive guard to create a "domestic dynamic for the reforms required to achieve greater openness, while at the same time minimizing the political problems of disrupting existing sources of incomes and rents" (Schiff & Winters, 2003, p.10). As unilateral tariff liberalization is politically difficult to implement due to the fact that domestic groups believe that government is losing its economic power by lowering tariffs and taking nothing from other countries, membership in an RIA further provides a means for receiving reciprocal concessions from other partners in return (Ravenhill, 2005, p.123).

In the political context, RIAs are also seen as a way to adapt to capitalistic system. For example, with the collapse of the Soviet Union in the late 1980s, this was the case for Eastern European and the Baltic countries. The membership of these countries in Central European Free Trade Area (CEFTA, 1992) was aimed to increase the compliancy pace of these countries to the market-friendly capitalism.

On the other hand, many industrial countries employ regionalism option to tackle with non-traditional security threats like environmental damage, drug smuggling, illegal migration and organized crime originating from less developed countries (Ravenhill, 2005, p.122). For example, while these security considerations contributed significantly in Euro-Mediterranean agreements, the U.S. partnership with Mexico in NAFTA was used as a

[1] The history of Turkey-EU relations involves similar political concerns. During the 1960s, the relation with the EEC was wanted as a guarantee against the Communist threat. On the other hand, during the 1980s, it was considered as a protection against radical religious tendency in Turkey.

way to help Mexico stabilize and prosper to avoid spillovers of unrest and population (Schiff & Winters, 2003, p.197).

Moreover, when a country becomes a member of an RIA, since integrated region will act as one unit, it will improve the bargaining power of member countries against non-member countries and will provide insurance against unwanted developments within the multilateral trade negotiations[1]. For example, many South-South agreements of the first wave of regionalism (1950s-1970s) were focused on to improve their bargaining power with transnational corporations and with other trading countries (Ravenhill, 2005, p.122). By participating in RIAs, governments can further maintain their sovereignty by pooling it with others in international economic area where most of the countries are not capable to express their interests. This is especially true for many developing countries that lack sufficient expertise on large number of covered topics and policies to participate efficiently in multilateral trade negotiations (Mansfield & Reinhardt, 2003, p.835). However, it should be noted that acting as a one unit effect will depend on the type of agreement (FTA or CU) and the interests of member states.

In order to stimulate the multilateral trading system into faster and deeper action in selected areas, regional integration can also be seen as an important strategical policy. For example, according to Gary Hufbauer of Peterson Institute of International Economics, China and India have taken the option of conducting bilateral FTAs rather than making the necessary consessions to finish the Doha Round negotiations ("The noddle bowl", The Economist, 2009, p.64). RIAs would also extend the coverage of measures from border-related to behind-the-border and non-economic fields of cooperation, which are generally out of the subject area of the GATT/WTO system (Benini & Plummer, 2008, p.269).

Reaction to other countries integration policies or the fear of being outside while the rest of the world involves in regional integration arrangements will be another reason for participating in RIAs. For instance, although it was argued that the US used RIAs as a tool to keep the EC in line with the Uruguay Round negotiations, the successful completion of

[1] Mansfield and Reinhardt (2003, p.837) state that RIAs are more likely to form during an multilateral trade negotiation than when there is no such negotiation due to the increased desire for insurance throughout this negotiation.

the Round did not turn the US attitude to its previous multilateral stance. More friendly and enthusiastic stance of the US on regionalism has further improved due to (Schiff & Winters, 2003, p.10):

- increasing influence of business lobbies in the US policymaking,
- decreasing competitiveness especially due to the growing trade distortions resulting from the Common Agricultural Policy of the EC, and
- decrease in the US' willingness to bear the costs of managing the global system.

The response to the US enthusiasm in regionalism is seen in the Asian side of the world. Chinese and Japanese search for regional integration opportunities have been seen as a reaction to the increased interest of the US in such arrangements in the recent decade. Moreover, in the second wave of regionalism, the completion of the Single Market Program (1992) of the EC and the establishment of NAFTA (1994) boosted the interests of other countries in regional integration attempts.

Hence, RIAs may create domino effects all over the world. As a result, the perceived threat from the formation of an RIA let excluded countries either apply for membership in this RIA or form their own integration agreement (Greenaway and Milner, 2002, p.5). This contagion effect is also valid even for the members of a specified RIA. These countries may search for other regionalism opportunities as a way to reduce dependence on the existing regional partners, like the case for FTAs of Mexico with the EU and Japan (Ravenhill, 2005, p.130).

Additionally, neo-functionalist analysis (Haas, 1958; Lindberg, 1963) asserts how a regional grouping could catalyze further deepening of integration as cooperation in one area would result in pressures for cooperation in other areas due to the increased costs of pursuing uncoordinated policies within the group (cited in Ravenhill, 2005, p.137). According to Padoa (2003), for example, trade and financial interdependence prevailing in RIAs and the level of co-ordination are likely to reinforce each other, as in the case of the EU:

In the EU, institutional progress beyond the creation of a customs union towards a single market and an economic and monetary union was associated with a deepening of economic integration. In parallel, increasing economic integration validated and supported the process of institutional integration. From 1968 to 1992 when the EU progressed from a free trade area to becoming a single market, the number of binding legal acts across policy areas adopted by the EC increased substantially.

5.3 Broadening Agenda of the GATT/WTO Rounds

The development of GATT/WTO system by itself has also constituted a significant motive for the formation of RIAs. Although it is natural to expect that the development of multilateral trading system would decrease the need for regional integration, the present situation proves the opposite case. RIAs are increasing in significant rates despite liberalization attempts taken in the multilateral ground. In order to understand the underlying principles for such a movement, this section will study the components of the GATT/WTO system that push countries towards regionalism. Table 5.1 reports the general lines of the GATT/WTO rounds[1].

Table 5.1 The GATT rounds (Source: the WTO)

Year	Name (Place)	Subjects included	Number of countries
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1950-1951	Torquay	Tariffs	38
1955-1956	Geneva	Tariffs	26
1960-1961	Dillon Round	Tariffs	26
1964-1967	Kennedy Round	Tariffs and anti-dumping measures	62
1973-1979	Tokyo Round	Tariffs, non-tariff measures, "framework agreements", the Enabling Clause	102
1986-1994	Uruguay Round	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, establishment of the WTO, etc.	123

[1] The ongoing Doha Development Agenda of the WTO, on the other hand, has launched in 2001.

In the GATT system, while the early Rounds were essentially about tariff liberalization in manufactures, change in the subject area of the system initialized by the launch of Kennedy Round (1964-67) that introduced anti-dumping measures to the previously dominant tariff measures and reformulated tariff cuts as the "linear cut" or the "across-the-board tariff reductions". The reason behind such a change in the Kennedy Round was previously stated in 1962 Trade Expansion Act of the US as (Baldwin, 2006a, p.1477):

> *The growth of the European Common Market*- an economy which may soon nearly equal our own, protected by a single external tariff similar to our own- has progressed with such success and momentum that it has surpassed its original timetable, convinced those initially skeptical that there is now no turning back and laid the groundwork for a radical alteration of the economics of the Atlantic Alliance…. A trade policy adequate to negotiate item by item tariff reductions with a large number of small independent states will no longer be adequate to assure ready access for ourselves –and for our traditional trading partners in Canada, Japan, Latin America and elsewhere– to a market nearly as large as our own, whose negotiators can speak with one voice but whose internal differences make it impossible for them to negotiate item by item.

The following round, Tokyo Round (1974-79), included 102 participant countries and further broadened the subject area of international trading system by adding non-tariff measures and framework agreements. The codes[1] of Tokyo Round included subsidies and countervailing measures, technical barriers to trade (standards code), import licensing procedures, government procurement, customs valuation, anti-dumping, bovine meat arrangement, international dairy arrangement and trade in civil aircraft. While these codes were the initial examples of the rule-based trading system, although for a group of countries at that time, they further constituted the foundations of the following round, i.e. Uruguay Round.

[1] As these agreements are accepted only by a subset of member countries, not by all of the GATT members, they are dubbed as the 'codes'.

As it is explained above, negotiations in the longest and the most complicated round, Uruguay Round, launched in 1986 and lasted until attaining agreement in 1994[1]. With 550 pages of the basic texts and approximately 60 agreements that covered an umbrella agreement establishing the WTO, the multilateral agreements on trade in goods, TRIMs, GATS, TRIPs, dispute settlement understanding, trade policy review mechanism, and plurilateral trade agreements, the Marrakesh Agreement of the Round had been signed by member countries of that time. As the package included multilateral agreements annexed to a single document, i.e. to the Marrakesh Agreement, all agreements have become binding on all of the member countries as a single body of law (Matsushita et al., 2003, p.7). Hence, through such an agreement formation, the 'single undertaking mechanism' has been introduced to the international trading system. It should be also noted that this mechanism and the subjects included in the final agreement were mainly determined by the so-called QUAD (Canada, the EU, Japan and the US) that was formed in Tokyo negotiations (1993) of the Round.

Establishment of the supranational authority, the WTO, was the vital outcome of Uruguay Round. However, the main reason that accelerated the pace of regionalism has stemmed from the enlargement of the mission of WTO, together with the single undertaking mechanism. The Uruguay Round broadened the scope of negotiations to tariffs, non-tariff barriers, contingent protection, intellectual property protection, and new sectors like agriculture and services. The extended subject matters in the WTO system, as a result, have made it hard to find accepted solutions on the negotiated topics.

At the same time, while the number of members that signed the GATT was twenty-three[2], the number of signatories at the end of Uruguay Round was one hundred twenty-three. By 2008, the number of WTO members has further increased to one hundred fifty-three. Hence, arriving at unanimous decision and the possibility to conclude existing negotiation were certainly easier in the GATT system than the WTO system when the number of

[1] Uruguay Round negotiations were held in the following places: Monte Real (Dec 1986), Geneva (Apr 1989), Brussels (Dec 1990), Geneva (Dec 1991), Washington (Nov 1992), Tokyo (Jul 1993), Geneva (Dec 1993) and Marrakesh (Apr 1994).

[2] These countries were Australia, Belgium, Brazil, Burma, Canada, Ceylon, Chile, China, Cuba, the Czechoslovak Republic, France, India, Lebanon, Luxembourg, Netherlands, New Zealand, Norway, Pakistan, Southern Rhodesia, Syria, South Africa, the United Kingdom, and the United States.

members and the extended coverage are taken into account[1]. This, in turn, has led to prolonged periods of negotiation, as well as increased disputes with the third countries since the initialization of Uruguay Round. While the number of disputes in the WTO has reached to 405, the failure of the ministerial meetings of WTO in Seattle (1999), in Cancun (2003) and in the other Doha Round negotiations has further proved impossibility of arriving common decisions in the recent trading system. Table 5.2 presents WTO ministerial conferences since its establishment.

Table 5.2 Ministerial conferences in the WTO period

Date	Name
Dec 1996	Singapore
May 1998	Geneva
Nov 1999	Seattle (Washington)
Nov 2001	Doha (Qatar): Launch of the Doha Round Negotiations
Sep 2003	Cancun (Mexico)
Dec 2005	Hong Kong
Nov 2009	Geneva

These negotiations were largely unsuccessful due to the extended agenda of WTO. For example, Doha Round meetings, that include the 'Singapore Issues', try to negotiate on 40 subjects. Some of these subjects are: agriculture; cotton; services; market access for non-agricultural products (NAMA); balance between agriculture and NAMA; TRIPs; TRIPs and public health; TRIPs non-violation and situation complaints; TRIPs and biodiversity; investment; competition; transparency in government procurement; trade facilitation; anti-dumping; subsidies; regional agreements; dispute settlement; environment; e-commerce; aid for trade; special and differential treatment; rules of origion; technical barriers and customs valuation.

It is generally accepted that getting stuck in the prolonged negotiations of Uruguay Round caused significant increase in the number of RIAs. While it was expected that the successful conclusion of the Round would retard this trend, one and a half decade history

[1] While the Geneva Round (1947) was concluded in six months, the conclusion of the Uruguay Round attained after eight years.

of the WTO has revealed that the expected slowdown has not been realized yet. To overcome the deficiencies of the system and to solve their trade-related problems, the more and more countries have interpreted the formation of RIAs as an accelerated way of solution.

In this respect, RIAs are interpreted as an intermediate step and seen as the laboratories for deeper integration which covers issues proposed for future WTO disciplines (called as WTO-plus). These deeper integration measures include subjects what make Doha Round negotiations impossible to conclude and contain agreements on market regulations, on the domestic competition policies, on environmental policies, on the harmonization of standards and on the regulations of FDI. While Doha Round Negotiations are stucked in these issues, the regional alternatives are following more active role in these issues in order to get expected outcomes within the group and for the bilateral links with the third countries. For example, since the early 1990s, when it is understood that it is hard to reach desired outcomes at the multilateral level, pro-liberalization governments like the US, Singapore, Chile and Australia have employed RIAs in order to escalate the pace of trade liberalization and to promote 'deeper integration' (Ravenhill, 2005, p.124). In this sense, NAFTA has been regarded as one of the first RIAs that included these deeper integration measures into its integration agenda. For example, on investment, following the guidelines expected in NAFTA, the bilateral agreements of the US involve binding obligations on several investment-related issues like minimum standards of treatment and limits to the use of performance requirements (Cosbey et al., 2004, p.6).

Further, RIAs, by providing smaller number of negotiators, propose more effective dispute settlement than the one of WTO. Hence, whether it is due to the effectiveness of the dispute settlement mechanism or the easiness of negotiating with smaller participants, the regional agreements are increasingly used by governments both as a substitute for a global agreement and as a way to induce other countries to make concessions in global negotiations (Ravenhill, 2005, p.129).

The relationship between the world trading system and developing countries also deserves attention in terms of increased interest of these countries in regional integration.

Broadening agenda of the GATT/WTO has significantly affected the developing countries' search for regional integration opportunities.

The rule-based trading system has been generally proposed as the best way for developing countries as these countries are relatively small and disable to affect the policies of larger countries (Hoekman et al., 2003b, p.2). But, it is the same system that also pushes these countries towards regionalism. Benini and Plummer (2008, p.271) state:

> In the past, developing countries were not active at GATT rounds, as they generally were 'free-riders' on commitments between developed countries from which they also received MFN benefits. The cost of this approach became evident in time; the sectors that were being liberalized were of principal interest to developed, rather than developing countries.

At the end of the Uruguay Round, 'single undertaking' principle together with undemocratic nature of the decision making resulted in "favoring rich over poor countries and corporate profits over citizens' well-being" (Gavin & van Langenhove, 2003, p.289). Hence, the world trading system is largely affected from the interests of developed countries. As Hoekman et al. (2003b, p.2) state that the rules of the system are "less demanding about distortionary policies that are used by *developed* countries and they largely mirror the disciplines that have over time been put in place by them".

Some of the examples of these policies are the use of agricultural subsidies, import quotas on textiles and apparels, and the protection of intellectual property rights. Additionally, in the new trade issues, like customs valuation, investment measures and TRIPs, it is understood that the term 'one size fits all' does not hold. The concessions granted by developing countries in these areas require high costs of implementation, which is not the case for developed countries. Hence, developing countries have started to employ regionalism option to best serve their national economic interests that can not be fulfilled in the multilateral trading system.

CHAPTER 6 LEGAL AND ADMINISTRATIVE STRUCTURE OF RIAs

The GATT/WTO system is formed of a set of general rules (called as articles) governing the conduct of the parties in international trade. Most of these specified rules are designed to secure the smooth working of the desired tariff concessions (Matsushita et al., 2003, p.3). While there are 39 articles and the enforcement mechanism has a fundamental importance for the smooth-working of the system, the principles of reciprocity and non-discrimination (Article I) constitute two arteries of the GATT/WTO system.

However, as it is studied in Section 4.2.2, the GATT system had also introduced an exception to the principle of non-discrimination. This exception was worded in the GATT Article XXIV. This legal clause has stated the conditions required for the formation of FTAs/CUs. The Article XXIV has further supplemented by two other articles through the development of the GATT/WTO system. Starting with the 1960s, the growing concern about the developing countries' participation in international trade resulted in several attempts. The initial steps taken in the UNCTAD had further resulted in similar attempts in the GATT system. Consequently, the Enabling Clause introduced to the system through Tokyo Round (1979). On the other hand, when the informal GATT system gained its legal standing via the formation of the WTO, the services sector has been one of the important subjects of the international trading system. This, as a result, necessitated defining the code of conducts for the formation of RIAs that cover services sector. This requirement has been fulfilled through the introduction of the GATS Article V.

In this chapter, the basic lines of the GATT Article XXIV, the Enabling Clause and the GATS Article V[1] will be studied, respectively. As the GATT/WTO system has generally been critized due to the ambiguity of requirements listed in related articles, Section 4 will try to point out the critiques raised against these articles. On the other hand, as RIAs that are formed via these articles has been assessed by the Committee on Regional Trade

[1] Full versions of each article are retrieved from the WTO website and can be found in Appendix A, Appendix B and Appendix C, respectively.

Agreements (CRTA, 1996) body of the WTO, the final section will study this committee and the critiques related to the working of the CRTA.

6.1 GATT Article XXIV

The GATT Article XXIV which can be seen as the main tool for discriminatory trading is a legal clause that tries to clarify the conditions required for the formation of customs unions and free trade areas. Under the headline "Article XXIV: Territorial Application — Frontier Traffic — Customs Unions and Free-trade Areas", the initial premise lies on defining the extent of the policy measures applied towards non-member countries of the integration. Accordingly, it is argued that the prohibitive upper-bound for the height of the trade measures of integrated unit would be the one that exist before the formation of RIA. It states as follows:

> The formation of a customs union or of a free-trade area or the adoption of an interim agreement that will lead to such formations should not make the duties and other regulations of commerce to non-contracting parties be higher or more restrictive than the applications prior to the formation of a customs union or of a free-trade area.

Article XXIV here refers to the GATT Article XXIV and its extensions: Ad Article XXIV (its updates) and the 1994 "Understanding". With this enlarged content, it further draws the main lines for the creation of FTAs and CUs as follows:

- A customs union provides that:
    - duties and other restrictive regulations of commerce are eliminated with respect to substantially all the trade within the territories of the union or at least with respect to substantially all the trade in products originating in such territories, and,
    - 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, on the other hand, provides the formation in which the duties and other restrictive regulations of commerce are eliminated on substantially all the trade in products originating in the constituent territories.

While it is stated that given RIA should eliminate the internal tariffs prevailing among member countries for both types of the agreements, in the case of CU, it further requires the determination of common external tariff (CET). These requirements are presented via three principal restrictions. Accordingly, first of all, an RIA must not, "on the whole", raise protection against excluded countries. Secondly, an RIA must reduce internal tariffs to zero and remove "other restrictive regulations of commerce" other than those permitted by other GATT articles. Finally, it must cover "substantially all trade" among the member countries.

While elimination of trade barriers for substantially all trade of the union aims to strengthen possible trade-creation effect, determination of upper-bound for external trade barriers is introduced in order to decrease trade-diversion effect as much as possible. Hence, the requirements of this article have been designed so as to ensure that the trade-diversion effect is less than the trade-creation effect of RIAs (Savaş, 2004, p.186).

Some of the leading examples of the RIAs formed via the GATT Article XXIV are as follows: Caribbean Community and Common Market (CARICOM, 1973), European Union (EU-Treaty of Rome, 1957), European Free Trade Association (EFTA-Stockholm Convention, 1960), the North American Free Trade Agreement (NAFTA, 1994), and Southern African Customs Union (SACU, 2004).

6.2 Enabling Clause

Developing countries have participated to international trading system in different degrees throughout the development of the GATT/WTO system. While they were inactive or passive elements during the first six rounds of the GATT, the situation has been changed thereafter. This change was mainly originated from the efforts taken in UNCTAD.

In the mid-1950s, with the independence of a large number of colonies, the concept of preferential treatment towards developing countries emerged (Hoekman et al., 2003a, p.16). The initial attempts on the issue included the creation of UNCTAD in 1964, as well as the formation of Group of 77 (G-77) of developing countries in the UN. This was followed by the inclusion of the draft of Part IV of the GATT that led developing countries special status in the multilateral system in 1965. It was stated that the reason for the adoption of Part IV –entitled as "Trade and Development"– by the GATT contracting parties was a reaction to the creation of UNCTAD (ibid., p.17). Whatever the original purpose was for it, the idea of special and differential treatment maintaining non-reciprocal reductions of trade barriers in favor of developing countries had been introduced to the international trading system.

The first Secretary-General of UNCTAD, Raul Prebisch, was the one who initially stated the need for a change in attitudes towards developing/least developed countries in international trade. Prebisch's idea realized through adoption of the Generalized System of Preferences (GSP) at UNCTAD II in New Delhi in 1968. The GSP was designed to allow preferential treatment –through partial or total elimination of tariff rates– to certain quantities of products originating from developing countries in the markets of developed countries. The Resolution 21 (ii) of 1968 states the main lines of GSP[1] as follows (UNCTAD, website):

> …the objectives of the generalized, non-reciprocal, non-discriminatory system of preferences in favour of the developing countries, including special measures in favour of the least advanced among the developing countries, should be:
>
> - to increase their export earnings,
> - to promote their industrialization, and
> - to accelerate their rates of economic growth.

The adoption of GSP schemes was further supported by the GATT system through the adoption of a waiver for GSP in 1971. This was a waiver to Article I (MFN clause) for ten

[1] According to the UNCTAD website (as of December 22, 2008), there are currently 13 national GSP schemes notified to UNCTAD. These are as follows: Australia, Belarus, Bulgaria, Canada, Estonia, the EU, Japan, New Zealand, Norway, the Russian Federation, Switzerland, Turkey and the USA.

years in order to let developed countries employ GSP schemes toward developing countries. Beside GSP schemes, there were also rising concerns about the participation of developing countries in RIAs. Again, some kind of flexibility on the conditions of forming such agreements was demanded. This flexibility and permanent privilege for GSP schemes came into life through the inclusion of the Enabling Clause (1979) in the Tokyo Round. The important aspect of this clause is that "it calls on industrialized countries not to seek reciprocal concessions from developing countries that are inconsistent with their individual development, financial and trade needs" (Hoekman et al., 2003b, p.15).

In the GATT/WTO system, the Enabling Clause which is officially entitled as "Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries" highlights the asymmetric treatment of developing countries on the following points:

- Preferential tariff treatment accorded by developed countries to products originating from developing countries in accordance with the Generalized System of Preferences
- Differential and more favourable treatment in non-tariff measures
- Regional or global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which may be prescribed by the member countries, for the mutual reduction or elimination of non-tariff measures, on products imported from one another
- Special treatment on the least developed among the developing countries in the context of any general or specific measures in favour of developing countries

The Enabling Clause made special and differential treatment for developing and least developed countries an important element of the international trading system. As this clause has been stated as a permanent waiver to the MFN clause under developed countries' GSP schemes, i.e. exempting developing countries from the reciprocity principle in these schemes, it has also enabled developing countries to form RIAs which are not in full conformity with the requirements of the GATT Article XXIV. Hence, it is another

relaxation to Article I (MFN clause), but this time in favor of developing and least developed countries.

Related to the formation of RIAs, the Enabling Clause drops the conditions on the coverage of trade and lets developing countries determine the extent of the liberalization. In sum, the Enabling Clause "calls for preferential market access for developing countries, limits reciprocity in negotiating rounds to levels 'consistent with development needs' and provides developing countries with greater freedom to use trade policies than would otherwise be permitted by GATT rules" (Hoekman et al., 2003b, p.4).

Some of the important examples of the RIAs that are formed with the Enabling Clause are: Economic Community of West African States (ECOWAS, 1993), ASEAN Free Trade Area (AFTA, 1992), Common Market for Eastern and Southern Africa (COMESA, 1994), Southern Common Market (MERCOSUR, 1991) and West African Economic and Monetary Union (WAEMU, 2000).

6.3 GATS Article V

The subject matters of international trading system have been broadened significantly since the initiation of the GATT system. Trade in manufactured goods has been accompanied by trade in services that include sectors like banking, insurance, communication, transportation and tourism. Consequently, this change necessitated to introduce legal framework that would organize trade in services. As one of the by-products[1] of the Uruguay Round (1987-1994), the General Agreement on Trade in Services (GATS) has been designed for this purpose.

When the GATS has been included as a new actor of the trading system, RIAs dealing with trade in goods have been accompanied by RIAs that cover trade in services. As a result, the GATT/WTO system has employed the GATT Article XXIV and the Enabling Clause to

[1] Trade Related Investment Measures (TRIMs) that ensures national treatment of foreign direct investment and Trade Related Intellectual Property Rights (TRIPs) which is a safeguard agreement for the intellectual property can also be stated as the newly introduced areas of the GATT/WTO system.

specify conditions for the formation of RIAs covering merchandise trade, the GATS Article V to specify the requirements for RIAs covering trade in services. Accordingly;

- An integration that will liberalize trade in services between or among the parties to such an agreement should have following properties:
    - substantial sectoral coverage,
    - elimination of substantially all discrimination for the covered sectors either at the entry or in a specific time interval that includes;
        - ◊ elimination of existing discriminatory measures, and/or
        - ◊ prohibition of new or more discriminatory measures,
- When developed countries' participation is the case, some kind of flexibility should be provided on the conditions of integration. Moreover,in an agreement that contains only developing countries as the members more favourable treatment may be granted to specified persons of the members.

Although the general structure is the same, the condition that requires not to raise barriers to third countries is rather tighter in GATS Article V relative to the GATT articles. It is applied sector by sector instead of "on the whole" requirement, and service suppliers of non-member countries that are involved in "substantive business" within the boundaries of regional integration before the formation of RIA must be treated equally in the region (Schiff & Winters, 2003, p.250).

6.4 Critiques of Related Articles of RIAs

While the existence and the permanence of RIAs are guaranteed through their increasing number, several issues have emerged related to their effects on members, on non-members and on the global order. These discussions are generally centered on the insufficiency of the GATT/WTO system on determining the clear-cut requirements for the formation of RIAs. The main critiques raised against the legal structure of the GATT/WTO system that govern RIAs come from the following points:

- the inefficiency of required conditions
- the issues on enforceability of the articles
- the ambiguous wordings like “substantially all trade”, “on the whole” and “other restrictive regulations of commerce” of the related articles

The one of the initial critiques of the GATT Article XXIV came from Kenneth Dam. Dam’s (1963, p.619) critique is like the overall report of all the deficiencies of the legal basis of RIAs and stated as follows:

> If a single adjective were to be chosen to describe article XXIV, that adjective would be “deceptive”. First, the standards established are deceptively concrete and precise; any attempt to apply the standards to a specific situation reveals ambiguities which, to use an irresistible metaphor, go to the heart of the matter. Second, while the rule appears to be carefully conceived, the principles enunciated make little economic sense. Third, the dismaying experience of the Contracting Parties has been that no customs union or free-trade area agreement presented for review has complied with article XXIV and yet every such agreement has been approved by a tacit or explicit waiver.

Furthermore, as Schiff and Winters (2003, p.245) argue, the requirements of these articles are not adequate to ensure that regionalism would result in economic advantages to either its members or non-members. Hence, these conditions would not prevent the formation of RIAs that have serious negative effects on non-member countries. Moreover, RIAs that are stated as GATT-compatible can be “significantly trade diverting; excluded countries can suffer terms-of-trade declines; protection can increase; and institutions can arise that make liberal policies less likely” (ibid., p.248).

Although there are attempts like the “1994 understanding of the interpretation of Article XXIV of GATT” to improve the compatibility of regionalism with multilateralism, the interpretation of the WTO conditions on regionalism is still troublesome. The ambiguous statements like “substantially all trade”, the “other restrictive policies” and disregarding barriers other than tariffs are the principal examples that dilute the working mechanism.

First of all, there is no consensus on the meaning of "substantially all trade" statement. Does it refer to the proportion of actual trade covered or to the inclusion of all major sectors of the economy? If it refers to percentage, what percentage would satisfy the "substantially all trade" criteria? The ambiguity is also prevalent on the condition that speficies the extent of external trade barriers as: "not on the whole be higher or more restrictive". There is no consensus on whether the words "on the whole" and "general incidence" refer to "each item in the common external tariff schedule or to the common external tariff schedule as a whole" (Dam, 1963, p.619). The situation is not different for the conditions of the GATS Article V. It provides no explanation for the "substantially all trade" requirement other than it must be "understood in terms of number of sectors, volume of trade, and modes of supply" (Chakraborty, 2003, p.10).

Although the ambiguity on "substantially all trade" phrasing is still prevalent, the study of RIAs held by the WTO tries to make some kind of estimation: "… most *RIA*s attain a common interpretation of '*substantially all trade'* and 'reasonable length of time'- liberalization of 90 per cent of tariff lines by year ten of the agreement" (Estevadeordal et al., 2009, p.6). However, when it is assumed that tariffs and other restrictive regulations are eliminated on 90 per cent of internal trade, and the major industries left in the remaining 10 per cent are excluded from the internal liberalization of the agreement, it would satisfy the "substantially all trade" criterion of the WTO, but in what terms?

Additionally, the treatment of nontariff barriers (like antidumping duties, safeguards and variable levies) and the rules of origin in assessing the overall level of trade restriction are not defined. The requirement that "other restrictive regulations of commerce" be removed between members is ambiguously worded. Hence, these unclear statements result in many RIAs that involve these kinds of provisions.

Moreover, trying to weigh "other restrictive regulations of commerce" against tariffs is "a task which if not impossible at least requires an unverifiable estimate of what tariff level would restrict imports to the levels permitted by particular" measures and "…compensation arrangements under article XXIV are illogical since they require the customs union to grant compensation for injuries arising to third parties from the creation

of the common external tariff but not for similar injuries arising from the discriminatory elimination of internal tariffs" (Dam, 1963, p.621, p.631).

The rules specified by the Enabling Clause are, in addition to being ambiguous, even less restrictive than those of the Article XXIV and they make no reference to coverage of trade, the complete elimination of trade barriers or, as in the case of the other articles, a time schedule for implementation pace (Ravenhill, 2005, p.143).

Finally, it is also disputable that while FTAs and CUs are allowed and legalized through related articles, why the preferential trade agreements are not counted as an acceptable kind of integration. Dam (1963, p.633) questions this dilemma as:

> Preferential arrangements which involve partial rather than complete elimination of intermember tariffs are absolutely forbidden… Since the tariff reduction inherent in such a preferential arrangement might be considered a movement toward free trade, albeit not so dramatic as that produced by a customs union or free-trade area, and since such a preferential arrangement by definition involves less discrimination against nonmembers than a customs union or free-trade area, the justification for proscribing such arrangements absolutely is not clear.

6.5 Committee on Regional Trade Agreements (CRTA)

In the GATT/WTO system, RIAs have to be notified to the WTO (previously, to the GATT). The conformity check of the proposed RIA to the GATT/WTO system was done by an ad hoc working party until 1996. Since then, this procedure has been handled by the Committee on Regional Trade Agreements (CRTA) of the WTO. Examination of individual regional agreements and the consideration of the systemic implications of the agreements for the multilateral trading system have been two principal duties of the CRTA. The main motive for establishing such an intermediary branch is stated as to increase the transparency, efficiency and consistency of an RIA appraisal of the WTO.

When the systematic procedure applied in the GATT/WTO system for the establishment of any RIA is examined, the first step includes the notification of all RIAs to the related councils. While RIAs that depend on Article XXIV as a provisional basis should be notified to the Council for Trade in Goods (CTG), RIAs that adopt the Enabling Clause are notified to the Committee on Trade and Development (CTD). RIAs that cover trade in services are, on the other hand, notified to the Council for Trade in Services (CTS). After the required notification, these councils transfer the agreement proposal to the CRTA. However, unlike CTG, CTS does not have to send agreement to the CRTA for examination, the process is optional.

It should be noted that WTO gives full flexibility to the parties to an RIA in determination of the notification date of their agreement. Accordingly (WTO, 1996, p.2): "Of the RTAs thus far notified under Article XXIV, one third were notified between the date of signature and the date of entry into force, and half were notified after the date of entry into force. On average, the interval between the date of entry into force and the date of notification entailed a delay of about five weeks."

In the CRTA, the examination of given agreement starts with written or oral replies of the members of integration to the WTO's written questions or questions raised at the CRTA meetings. Depending on these answers, the examination report is drafted by the Secretariat. Upon the acceptance of the report by the CRTA, it is submitted to the General Council of the WTO for adoption. Similar to the notification date of RIAs, the WTO proposes specification of a certain time period for each step but it does not enforce any time constraint on conclusion and the adoption of the report.

Regardless of the unsuccessful meetings like Seattle and Cancún, and other Doha Round negotiations, in the international trade system which is governed by the WTO, there are also attempts to find better ways for organizing and controlling the proliferating RIAs. For example, the Doha Declaration (2001) has stated clearly the need for clarifying and improving disciplines under the RIA-related provisions of the WTO through taking into account the developmental aspects of the RIAs. On the other hand, the new transparency mechanism for RIAs established on a provisional basis by the General Council on 14

December 2006 is one such attempt that aims to rehabilitate the system for the contemporary world. Accordingly, this mechanism provides for early announcement of any RIA and the notification to the WTO. Moreover, it is intended that the CRTA will directly examine RIAs covering the GATT Article XXIV and the GATS Article V rather than applying separately to CTG and CTS, and the CTD will inspect RIAs with the provision of the Enabling Clause, as was the case previously.

Although there are attempts to strengthen the position and working of the CRTA, this committee (previously, ad hoc working party) is not free of critiques on the regionalism debate. There are several critiques stating that the CRTA is not an efficient mechanism to control the ongoing trend of RIAs. For example, inefficiency of the examining body of the GATT/WTO system depicted itself firstly in the Treaty of Rome (1957) experience of the GATT. While it was apparent that there were contradictions to Article XXIV, the examination of the Treaty was left uncompleted due to the threat of the European countries to quit the GATT.

This case, eventually, resulted in the loss of confidence together with the loss of authority of the GATT. From that time onwards, the most of RIAs have not applied for the conformity check, rather they have announced to come into existence, without considering whether they fit well into legal structure or not. Sampson (1996, p.90) notes that this conformity check of RIAs as one of the most unsatisfactory of all GATT procedures, and states as follows:

> Of the 80 working parties that have examined the conformity of agreements, only one has ever found an agreement to be fully in conformity- *the Czech Republic and the Slovak Republic Customs Union*. On the other hand, no regional agreement has been found not to be in conformity, despite the fact that this has clearly been the case for some agreements.

Moreover, the GATT/WTO system is also criticized on the ground that the assessment process employed in the system is so slow to conclude that the proposed RIA is the WTO-compatible. The WTO web page on CRTA states that "…no examination report has been

finalized since 1995 because of lack of consensus." While this constitutes another bottleneck in the system, the lack of clear systematic rules in front of the CRTA also an important element of inconsistency and inefficiency while assessing particular RIAs.

CHAPTER 7 PRESENT SITUATION OF REGIONAL INTEGRATION

RIAs legalized by the GATT/WTO system are important components of the international trading system since the advent of the GATT in 1947. While there are multilateral attempts to determine global rules for the system, the increasing number of RIAs leads into the fragmentation of the multilateral trading system into several regional blocs which determine their own rules of conduct. This chapter aims to clarify the spread of regional integration to all over the world.

In order to do this, in the first section, related statistics which provide a general overview of regional integration will be presented. These statistics include the number of RIAs, the distribution of RIAs according to type of agreement, the distribution of RIAs according to the legal basis, the number of RIAs existing in the specified regions, and intra-regional exports and extra-regional imports of selected RIAs. These statistics are mainly taken from the Regional Trade Agreements Database of the WTO, except the intra-regional and extra-regional trade values which are taken from the UNCTAD Handbook of Statistics 2009.

In the following sections, the important examples of RIAs existing in Europe, Americas, Asia, Oceania and Africa will be presented, respectively. As the economic, political and the GATT/WTO related motives for the formation of RIAs are presented in detail in Chapter 5, in these sections, the main lines will cover the membership evaluations, as well as the structural change, if it exists, of the given RIAs. The sample of RIAs that are studied include the European Union (EU), European Free Trade Association (EFTA), the Turkey-EU customs union, North American Free Trade Agreement (NAFTA), Mercado Común del Sur (MERCOSUR), the Andean Community (CAN), the Caribbean Community (CARICOM), Association of Southeast Asian Nations FTA (AFTA), South Asian Free Trade Area (SAFTA), the Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), Southern African Customs Union (SACU), Economic

Community of West African States (ECOWAS), West African Economic and Monetary Union (WAEMU), and Common Market for Eastern and Southern Africa (COMESA).

7.1 General Overview of Regional Integration

The upward surge in the number of RIAs has started to grasp attention of the international economists and other professionals since the 1990s. Figure 7.1 depicts rapidly increasing trend of the number of RIAs notified to the GATT/WTO, including inactive RIAs between the years 1948 and 2009.

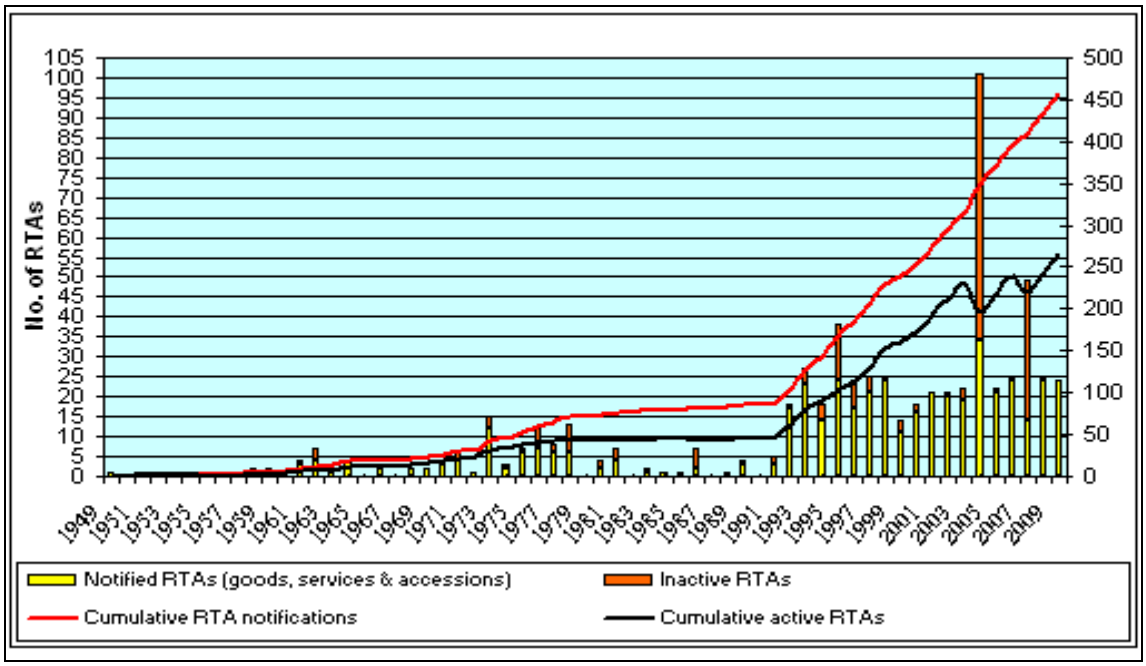

Figure 7.1 The number of RIAs notified to the GATT/WTO (Source: the WTO)

It should be noted that this figure shows the existing situation partly, since the WTO does not give any time schedule for the notification of RIAs to the system. Hence, the number of such agreements is expected to be higher. Appendix D enlists all of RIAs (total 272 RIAs) that are notified to the GATT/WTO and in force as of March 2010.

Although the GATT system enabled or legalized the formation of RIAs by the GATT Article XXIV which was accompanied later by the Enabling Clause, the historical data reveal that the number of regional integration agreements is negligible when compared to

the ones that have emerged after the initialization of the Uruguay Round. As it is stated by the WTO, "in the period 1948-1994, the GATT received 123 notifications of RIAs, and since the creation of the WTO in 1995, over 300 additional arrangements covering trade in goods or services have been notified". Hence, the strict predominance of the WTO system on the issue is apparent. Factors that have significantly reinforced the role of the WTO on the regionalism debate include extended and diversified subject matters of multilateral trading system, introduction of RIAs covering trade in services (seventy-six of two hundred seventy two RIAs are in services), difficulties on tackling with disputes raised in the WTO, and impossibility of reaching unanimous decisions with increased number of member countries of the WTO.

Currently, all WTO members except Mongolia have involved in at least one RIA. The "Regional Trade Agreements" gateway of the WTO reports that approximately 460 RIAs have been notified to the GATT/WTO up to March 2010. As the WTO states, "of these RIAs, free trade agreements (FTAs) and partial scope agreements account for over 90%, while customs unions account for less than 10 per cent". Moreover, Figure 7.2 shows percentages of RIAs that are notified and differed according to legal standing.

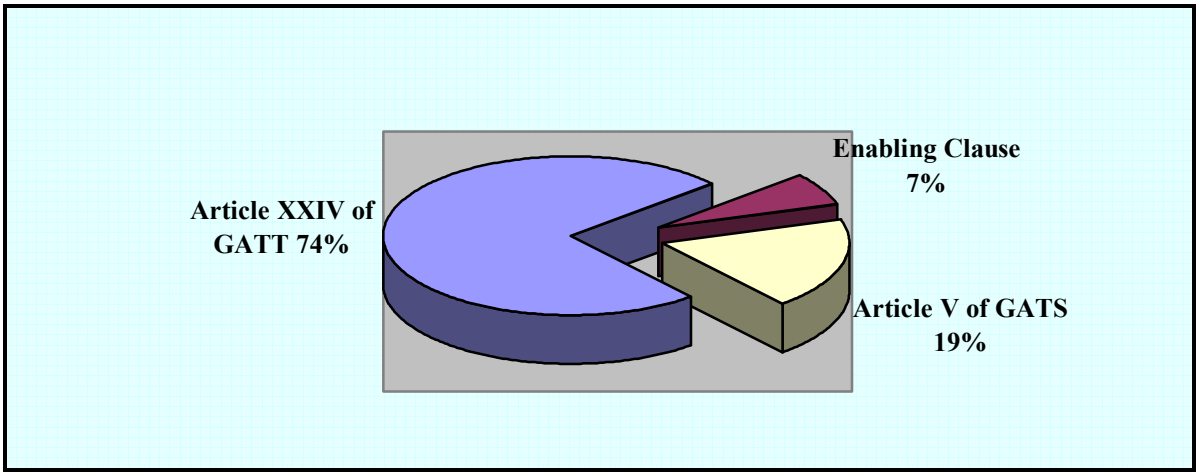

Figure 7.2 Distribution of legal standing of RIAs

According to Figure 7.2, 74 per cent (345 RIAs) of the notified RIAs have taken Article XXIV as a legal base. While 19 per cent (86 RIAs) of these agreements have been established with the GATS Article V as a legal basis, 7 per cent (31 RIAs) have depended

on the Enabling Clause. There are three interpretations that can be derived from this figure. First of all, Figure 7.2 shows that RIAs dealing with trade in goods are still a dominant factor of international economics. Secondly, although being a comparatively new actor in the global system, the share of RIAs that cover trade in services is significant, and it can be inferred that in a reasonable time-length this share would be relatively close to the one of RIAs that cover trade in goods. Finally, Figure 7.2 also highlights that since its adoption in the Tokyo Round (1979), the Enabling Clause has not been, yet, a strong motive for developing countries' participation in RIAs that involve countries that have similar development levels. For such tendency, the main reason lies at the distinction between South-South agreements and North-South agreements. Historical experience has shown the success of the latter over the former.

As of March 2010, there are 272 RIAs notified and entered into force, as shown in Figure 7.3. Agreements covering trade in services are generally called as Economic Integration Agreements (EIAs) in the WTO. The number of these agreements is 76. 196 agreements, on the other hand, cover trade in goods. Of these RIAs, 21 agreements are formed as CUs, 14 are formed as preferential trade agreements, and the rest, which constitutes the larger part of these agreements, are formed as FTAs.

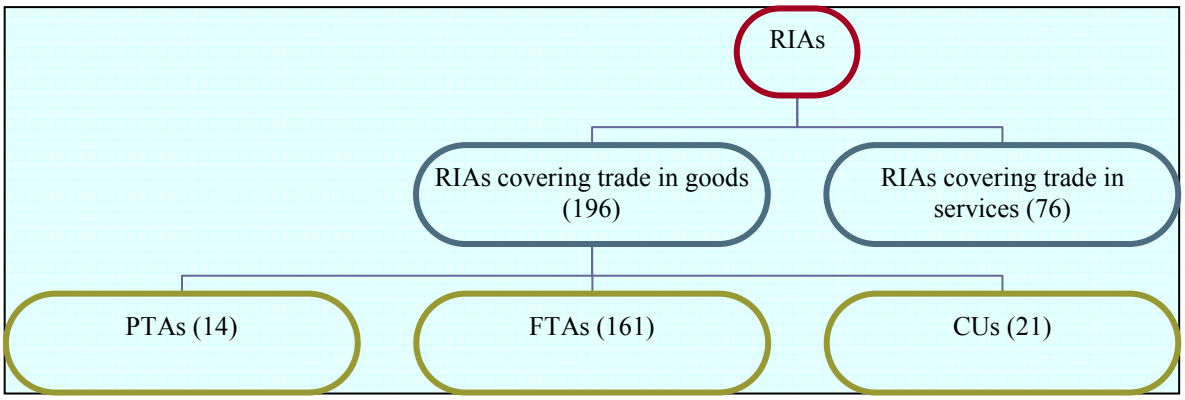

Figure 7.3 The number of RIAs covering trade in goods and trade in services

Hence, the dominance of FTAs over CUs is apparent from the statistics. The main reason behind this kind of intensity derives from the restrictiveness of CUs relative to FTAs. While member countries of FTAs are free within the limits of the GATT/WTO system on deciding the level of external tariff rates, CUs necessitate some kind of sacrifice for some

of the members of union as this kind of agreements depends on the determination of the common external tariff (CET) that will be imposed on third countries.

Geographical data on RIAs, on the other hand, will be helpful to see the locomotive areas of the world that contribute to the spread of regionalism. This data is shown in Table 7.1.

Table 7.1 Regional distribution of RIAs

Region	**Trade Coverage**	**Total**			**Intra-regional**		
		CU	**FTA/EIA**	**PTA**	**CU**	**FTA/EIA**	**PTA**
North America	Goods	–	28	3	–	1	–
	Services		21			1	
Central America	Goods	2	17	1	1	3	–
	Services		17			3	
South America	Goods	3	20	5	2	1	–
	Services		20			2	
Caribbean	Goods	1	3	2	–	–	–
	Services		3			–	
Europe	Goods	10	63	3	10	24	–
	Services		19			10	
Commonwealth of Independent States	Goods	1	30	1	1	27	–
	Services		–			–	
Africa	Goods	5	19	2	5	2	–
	Services		1			–	
Middle East	Goods	1	20	3	1	–	–
	Services		4			–	
West Asia	Goods	–	7	9	–	4	2
	Services		2			–	
East Asia	Goods	–	36	6	–	13	2
	Services		33			12	
Oceania	Goods	–	12	2	–	3	2
	Services		9			1	

First impression that can be derived from this table is that today, RIAs are not limited only to specific regions. It may sound confusing, but the present situation suggests that RIAs are not regional anymore. As it is also listed in Appendix D, there are lots of agreements that bring together countries that located in different parts of the world. This is also shown in

intra-regional, i.e. within the given geographic area, figures of Table 7.1. The number of such agreements is significantly lower than given values of related regions. For example, there are 2 intra-regional RIAs out of 52 RIAs that include countries from North America. While there are 44 agreements of European countries in this region, there are 51 agreements that these countries have signed with countries located outside Europe.

The dominance of Europe on the issue is significant from the figures. While there are 82 FTAs/EIAs, there are 10 CUs in which European countries involve as one of the members. Since the number of RIAs originating from Europe is so high, it will be hard for other regions to catch up this kind of intensity. The leading examples of the region are the EU and EFTA. Europe is followed by the Americas (North, Central, and South). The table shows that the figures prevailing in each part of the continental America is close to each other, as the numbers of RIAs are 37 for Central America, 52 for North America and 48 for South America. The US' favoritism on regional integration in the Northern part has constituted the main driving force for the increased interest of Central and Southern American countries in regionalism. CACM, CAN, CARICOM, LAFTA and MERCOSUR are some of the examples prevailing in the Americas, in addition to NAFTA which constitutes the locomotive agreement of the region.

Although Asian part of the world is the late participant of regional integration attempts, the number of RIAs originating from Asia is increasing and catching up the trend. Association of Southeast Asian Nations (ASEAN) was the initial step for the regionalism experience of Asian countries. While the most of FTAs existing in the continent are the extension of ASEAN through FTAs like ASEAN-Japan FTA and ASEAN-China FTA, the leading examples include AFTA, APTA and SAPTA. The history of RIAs in Africa, on the other hand, is older than the one of Asia, although the numbers do not depict this fact. The RIAs are mainly conceived as a way to assure political stability in the continent. COMESA, ECOWAS and SACU constitute some of the examples of the continent. While the number of RIAs in the Middle East (like PAFTA and ECO), Commonwealth of Independent States (like CEFTA) and Oceania (like ANZCERTA and SPARTECA) are also noteworthy, the implications of these RIAs on the multilateral trading system is less significant when it is

considered that North America, Western Europe and East Asia are three main arteries of the international trading system.

The intra-trade volumes of RIAs would also contribute to drive some conclusions on the trend of RIAs. Table 7.2 and Table 7.3 report UNCTAD Handbook of Statistics (2009) data on the percentages of intra-regional exports and extra-regional imports for selected RIAs, respectively. These agreements include five RIAs from Africa [CEMAC (1999), COMESA (1994), ECOWAS (1993), SADC (2000) and WAEMU (2000)], five RIAs from America [CACM (1961), CARICOM (1973), LAIA (1981), MERCOSUR (1991) and NAFTA (1994)], four RIAs from Asia [APTA (1976), ASEAN (1992), ECO (1992) and GCC (2003)], two pioneers from Europe [EFTA (1960) and the EU (1957)].

Table 7.2 Intra-regional exports for selected RIAs

	Intra-regional exports (% of total exports)						
	1980	1990	2000	2005	2006	2007	2008
Africa							
CEMAC	1.61	2.26	1.05	0.90	0.90	1.06	0.84
COMESA	1.80	4.73	4.67	4.63	4.57	4.60	4.66
ECOWAS	9.65	8.00	7.63	9.34	8.42	9.17	9.00
SADC	0.36	3.13	12.33	12.15	10.86	11.78	11.35
WAEMU	9.60	12.98	13.12	13.37	13.11	15.12	13.43
America							
CACM	24.39	15.26	19.11	20.12	16.46	17.46	18.43
CARICOM	5.56	8.04	14.52	11.63	11.42	15.62	14.61
LAIA	13.92	11.56	13.17	13.63	14.34	15.06	16.14
MERCOSUR	11.60	8.86	20.00	12.89	13.49	14.98	15.45
NAFTA	33.58	41.39	55.71	55.75	53.85	51.29	49.48
Asia							
APTA	1.71	1.60	7.96	10.96	10.91	11.20	11.67
ASEAN	17.28	18.94	22.98	25.33	24.94	25.20	25.38
ECO	6.31	3.24	5.55	7.56	8.43	9.01	8.29
GCC	2.97	7.98	4.88	4.54	4.53	4.87	4.47
Europe							
EFTA	1.07	0.79	0.59	0.53	0.56	0.70	0.78
EU	62.18	67.49	67.69	67.37	67.67	67.89	67.17

Table 7.3 Extra-regional imports for selected RIAs

	Extra-regional imports (% of total imports)						
	1980	1990	2000	2005	2006	2007	2008
Africa							
CEMAC	96.29	96.43	97.15	97.12	97.08	97.32	97.13
COMESA	98.38	95.78	96.70	94.69	94.77	95.62	95.55
ECOWAS	88.64	89.25	89.41	89.32	90.42	90.91	91.37
SADC	97.80	94.63	80.77	83.83	84.96	84.24	84.38
WAEMU	94.62	90.32	91.12	91.14	91.67	92.00	92.40
America							
CACM	80.41	90.34	87.44	87.96	87.78	87.53	86.63
CARICOM	90.96	94.18	91.57	91.70	91.63	88.52	89.19
LAIA	87.82	84.98	86.35	82.98	82.17	81.92	82.06
MERCOSUR	91.73	85.79	80.25	81.09	81.36	81.40	84.41
NAFTA	67.19	66.08	59.52	65.09	65.70	65.87	66.54
Asia							
APTA	98.69	98.80	90.21	86.17	86.02	85.49	85.93
ASEAN	85.65	84.78	77.53	75.66	75.25	75.28	73.71
ECO	95.75	96.83	94.49	93.33	92.56	92.45	91.90
GCC	93.44	91.62	91.04	92.75	92.34	93.08	92.88
Europe							
EFTA	98.99	98.98	99.21	99.26	99.16	99.24	99.12
EU	44.93	35.71	37.49	37.36	36.68	35.91	37.40

In African RIAs, it is seen that percentages for intra-regional exports are significantly lower than related shares of other RIAs (except EFTA). While this leads to question the effect of regional agreements among countries that are at similar development levels, it further shows that political concerns are the main factor for the formation of these agreements. For CEMAC and COMESA, percentages of intra-exports are not significant as they change in the range of 1 to 5 per cent. ECOWAS, SADC and WAEMU are, on the other hand, relatively more integrated as their intra-export shares change between 7 to 14 per cent since 2000. However, these rates still are not comparable to higher rates of RIAs established in other continents. Among three, SADC shows clear impact of regional integration on trade as percentages of intra-trade exports are approximately quadrupled in

2000. In Africa, overall, persistent high percentages of extra-regional import levels show that members of these RIAs are still dependent on third countries for their trade relations.

In America, RIAs other than NAFTA have moderate percentages of trade shares. However, it should be noted that compared to their African counterparts, these RIAs have significant shares as they alternate between 5 per cent and 25 per cent. While CACM has relatively higher intra-group export shares, LAIA and MERCOSUR show lower rates of extra-regional imports. As it is stated before, NAFTA is the locomotive agreement for America. While the share of intra-NAFTA exports was 33 per cent in 1980, it has significantly increased to average of 53 per cent after 2000. On the other hand, extra-NAFTA imports have not show much oscillation (except the year 2000), as the related shares are changed around 65 per cent.

In Asia, regional agreements of ECO and GCC have not contributed significantly to increase intra-regional export shares. Moreover, these RIAs have high extra-regional import values. On the other hand, for the case of APTA, gradual increase of intra-regional export shares and decrease of extra-regional import shares are significant after 1990s. ASEAN which is the locomotive agreement of the continent shows the effect of integration through its increased intra-regional exports. While intra-ASEAN export share was 18 per cent in 1990, it increased to 25 per cent in 2008. However, these intra-regional shares are much lower than intra-regional shares of NAFTA and the EU. Although extra-regional import shares are still considerably high, percentage of these imports has fallen to 73 per cent in 2008.

Trade shares for EFTA which alter between 0.5 per cent and 1.1 per cent depict that the economic concern was not a primal motive behind the formation of this RIA. EFTA largely depends on third countries (especially on the EU) for its exports and imports. However, ineffectiveness of EFTA on trade relations does not constitute a major problem as the EU puts the continental Europe to the top of regional integration issue. Its importance comes from both being the first successful regional integration attempt and its high level of integration as it has reached to EMU level. The data show that approximately 67 per cent of total exports of EU originate from the member countries of the Union. The

shares of extra-import, on the other hand, change around 36 per cent. This percentage is much lower than extra-trade share of NAFTA. Hence, high percentages of intra-EU exports together with low percentages of extra-EU imports suggest inwardness of the EU on the global scale.

In sum, the effect of NAFTA and the EU on intra-trade levels are significant. While it is taken account that the most of the leading powers –the US, Britain, Germany, France, etc.– are members of either the EU or NAFTA, it should be emphasized that inwardness of these arrangements affects the global trading system more than any other RIA. Moreover, as ASEAN (later, AFTA) figures also show systematic increase in these levels, ASEAN constitutes the third leg of the regionalism debate.

The increased levels of intra-trade levels in these agreements show that while members are turning into intra-group for their exports and imports, some other non-member countries extensively lose from this shift. Hence, concerns over the regional integration issue have mainly centered on the following question: what does increased integration of regional groupings imply for the global order?

7.2 Regional Integration in Europe

This section will try to examine more closely two leading examples of RIAs formed in Europe, namely the EU (and its predecessors) and EFTA. At the end of the section, some notes on the Turkey-EU customs union will be presented. Table 7.4 shows membership evaluation and structural development of the EU and EFTA, with year of membership in parentheses.

Table 7.4 Evaluation of EU and EFTA

RIA	Member countries	Type of the agreement
EU	Belgium (1952), France (1952), Germany (1952), Italy (1952), Luxembourg (1952), Netherlands (1952), Denmark (1973), Ireland (1973), United Kingdom (1973), Greece (1981), Portugal (1986), Spain (1986), Austria (1995), Finland (1995), Sweden (1995), Cyprus (2004), Czech Republic (2004), Estonia (2004), Hungary (2004), Latvia (2004), Lithuania (2004), Malta (2004), Poland (2004), Slovakia (2004), Slovenia (2004), Bulgaria (2007), Romania (2007)	EEC-1957 (Treaty of Rome) (CU) EC-1967 (Merger Treaty) (CU) EU-1992 (Maastricht Treaty) (CU) EU-1999 (EMU)
EFTA	Austria (1960-1994), Iceland (1960), Norway (1960), Portugal (1960-1985), Sweden (1960-1994), Switzerland (1960), Finland (1986-1994)	EFTA-1960 (Stockholm Convention) (FTA) EEA-1994 (EU&EFTA)

The European Union

As a starting point, it can be stated that the idea behind integration of Europe goes back as late as to the 18th century. The term "United States of Europe" had been launched by Victor Hugo in the Congress of Press, Paris in 1848 (Adriana, 2008, p.313). The history of the formation of the world's largest RIA, the EU, on the other hand, starts with the establishment of the European Coal and Steel Community[1] (ECSC-1951) by Belgium, France, Germany, Italy, Luxembourg, and Netherlands via the Treaty of Paris. Although it covered limited number of products, ECSC was a hybrid of a customs union and free-trade area in that "it did not provide for a common external tariff but neither did it leave its members free to…pursue independent external commercial policies" (Dam, 1963, p.638). While the ECSC provided an integrated market for the coal and steel which were the critical components of the military industry and a unified labor market for this sector, the main objective was to enable the reconstruction of Germany's after war economy and to integrate it into the other economies of Europe (Ravenhill, 2005, p.120).

[1] The other attempts for integration, namely European Political Community (EPC) and European Defence Community (EDC) could not be successful.

In the following years, search for deeper integration led these six countries to sign the Treaty of Rome in March 1957 that established the CU of European Economic Community (EEC). Initial policies of the union covered the elimination of internal tariffs, the removal of quantitative import restrictions, the elimination of restrictions on movement of capital and labor, the establishment of a common external tariff and the Common Agricultural Policy (CAP)[1] (Dam, 1963, p.641).

Through the Brussels Treaty (Merger Treaty-1967) the ECSC, European Atomic Energy Community and the EEC combined in an executive level and named as the European Community (EC). Period of major expansion occurred through the memberships of Great Britain, Denmark and Ireland in 1973. As Greece joined the EC in 1981, Spain and Portugal participated in 1986. In the same year, the EC signed the Single European Act (SEA). The SEA resulted in "a storm of liberalizing directives and a substantial deepening of economic integration" (Baldwin, 2006a, p.1481). While the Maastricht Treaty[2] of 1992 changed the title of the EC into the European Union (EU), it also initiated the Single Market Program and set rules for the validation of the monetary union. According to Gavin & van Langenhove (2003, p.282), the "quantum leap from the internal market to monetary union was in response to the fall of the Berlin Wall and to integrate a reunited Germany into Europe". The Single Market Program of European integration aims to establish four freedoms: the free movement of goods, services, people and money. The Program includes (Shiells, 1995, p.32):

> …the removal of border controls on intra-EU goods shipments and the movement of people, harmonization of indirect taxes, establishment of minimum product standards, removal of domestic regulatory barriers to cross-border provision of services, elimination of public procurement practices favoring national producers, EU-wide competition policy to assure free movement of goods between EU members.

[1] The EU initiated the CAP in 1962.
[2] The Maastricht Treaty (1992) has been followed by the Treaty of Amsterdam (1997), the Treaty of Nice (2001) and the Treaty of Lisbon (2007).

In 1995, the fourth expansion occurred through memberships of Austria, Finland and Sweden. In the same year, Schengen system that regulates the EU's common visa and border regime signed in Luxembourg. The monetary union decision of the Maastricht Treaty was realized when the Euro[1] became the common currency of the EU on January 1, 1999. Whilst Czech Republic, Cyprus, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia became members of the EU in 2004, the number of member countries has extended to twenty-seven with accessions of Bulgaria and Romania in 2007[2].

In addition to its enlargement policy, the EU also organizes its external trade links via several channels. Between 1957 and the early 1970s trade agreements that constituted a 'pyramid of preferences' were one of the foreign policy tools of the EU (Pomfret, 2007, p.935). This network of trade agreements contained the southern Mediterranean countries and the Africa, Caribbean and Pacific (ACP) countries that were former European colonies. The arrangements with the ACP countries were organized within the framework of Lomé Conventions (firstly in 1975)[3]. Most ACP exports gained non-reciprocal duty-free access to the Europe as a result of these Conventions. The late 1980s, on the other hand, resulted in more active role of Western Europe on the Central and Eastern side due to the collapse of Soviet Union. As a result, the EU signed several bilateral trade agreements with the ex-communist countries of the region.

Starting with the mid-1990s, the EU has turned to organize its bilateral trade links with several Mediterranean countries. In this respect, the EU initiated the Barcelona Process in 1995 that aims to establish a Euro-Med free trade zone by 2012. While the CU with Turkey was the first step, bilaterals called as Euro-Meds with Tunisia and Israel followed it in 1995. Other bilaterals of the Barcelona Process included Morocco (1996), Jordan (1997), Palestinian Authority (1997), Egypt (2001), Algeria (2002), Lebanon (2002) and Syria (2004). As it is stated before, two Mediterranean countries, Cyprus and Malta, on the other hand joined the EU in 2004.

[1] The Euro is used by 16 countries of the EU as of 2009.
[2] The candidates for membership in the EU include Croatia, the former Yugoslav Republic of Macedonia and Turkey.
[3] While prior to Lomé I there were Yaoundé Agreements, other Lomé conventions were Lomé II (1980-1985), Lomé III (1985-1990), Lomé IV (1990-1995), Lomé IV *bis* (1995-2000).

The 2000 Cotonou Partnership Agreement[1] with African, Caribbean and Pacific countries, on the other hand, has renewed the coverage of the Lomé Conventions through negotiations of reciprocal North-South RIAs (Economic Partnership Agreements-EPAs) with 79 countries. Moreover, the 2001 Everything But Arms regulation granted duty- and quota-free access of exports (except armaments and sensitive agricultural products as rice, bananas and sugar) of all the least developed countries to the EU markets which have restrictive rules of origins (Hoekman et al., 2003b, p.6; Pomfret, 2007, p.935). While the EU signed FTAs with Mexico (2000) and Chile (2003), it is also negotiating the formation of FTAs with the members of GCC and the members of MERCOSUR. The EU employs these negotiations mainly as a strategic policy. While the negotiations with GCC countries are motivated by establishing trade links with the important energy suppliers, the negotiations with MERCOSUR countries are carried out in order to decrease the competitive power of the US (NAFTA) in the region (Guerrieri and Caratelli, 2006, p.152,154).

While the number of regional agreements that the EU signing with outside countries has been increasing, in order to deal with the the increased complexity arising from different rules of origins (RoOs) applied in each FTA, the EU also initiated the Pan-European Cumulation System (PECS) in 1997. This system has been established in order to cumulate the determination of RoOs among many member countries of the agreements.

European Free Trade Association

The integration attempt through the formation of the EEC had been resulted in similar attempts in the region, like European Free Trade Association (EFTA). In 1960, the Stockholm Convention[2] resulted in the formation of EFTA with original members Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the UK. EFTA was conceived as a "British-led response to the formation of the EEC and to the breakdown of negotiations for a free trade area composed of the seventeen members of the Organization of European Economic Cooperation" (Dam, 1963, p.654).

[1] The Cotonou Agreement has been complemened by the Lisbon Declaration (2007) that defines the framework for the Africa-EU strategic partnership.
[2] The Stockholm Convention has been updated with the Vaduz Convention (2001).

In 1970, Iceland became a member of the EFTA. In 1972, in order to be a member of the EEC, Denmark and the UK left the Association. At that time, the remaining members started to arrange bilateral trade agreements with the EEC. Portugal left the Association for EEC membership in 1985. Interaction between EEC further deepened through the elimination of tariffs on trade in industrial goods (1977) and Luxembourg Declaration (1984) of the EEC and the EFTA countries. Accession of Finland and Liechtenstein to the EFTA occurred in 1986 and 1991, respectively. The agreement on the European Economic Area (EEA) (the "internal market") that would extend Single Market of the EU to EFTA entered into force in 1994. The EEA covers the inclusion of EU legislation on the free movements of goods, services, people and capital, in addition to the co-operation in other areas like the environment, education, etc[1]. The following year, Austria, Finland and Sweden left EFTA to join the EU. As a result, Iceland, Liechtenstein, Norway (three of four EFTA members[2]) and 27 members of the EU constitute the members of the EEA.

The followings are FTAs that EFTA signed with other countries: Spain (1979), Turkey (1991), the former Czechoslovakia, Israel, Poland and Romania (1992), Bulgaria and Hungary (1993), Estonia, Latvia, Lithuania and Slovenia (1995), the Palestinian Authority and Morocco (1999), Macedonia and Mexico (2000), Croatia and Jordan (2001), Singapore (2002), Chile (2003), Lebanon and Tunisia (2004), the Republic of Korea (2005), the Southern African Customs Union (SACU) (2006), Egypt (2007), Canada (2008). Moreover, EFTA members are currently negotiating on the formation of FTAs with Algeri, Hong Kong, India, Peru, Thailand and Ukraine.

The Turkey-EU customs union

Turkey is a member of the GATT system since 1951. As other countries of the system, Turkey has also involved in RIAs. However, it can be stated that Turkey has not followed active stance until the mid-1990s, except 32-year long negotiations of CU with the EU.

[1] The internal market does not include the EU's CAP, customs union, common trade policy, common foreign and security policy and monetary union.
[2] Since the participation is rejected on referendum, Switzerland is not a member of EEA, although it is of EFTA.

The history of the negotiations for forming customs union between the EEC and Turkey dates back to 1960s. When the full membership application to the EEC was rejected, this resulted in Ankara Agreement (1963) that would regulate the bilateral relations until the attainment of the full membership status. This agreement further supplemented by the Additional Protocol (1970) that determined provisions for the completion of the customs union. As a result of these provisions, Turkey undertook several liberalization policies in the 1980s. With some time delay, Turkey-EU Customs Union has been established in 1996 via Association Council Decision No. 1/95 (1995). While the CU covers industrial and the processed agricultural product, the remaining agricultural products will be included to the Union when Turkey adopts the Common Agricultural Policy (CAP) of the EU. The CU undertakings of Turkey include[1] (the Undersecretariat of the Prime Minister for Foreign Trade website):

- Elimination of all customs duties and charges with equivalent effect applied to imports of industrial products from the EU,
- Adoption of common customs tariff of the EU for imports [of industrial products] from the third countries,
- Establishment of a system for processed agricultural products, in which agricultural and industrial components of the duties are differentiated and abolishment of the duties for the industrial component.

Moreover, Turkey-EU CU has been coupled by several free trade agreements signed with other countries. Currently, there are fifteen PTAs/FTAs in which Turkey has a membership status. These agreements include FTAs with EFTA (1992), Israel (1997), Former Yugoslav Republic of Macedonia (2000), Bosnia and Herzegovina (2003), Croatia (2003), Palestinian Authority (2005), Tunisia (2005), Morocco (2006), Egypt (2007), Syria (2007), Albania (2008), Georgia (2008) and Montenegro (2010). Two PTAs are Protocol on Trade

[1] In addition to these, Turkey has adopted the EU rules of origin and customs procedures of the EU that include customs valuations, customs declaration, release for free circulation and duty-suspension arrangements (Kaminski and Ng, 2007, p.38).

Negotiations[1] (1973) and Economic Cooperation Organization[2] (ECO, 1992). It is noted further that Turkey is negotiating FTAs with following countries: Jordan, Lebanon, Faeroe Islands, South Africa, Mexico and Chile.

7.3 Regional Integration in Americas

The history of RIAs in America dates back to the interwar years in which the US Reciprocal Trade Agreement Act (1934) led significant increase in the number of bilateral trade agreements of the US. Hence, it can be said that the US, as it is expected, is the locomotive country for this region. While countries that wanted and succeeded to sign RIAs with the US constitute one side, countries that failed to sign an agreement with the US and opted for forming their own RIAs constitute the other side in regionalism experience of the Americas. Table 7.5 shows membership evaluation and structural development of NAFTA, MERCOSUR, CAN and CARICOM.

Table 7.5 Evaluation of NAFTA, MERCOSUR, CAN and CARICOM

RIA	Member countries	Type of the agreement
NAFTA	Canada (1994), Mexico (1994), the US (1994)	CUSFTA-1989 (FTA) MUSFTA&CUSFTA: NAFTA-1994 (FTA)
MERCOSUR	Argentina (1991), Brazil (1991), Paraguay (1991) and Uruguay (1991)	MERCOSUR-1991 MERCOSUR-1995(CU)
CAN	Bolivia (1969), Chile (1969-1976), Colombia (1969), Ecuador (1969), Peru (1969) and Venezuela (1973-2006)	CAN-1969 CAN-1993 (FTA)
CARICOM	Bahamas (1973), Barbados (1973), Guyana (1973), Jamaica (1973), Trinidad and Tobago (1973), Antigua and Barbuda (1974), Belize (1974), Dominica (1974), Grenada (1974), Montserrat (1974), Saint Kitts and Nevis (1974), Saint Lucia (1974), Saint Vincent and the Grenadines (1974), Suriname(1995), Haiti (2002)	CARICOM-1973 (CM)

[1] Other members of Protocol and Trade Negotiations are Bangladesh, Brazil, Chile, Egypt, Israel, Republic of Korea, Mexico, Pakistan, Paraguay, Peru, Philippines, Romania, Tunisia, Uruguay, the Former Republic of Yugoslavia.

[2] Other members of ECO include Afghanistan, Azerbaijan, Islamic Republic of Iran, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkmenistan and Uzbekistan.

Keeping aside the secret trade treaty between Canada and the US of 1947, regional integration attempts in the continental America did not show progress as significant as their counterparts in Europe until the 1980s. Initial example was the 1958 Defense Production Sharing Agreement that liberalized armament trade preferentially between Canada and the US. This was followed by 1965 Canada-US Auto Pact that granted duty-free treatment for the automotive industry. According to Baldwin (2006a, p.1481), the slow progress on the US-Canada bilateral trade relations, especially the resistance of Canada to the formation of FTA with the US, between the years 1965 and mid-1980s was stemmed from the Canadian industry's fear that it would be dominated by the US industrial power.

While the hegemonic power of the US led countries be careful on the efforts for regional integration, the first step came from the Canadian side by proposing the Canada-US FTA (CUSFTA) in 1986. Due to lengthy negotiations, CUSFTA entered into force in 1989. Since MFN tariffs of these countries were low, it has been stated that preferential access to each other's markets made little difference to bilateral trade flows of two (Pomfret, 2007, p.929). In this FTA, trade objectives were substituted by the motive of insurance against unilateral protectionist measures.

On the US side, it can be stated that bilateral and regional trade agreements constitute growing importance for trade policy, especially since the 1980s. Some of these bilaterals include partners outside the Western hemisphere. While the first example was the 1985 the US-Israel FTA which was a response to an EU-Israel FTA, "the bilateral trade agreements negotiated by the USA since 2001 –Jordan, Singapore, Australia, Bahrain, Morocco and South Africa- are intended to reward allies" (Pomfret, 2007, p.936). This integration policy resulted in two more RIAs, bilateral agreements with Oman and Peru which entered into force in 2009. The US has also signed FTAs with Colombia, Korea and Panama, but for the time being, these FTAs are pending for the Congressional approval to come into effect.

While the US employs special and differential treatment on bilateral trade with large number of African countries through the US African Growth and Opportunities Act, there are also several grounds on which the US has been seeking to establish bilateral or minilateral (more than two countries) links with countries outside Americas. For example,

the US is participating in Enterprise for ASEAN Inititative to sign bilateral agreements with ten members of ASEAN and in Middle East Free Trade Area Initiative in order to sign bilateral investment treaties and FTAs with some of the countries of this region.

With the debt crisis of the 1980s, Mexico changed his protectionist policies through undertaking unilateral liberalizations on tariffs and non-tariff barriers, joined the GATT and signed several bilateral trade accords with the US and Canada (Baldwin, 1997, p.870). In 1988, the US-Mexico bilateral trade talks were centered on Mexico-US FTA (MUSFTA). Concerns over possible trade diversion effect of MUSFTA let Canada to demand trilateralizing the Mexico-US bilateral. As a result, CUSFTA and MUSFTA have been expanded to three-partied agreement and the result was the establishment of North American Free Trade Agreement (NAFTA). NAFTA has entered into force by January 1994. While for Mexico the main driving forces for the membership in NAFTA were to gain secure market access (as for Canada) and to lock in regulatory reforms, for the US these motives can be categorized into three as (Sampson, 2003, p.13):

> First, with a market of ninety million consumers, was of commercial interest to some leading US sectors. Second, Mexican poverty levels created problems of immigration for the US. Third, if the US did support economic and other reforms in Mexico, the embrace had to be so tight that these reforms would be permanently locked in.

Furthermore, each NAFTA member also continues to participate in regional integration attempts in the forms of bilateral agreements with individual countries or with existing RIAs. While Canada concluded bilateral agreements with Chile (1997), Israel (1997), Costa Rica (2002), EFTA (2009) and Peru (2009), Mexico concluded bilateral agreements with Costa Rica (1995), Chile (1999), EC (2000), Israel (2000), EFTA (2001), Northern Triangle (El Salvador, Guatemala, Honduras) (2001) and Japan (2005).

In the 1980s, Southern American side of the continent had also tried to catch on the position that was similar to Mexican experience on US trade talks. "Chile, Brazil, Argentina, Uruguay and Paraguay all formally or informally approached the US with requests for FTAs" (Baldwin, 2006a, p.1482). Rather than going on FTAs with these countries, the US government (George W. Bush administration) offered the Enterprise for

the Americas Initiative in 1990 that aims to form Free Trade Area of Americas (FTAA) at the end of the process. Initiative required initially unilateral liberalization on each applicant country in the form of Framework Agreements. As a result, 26 countries singed this kind of Framework agreements in 1991 (ibid., p.1482). However, the FTAA process was ended in 2005.

When the attempts for signing FTAs with the US failed (or prolonged) for Latin American countries, the excluded countries tried to form their own RIAs, similar to the case in EFTA. Hence, Mercado Común del Sur (MERCOSUR)[1] (Southern Common Market) founded in 1991 with Argentina, Brazil, Paraguay and Uruguay as members. The founding treaty of MERCOSUR was the Treaty of Asunción. Later, the Treaty of Ouro Preto (1994) replaced and updated the Treaty of Asunción, and transformed MERCOSUR into a CU (1995). Bolivia, Chile, Colombia, Ecuador and Peru are participating in MERCOSUR as associate members. On the other hand, the membership application of Venezuela is waiting for the approval of Paraguay (the other member countries has approved).

Two other RIAs of the Americas which are examples of the South-South agreements and are not as significant as the aforementioned agreements of the region are the CAN and the Caribbean Community (CARICOM). The CAN has been established in 1969 through the Cartagena Agreement that aimed to attain economic and social cooperation via preferential agreement. The original members were Bolivia, Chile, Colombia, Ecuador and Peru. While Chile's membership ended in 1976, Venezuela was one of the members between the years 1973 and 2006. In 1993, the CAN was transformed into FTA via the elimination of internal tariffs. The Caribbean Community (CARICOM), on the other hand, is an extension of the Caribbean Free Trade Association (CARIFTA, 1966) into a Common Market via the Treaty of 1973. The reason for such an extension stated as "although a free-trade area had been established, CARIFTA did not provide for the free movement of labour and capital, or the coordination of agricultural, industrial and foreign policies" (CARICOM website).

[1] Regional integration agreements in the region date back to the formation of the Latin American Free Trade Association (LAFTA, 1960) which was replaced by the Latin American Integration Association (LAIA, 1980). Member countries of LAIA are Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela.

7.4 Regional Integration in Asia and Oceania

Regional integration experience of Asia, although relatively new when its counterparts in America and Europe are considered, is gaining significance in the recent years. As the Southeast Asia constitutes the third leg of the multilateral trading system, the increased interest in regionalism deserves attention for the future of the multilateral trading system. Together with the selected RIAs of Asia, this section will also study regional integration attempts of Australia and New Zealand in this section, as the most of bilateral trade agreements of these countries are signed with Asian countries. Table 7.6 gives some details on AFTA, SAFTA and ANZCERTA.

Table 7.6 Evaluation of AFTA, SAFTA and ANZCERTA

RIA	Member countries	Type of the agreement
AFTA	Indonesia (1967), Malaysia (1967), Philippines (1967), Singapore (1967), Thailand (1967), Brunei Darussalam (1992), Vietnam (1995), Lao PDR (1997), Myanmar (1997), Cambodia (1999)	ASEAN-1967 (political bloc) AFTA-1992 (FTA)
SAFTA	Bangladesh (1985), Bhutan (1985), India (1985), Maldives (1985), Nepal (1985), Pakistan (1985) and Sri Lanka (1985)	SAARC-1985 (regional cooperation) SAPTA-1995 (PTA) SAFTA-2006 (FTA)
ANZCERTA	Australia (1983) and New Zealand (1983)	NAFTA-1965 (FTA) ANZCERTA-1983 (FTA)

The starting point for the dispersion of RIAs in Asia is the Association of Southeast Asian Nations (ASEAN) that was established in 1967 by Indonesia, Malaysia, Philippines, Singapore, and Thailand. The main objective for the formation of ASEAN was "to unify to resist to communist ideology from China and to enhance political security in the region" (Baharumshah et al., 2007, p.386). Brunei Darussalam joined to the Association in 1984, Vietnam in 1995, Laos and Myanmar in 1997, and Cambodia in 1999. As Vietnam and Cambodia had been at war with other ASEAN countries and with each other prior to the membership, the participation of these countries in ASEAN has further contributed to the motive of promoting regional confidence (Ravenhill, 2005, p.122). Some of the aims of the

Association have been declared as to accelerate economic growth, social progress and cultural development in the region and to promote regional peace and stability through abiding respect for justice and the rule of law in the relationship among countries in the region (ASEAN website). However, until the consideration of forming FTA among the members, the main characteristic of ASEAN was to be a political bloc rather than an economic one.

It is generally stated that the FTA of ASEAN (AFTA[1]-1992) –with original members of Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand– was the starting point of East Asian regionalism (Aminian et al., 2008, p.5). With accessions of Vietnam (1995), Laos (1997), Myanmar (1997) and Cambodia (1999), the number of partner countries has been expanded to ten countries. While ASEAN countries agreed to eliminate tariffs among the original six members by 2010 and for new members by 2015, the leaders of ASEAN announced further that they aimed to transform AFTA into an ASEAN Economic Community by 2020. Intra-regional tariff liberalization has been realized through the Common Effective Preferential Tariff Scheme[2].

According to Baldwin (2006a, p.1489), regionalism did not contribute at all to the development of East Asian trade in the period of 1985-2000. The main driving forces behind the increased interest for regionalism in East Asia were the perception that the global economic institutions let the region down in the 1997/98 Asian crises[3] and the increase of China's economic power (Pomfret, 2007, p.936). The 1997 Asian crisis had let the region consider the need for regional cooperation that mainly focused monetary cooperation rather than trade cooperation. Nevertheless, with several factors like the increased interest of other regions of the world in RIAs (i.e. defensive response), slow pace of multilateral negotiations, the information technology (IT) revolution, and the growth of production sharing, regional trade integration has gained importance throughout the region (Kawai & Wignaraja, 2009; cited in Baldwin & Low, 2009, p.8).

[1] ASEAN's first attempt of an RIA was its 1979 RIA. However, this attempt was unsuccessful due to heavy reliance on administrative protection and objection of industrial and agricultural interest groups (DeRosa, 1995; cited in Baldwin, 1997, p.873).
[2] Rice is accounted as the highly sensitive agricultural product for Indonesia, Malaysia and the Philippines and kept out of the scope of the Scheme.
[3] IMF was highly criticized due to not taking into account economic realities of Asian countries.

The WTO membership of China in 2001 has further changed the regionalism pattern of the region. Negotiations for the formation of China-ASEAN FTA have triggered Japan-ASEAN FTA and Korea-ASEAN FTA negotiations due to a fear of these countries to lose their influence in the region. While ASEAN-China FTA has entered into force in 2003, ASEAN-Japan FTA has entered into force in 2008. Although it has been supposed to be phased in by 2010, ASEAN-Korea FTA talks have not been concluded yet. On the other hand, ASEAN-Australia-New Zealand FTA has entered into force in April 2010. The negotiations on the formation of ASEAN-India FTA are still continuing.

South Asian countries (except Afghanistan), on the other hand, formed the South Asian Association for Regional Cooperation (SAARC) in 1985. Members were Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka. The main motive was the political consultation. In 1991, Cooperation agreed to form a SAARC Preferential Arrangement (South Asian Preferential Arrangement, SAPTA) by 1997. However, SAPTA entered into force, prior to this deadline, in 1995. Member countries considered SAPTA as an initial step for the higher levels of integration, i.e. customs union, common market and so on. SAPTA superseded by the Agreement on South Asian Free Trade Area (SAFTA) that was signed in 2004, and entered into force in 2006. In SAFTA, "the special needs of the least developed partners *–Bangladesh, Bhutan, Maldives and Nepal–* are recognized by adopting concrete preferential measures in their favour on a non-reciprocal basis" (Aggarwal, 2008, p.7).

Related to the Asia-Pacific region, the Asia-Pacific Economic Cooperation (APEC, 1989) should also be noted. Although it can not be counted as an RIA, this cooperation aims at the promotion of trade and investment liberalization, and cooperation on economic and technical levels. APEC is one of the examples of inter-continental integration as it covers four continents: Asia, Oceania, North and South Americas. The original members were the US, Canada, Australia, New Zealand, Japan Korea and the six ASEAN countries (Indonesia, Malaysia, Philippines, Singapore, Thailand, and Brunei Darussalam). With accessions of China, Hong Kong, Mexico, Papua New Guinea, Chile, Peru, Russia and Vietnam, the number of member countries have risen to twenty-one. The Bogor Declaration at the 1994 APEC summit emphasized the consensus on the multilateral

approach adopted by the Cooperation. APEC states "open regionalism" of Bergsten (1997) as their motto. Accordingly, Cooperation aims to share benefits of free trade with non-members and to comply with the most favored nation (MFN) principal of the WTO (Aminian et al., 2008, p.5).

The regional integration agreements of Oceania, on the other hand, include the ones that are formed between Australia and New Zealand and the bilateral agreements that include one of these countries as a member. Beside partnership in APEC, New Zealand and Australia established FTA of Closer Economic Relations (CER) in 1983. It is also called as the Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA). Its predecessor was New Zealand Australia Free Trade Agreement (NAFTA) of 1965. While the reinforcement of the broader relationship between two countries is stated as the main objective of ANZCERTA, reduction of trade barriers and rationalization of industry constitute the common goals to follow (Sampson, 2003, p.14). Tariffs or quantitative restrictions between these two countries totally eliminated in 1990.

Australia and New Zealand have also been pursuing bilateral integration agreements with other countries, although the former is somehow dominant on the issue. The followings are RIAs that Australia and New Zealand have participated: Australia-Papua New Guinea FTA (1977), Australia-Singapore FTA/EIA (2003), Australia-Thailand FTA/EIA (2005), the US-Australia FTA/EIA (2005), Australia-Chile FTA/EIA (2009), New Zealand-Singapore (2001), New Zealand-Thailand FTA/EIA (2005), China-New Zealand (2008).

7.5 Regional Integration in Africa

Although the history of RIAs in Africa dates back to the first decade of 1900s, it can not be said that these RIAs were effective in the economic sense. These agreements have been generally motivated by assuring political stabilization in the region, rather than by economic considerations. Table 7.7 gives details on SACU, ECOWAS, WAEMU and COMESA.

Table 7.7 Evaluation of SACU, ECOWAS, WAEMU and COMESA

RIA	Member countries	Type of the agreement
SACU	Republic of South Africa (1969), Botswana (1969), Lesotho (1969), Swaziland (1969) and Namibia (1990)	SACU-1910 SACU-1969 SACU-2004 (CU)
ECOWAS	Burkina Faso (1975), the Republic of Capo Verde (1975), the Republic of Cote D'Ivoire (1975), the Republic of Gambia (1975), the Republic of Ghana (1975), the Republic of Guinee (1975), the Republic of Guinee Bissau (1975), the Republic of Liberia (1975), the Republic of Mali (1975), the Republic of Niger (1975), the Federal Republic of Nigeria (1975), the Republic of Senegal (1975), the Republic of Sierra Leone (1975) and Togolese Republic (1975)	ECOWAS-1975 ECOWAS-1993 (CU)
WAEMU	Benin (1994), Burkina Faso (1994), Côte d'Ivoire (1994), Mali (1994), Niger (1994), Senegal (1994), Togo (1994) and Guinea Bissau (1997)	WAEMU-1994 WAEMU-2000 (CU)
COMESA	Burundi (1981), Comoros (1981), Democratic Republic of the Congo (1981), Djibouti (1981), Madagascar (1981), Ethiopia (1981), Kenya (1981), Malawi (1981), Mauritius (1981), Rwanda (1981), Sudan (1981), Swaziland (1981), Uganda (1981), Zambia (1981), Zimbabwe (1981), Eritrea (1994), Egypt (1999), Seychelles (2001), Libya (2005)	COMESA-1981 (PTA) COMESA-1994 (FTA)

CHAPTER 8 THE EFFECTS OF REGIONAL INTEGRATION

There is a wide range of studies trying to examine/estimate the outcomes of regional integration in terms of the effects on member countries and non-member countries. These studies are coupled with studies that focus on the effects of regional economic integration on the globalization process, mainly in terms of its effects on multilateral tariff liberalization and multilateral free trade.

The purpose of this chapter is to understand the underlying mechanisms governing the existing situation in regional economic integration. Since the expected economic effects like economies of scale, industrial specialization, increased competition and the political factors like better policy measures of regional economic integration are studied in Chapter 5, in this chapter, the effects of regional integration on the global economic order will be studied. To this end, this chapter will cover four sections.

The main motive for the formation of RIAs is to gain a preferential access to the integrated economic area. This privilege, however, is gained at the expense of non-member countries. So, regional integration issue can not be assessed only from the viewpoint of member countries. Rather, the third countries constitute the crucial side of regional economic integration, as the deteriorating effects of RIAs are mostly beared with these countries. Although the Vinerian analysis (1950) of trade-creation and trade-diversion effects neglects other determinants of trade like product differentiation, imperfect competition and intraindustry trade, these effects constitute the basics for the analysis of the effects of regional integration. Rather than studying whether trade-creation effect dominates trade-diversion effect or not, the first and the second sections will focus on the effects of RIAs on members/nonmembers. While the effects of regional integration on member countries will be examined in the first section, the second section will study the effects of regional integration on non-member countries.

On the other hand, in the third section, the interrelationship between regional integration and globalization will be studied from the perspective of the effects of RIAs on multilateralism. For this analysis, this section will present two arguments: 'building blocs' and 'stumbling blocs' arguments of Bhagwati (1993). In the final section, what the increasing number of RIAs implies in terms of the globalization process will be outlined. Through such an analysis, it is aimed to find possible answers for the main question of this study: "Is regional economic integration complementary or contradictory to the globalization process?"

8.1 The Effects of Regional Integration on Members

Regional economic integration implies intergovernmental cooperation of countries. While it is generally the case that these countries have different development levels, in all of the cases, this cooperation involves countries that differ significantly in their economic structures and in their national interests. These underlying dissimilarities of member countries determine the effects of regional integration on each member. These effects are various and they generally take the following forms:

- The effects resulting from the costs of regional integration
- The effects resulting from the determination of common external tariff (CET)
- The effects resulting from the extent of internal liberalization
- The effects of regional integration on production structure of national economies
- The effects of regional integration on investment flows

Economic and political structures of member countries differ significantly especially in a regional integration agreement that involve both developed and developing countries. This discrepancy in the economic sizes of member countries results in a type of regional integration that has standards determined by the developed partner. Hence, developing member would find itself in trying to cope with these standards. As the adjustment costs will be higher, lower the development level of the member country, this brings the question that how the necessary adjustment costs of the developing country will be compensated.

Moreover, as most of the developing countries interpret tariff revenue as a significant source for the government budget, elimination of internal tariffs results also in distortions in the government budget. Since the developing members are likely to import more from their developed partners relative to their exports to these countries, the extent of tariff revenue loss will be higher for developing members. Hence, the burden of this liberalization on government budget will change according to the economic structure of members. This brings another question that how the tariff revenue loss will be compensated.

On the other hand, in the case of CUs, determination of the CET also yields significant problems within the regional group. Determination of the CET will lead lengthy negotiations on what level would be suitable for all members of regional integration. For many RIAs, determination of the CET could be succeeded only after several years of negotiations. For example, in the EU, member countries kept different tariff levels on some products (like bananas[1]) for more than thirty years after its establishment. In MERCOSUR, negotiations for determination of the CET determination continued fifteen years longer than expected and excluded some product categories (approximately one-quarters of total products) (Ravenhill, 2005, p.118).

Even if the CET is determined, the distribution of collected tariff revenues among member countries will result in an additional problem for the CU. Moreover, the formation of a CU is coupled with the concerns over the competitiveness of member countries. If exchange rates are not free to adjust, the common tariff will result in discrepancy in the competitiveness of these countries as the adjustment speed of inflation differs for each member. As Balassa and Stoutjesdijk (1975, p.43) state:

> …under- or over-compensation in exchange rates for price changes has the same effect as changes in tariffs and subsidies …. Variations in competitiveness due to price changes uncompensated by changes in exchange rates create obstacles to regional integration since countries do not wish to expose their producers to sudden

[1] The treatment of the UK and France on exports of ACP bananas was different than the one of the Germany and the Netherlands, even though the Community had supposedly adopted a common external tariff (Ravenhill, 2005, p.132).

and unforeseen changes in trade flows. To avoid these adverse consequences, it would be advisable for member countries to devalue *pari passu* with inflation.

On the other hand, for all types of regional integration, there is also another problem related to the extent and the coverage of internal liberalization. The Article XXIV that requires the elimination of internal tariffs on "substantially all trade" criterion does not prevent member countries from excluding the sensitive sectors (both political and economic) from the subjects included in regional integration. For example, while the EU has outlawed most of Mexican and South African agricultural products from FTAs it signed with these countries, Japan has excluded some of the agricultural products from the list of FTA signed with Singapore (Ravenhill, 2005, p.142). These exceptions further lessen the expected welfare gains of internal liberalization.

While there is a limited internal liberalization for trade in goods, the situation is not different for trade in services. Although it is stated that RIAs are likely to go beyond GATS schedules (Roy, Marchetti & Lim (2007), Stephenson (2002)), the most protected/discriminated services activities in developed countries are still largely unaffected by the formation of RIAs. Examples are "audiovisual for EFTA and the EC, maritime transport and certain professional services for the US, cross-border trade in a number of financial services for a variety of countries, and education services where there has been no significant improvement for the US, EC and EFTA member states" (Estevadeordal et al., 2009, p.10). Although NAFTA is announced as WTO-plus (or GATS-plus) in its provisions on investment, the member countries still take their sensitive sectors out of the scope of this agreement. While the exception list of the US includes the ownership of broadcasting, airlines and strategic sectors like nuclear energy, the list of Canada adds publishing and oil to the list of the US, and Mexico enlarges this list with sectors like petrochemicals, telecommunications, transport and the postal services (Woolcock, 2003, p.322).

Moreover, the expected benefits of regional integration may not be realized for all of the members equally. While the degree of economies of scale effect will depend on the number and the level of economic development of member countries, RIAs will also result

in different effects on the production structure of member countries. As a result of regional integration, some of the members will become the centers of production. In turn, this will result in monopoly positions and inefficient production in a regional boundary. While Elkan (1975, p.59) calls this effect as 'backwash', i.e. the polarization of development on one or a few partners, it is one of the important disadvantages of economic integration. RIAs will also cause increased concentration of members on the establishment of firms that will serve to the enlarged regional market. This kind of concentration will draw away factors of production (like capital and entrepreneurship) that would be used more efficiently for the production of exports to world markets (Balassa & Stoutjesdijk, 1975, p.41).

The expected increase in FDI flows after the formation of RIA may not be realized, either. As the Eclectic Theory of Dunning (1977) emphasizes there are three main determinants of FDI flows, namely firm-specific (ownership) advantages, internalization advantages and locational advantages. Regional economic integration can affect only one of these determinants that is locational advantages. Even if the formation of regional integration affects FDI flows, it has two directions. Similar to trade-creation and trade-diversion effects of Viner (1950), Kindleberger (1966) emphasizes investment creation and investment diversion effects of the formation of regional integration. Related to the EEC case, Kindleberger (1966, p.71) states:

> Investment creation was the response by the outside producer to the stimulus of trade diversion. Unable to lick them, he joined them, establishing a plant inside the Common Market to fill the market from which discrimination cut him off.… Investment diversion … was to stem from the anticipated reorganization of the European investment of outside companies that were already established in Europe to take advantage of newly arisen opportunities for economies of scale and specialization.

Overall, for most of the cases, the decisions of multinational enterprises to invest in the regional market will take into account the degree of integration as a factor, but the main factors will include development level of the host country, infrastructure, proximity to

other production and consumption markets, tax regimes, political and financial stability, sound local policies, good labour relations and the ease of external trade, i.e. open borders. For example, while the cases of China and Indonesia show that RIAs are not necessary for high volumes of FDI flows, the case of Greece shows that they are not sufficient (Winters, 2001, p.131). Furthermore, even if there are increased FDI flows, it may not contribute to the employment levels, or to the promotion of technology and of know-how processes. The FDI that aims to jump the tariff wall of a regional integration may result in misallocation of resources and immiserize growth in the host country (Balasubramanyam et al., 2002, 469).

8.2 The Effects of Regional Integration on Non-members

While regional economic integration implies liberalization for member countries, it implies protection of discriminatory status-quo for non-members countries. However, the extent of this protection is not limited to the pre-integration levels. It is generally the case that regional integration results in increased external protection. In order to analyze this outcome, it would be useful to study the following effects of regional integration that have significance in terms of non-member countries:

- The effects resulting from tariff protection of regional integration
- The effects resulting from other measures of protection in regional integration

When internal tariffs are eliminated in regional integration, external tariff levels are usually adjusted in order to compensate the related costs of internal liberalization. For example, in the case of FTAs, if a member country is dependent on tariff revenues, as it is the case for most of the developing countries, the removal of internal tariff levels within regional integration would force these countries raise their external tariff levels. Hence, this will imply that the larger the loss of revenue due to integration, the greater the increase in outside tariff levels to preserve fiscal balance and, as a result, the greater the trade diversion (Panagariya, 1999, p.499). For example, while average external tariffs of Germany was nearly doubled after its accession to the EEC in 1958, countries like Mexico, Israel and members of MERCOSUR increased their external trade barrier after joining RIAs (Mansfield & Reinhardt, 2003, p.833).

In the case of CUs, on the other hand, determination of the CET level will result in increase in the tariff levels of countries which had lower tariffs before the union and decrease in the tariff levels for previously higher-tariff countries. Beside trade diversion effect, another important effect of RIAs will be a market power effect which comes out when members form a customs union and adopt a common external tariff policy that lets them to impose higher tariff levels on non-member countries (Bagwell & Staiger, 1998, p.1179).

Hence, in addition to losing their export markets to the member countries of regional integration (trade-diversion effect), another drawback of the formation of RIAs will derive from the increased external protection. It is also possible that the formation of RIAs will affect non-members' terms-of-trade. As Mundell (1964) shows through three-country model, if two of these countries form a preferential area, their terms-of-trade with respect to the outside country would improve, and suggests that the non-members of a preferential trading arrangement might lose further due to terms of trade effects (cited in Baharumshah et al., 2007, p.385). This term-of-trade effect, on the other hand, will mainly depend on the economic power of the given regional integration to affect the world prices[1]. As regional economic integration is centred on the EU and the US, agreements of these entities will certainly affect the non-members' terms of trade.

On the other hand, as the tariff rates are bound against subsequent increase in the GATT/WTO system, both cases imply that such an increase in external tariffs further dilutes the GATT/WTO system, besides contrasting with non-discrimination principle. Although there are compensation requirements for those nonmember countries affected from the increase in the tariff level of union members, determination of such compensatory adjustment is stated in Article XXIV ambiguously. It is also possible that as actual tariff rates are generally lower than the bound rates, when the external tariffs of the members of FTA or the CET of CU are set below the bound rate but above the actual rate, although it obeys to the Article XXIV, this regional integration can overall increase its protection against non-member countries.

[1] Viner (1950, p.55) also states that "the greater the economic area of the tariff-levying unit, the greater is likely to be… the improvement in its terms of trade with the outside world resulting from its tariff". This implies deterioration in terms of trade of non-member countries .

In addition to tariff protection of regional integration, the lack of clarity on the requirements of related articles of the GATT/WTO system results in the introduction of new policy measures of protection[1], beside the protection through tariff levels. The provisions of RIAs on trade remedies (anti-dumping, countervailing and safeguard measures) are some examples of these measures that are motivated by the external protection. For example, anti-dumping measures are generally employed according to the specific interests of the integration. The extent of anti-dumping measures generally depends on the selected country, as well as the selected industries. Moreover, this situation is not different for other types of trade remedies. For example, the exclusion of members of the regional integration in safeguard actions further increases the degree of discrimination against non-member countries (Estevadeordal, Suominen &Teh, 2009, p.8).

Trade remedies are also coupled with other policy examples[2] of external protection used by the members of regional integration. For example, Common Agricultural Policy (CAP) of the EU is one of them. While the CAP has been introduced in order to protect the interests of local farmers, it coordinates the price structure of agricultural products in order to affect consumers' choice on behalf of the EU-products. Consequently, agricultural sector has become the most protected area of international trade since the introduction of the CAP. Moreover, the Single Market Program has also introduced more discriminatory tools against non-members in areas like product standards, cultural activities, certain service activities and the like (Kreinin & Schmidt, 1996, p.38-39). Another example can be given from Mexico. Serving its balance of payments crisis as an excuse, Mexico increased its unbound tariff levels on more than 500 non-NAFTA tariffs (for imports of clothing from 20 to 35 per cent) in 1995, while it reduced tariffs on imports originating from other members (Chakraborty, 2003, p.16).

[1] Rules of origins are the most important example of protective policies and will be covered in the next section.

[2] Another example is that (although it was removed later, as a result of the successful lobbying of the American firms), the EU had initially employed import licensing policy that discriminated against bananas coming from non-ACP countries.

8.3 The Effects of Regional Integration on Globalization

This section will try to study the factors through which regional economic integration affect the current globalization process or, with a more technical term, the current multilateral trading system. RIAs are introduced to the GATT/WTO system in 1947 as exceptional cases to the fundamental principles of non-discrimination and reciprocity. For the first wave of regionalism, the existence of such privileged integration agreements did not raise much concern. However, this situation has changed significantly in the second wave. Throughout the second wave, the number of RIAs has sky-rocketed. The everlasting increase in the number of RIAs is further accompanied by the increasing complexity of the subject areas and of the policy measures of these RIAs. These factors, together, have led to question the validity of allowing such an exception in the international trading system.

The intellectual studies that aimed to clarify the relationship between regional integration and globalization are mainly focused on the ultimate effects of RIAs on multilateralism. That is to say, whether these agreements are contributing to or contradicting with multilateral trading system. As Bhagwati (1993) questions whether RIAs are building blocs or stumbling blocs on the way of global free trade. This section studies this topic by two opposing arguments:

- Regional integration as the building bloc in front of globalization
- Regional integration as the stumbling bloc in front of globalization

8.3.1 Regional integration as the building bloc in front of globalization

For those who interpret RIAs as cementing components of globalization, regionalism and multilateralism are evolving hand in hand, and there is no threat coming from the increasing web of RIAs. In this view, as regional integration ensures free trade in its domain, it is regarded as a positive step for the global free trade. For example, Bergsten (1997, p.548) states that as trade-creating effects have generally exceeded trade-diverting effects of RIAs and as RIAs contribute positively to both internal and international dynamics, RIAs will eventually help to promote freer trade and multilateralism. Moreover,

the expected trade-diversion effect will not be a serious problem as external trade barriers have been gradually declined through several GATT/WTO rounds and are no longer very high.

The "open regionalism" defined by Bergsten (1997), on the other hand, is announced as another channel through which RIAs can contribute to multilateral trading system. Accordingly, this kind of regionalism is characterized by the following five elements that can be implemented simultaneously or independently: open membership; unconditional MFN treatment to all members; conditional MFN treatment to non-members (in case of an agreement to take similar steps); continuing multilateral liberalization; and the implementation of non-tariff and non-border reforms to facilitate trade. The enlargement of the EU and the closer relationship between ASEAN and APEC, as the examples of such regionalism, are said to be the pioneers of building blocs that operate in line with globalization (Baharumshah et al., 2007, p.388). Moreover, RIAs that are based on open economy principles and monitored by international institutions like the WTO would contribute also to the rest of the world with lower trade costs and improved financial stability in the global scale (Padoa, 2003).

In addition to this, the formation of RIAs further contributes to the multilateral trading system as these agreements contain additional provisions that are WTO-plus in nature. Hence, although some regard these arrangements as largely political-driven, there is another ground that counts regional economic integration as providing "new disciplines in the system" and covering "issues beyond what is in the WTO and establishes a potentially new system of global trade management parallel to that in the WTO" (Antkiewicz & Whalley, 2006, p.344). For example, several measures on customs procedures and trade facilitation adopted in the US-led RIAs provide broad range of commitments in the international trading system. As a result, these provisions can serve as the models for multilateral trade negotiations. It is also stated that regionalism can be used as a "competitive liberalization" strategy like the one followed by the US. Accordingly, increased interest of the US in bilateralism and regionalism is partly used as a tool to trigger greater efforts at the multilateral trade negotiations (Cosbey et al., 2004, p.24).

It can also be noted that there are also some who take regional integration and multilateralism as factors not counteracting (positively or negatively) against each other. Accordingly, since worldwide free trade is not attainable due to political constraints, deciding to follow MFN tariffs or opting for the membership in an RIA will result in the theory of the second best (Frankel et al., 1996, p.52). On the other hand, Baldwin (1993, 1997) states that regionalism are not necessarily substitutes for multilateral liberalization. According to these views, RIAs can not be dubbed as stumbling or building blocs, rather "regionalism is half of the trade liberalization wheel that has been rolling towards global free trade since 1958" (Baldwin, 1997, p.886).

8.3.2 Regional integration as the stumbling bloc in front of globalization

This section will study the basic arguments that interpret regional integration as the stumbling bloc for the multilateral trading system. This topic has been studied mainly according to two approaches. The first one is the economic theory approach and is limited by major economic concepts. The political economy approach is the second approach and covers economic and political concepts. Here they are studied separately as:

- The arguments of the economic theory approach
- The arguments of the political economy approach

The arguments of the economic theory approach

The "stumbling blocs" side argues that increased interest in regionalism constitutes a threat for the future of multilateral trading system. Accordingly, as the actual globalization process is more or less than free trade, the welfare theorems of trade theory that depend on the assumption of global free trade will not hold (Deardorff, 2004, p.3). As a result, the view that takes RIAs as partial steps in front of the global free trade is not well founded. Rather, as the elimination of any set of tariff levels does not necessarily cause an improvement in the allocation of world resources, regional agreements are "far from being halfway houses on the road to nondiscriminatory and freer trade" and in "direct conflict with those goals" (Dam, 1963, p.615).

Furthermore, trade liberalization envisaged in the formation of RIAs is not necessarily a positive step towards global trade as it is emphasized by building bloc defenders. As Panagariya (1999, p.495) notes reduction in the tariff on an input increases effective protection on the final product and can distort the move toward free trade. On the issue, Viner (1950, p.48) notes as follows:

> The major explanation (of why so many free traders support RIAs) seems to lie in an unreflecting association on their part of any removal or reduction of trade barriers with movement in the direction of free trade. Businessmen, however, and governments which had to try simultaneously to satisfy both special interests seeking increased protection and voters hostile to protection, have long known ways of making increased protection look like movement in a free-trade direction… Let us suppose that there are import duties both on wool and on woolen cloth, but that no wool is produced at home despite the duty. Removing the duty on wool while leaving the duty unchanged on woolen cloth results in increased protection for the cloth industry while having no significance for wool-raising.

"Open regionalism" support for the formation of RIAs is further not well-founded. As the negotiations for the accession of Turkey into the EU dates back to 1960s, the accession process of the EU can not be as open as it is stated, or it can be said that the openness of RIAs does not guarantee the membership. Additionally, another pioneer of open regionalism, APEC, has declared a moratorium on new membership until the end of 2010 (APEC website). Furthermore, the ideal behind the "open regionalism" is neoliberalism. In this liberal view, as purposeful political action behind regionalism is disregarded, governments are treated as acting "in accordance with the logic of global market forces asserted through the pressure of market competition", and as efficient market allocation leads to worldwide welfare gains in the long run, domestic distributive issues are also ignored (Nesadurai, 2002, p.14). The critics also highlight the contradiction in this term and state that "arrangements that are open can not be regionally confined and those that are regionally confined cannot be open" (Panagariya, 1999, p.502).

The deeper integration that includes the harmonization of several policies like competition policies, labor and environmental standards, investment measures and that are triumphed by the defenders of RIAs does not necessarily result in the expected beneficial outcomes, either. The complexity of the growing number of RIAs including their own deeper integration schedules makes RIAs stumbling blocs in front of global solutions.

Moreover, as the guidelines for deep integration are generally determined by developed countries, developing countries would find themselves adjusting their standards to those of developed countries without taking into account the suitability of these conditions on their economic structure (Panagariya, 1999, p.506). The example can be given from the membership of Mexico in NAFTA. Fred Bergsten stated that "under NAFTA the US made no concessions to Mexico while she got every concession she sought" (ibid., p.507). It is also the case for the EU enlargements. While the EU allows for some kind of flexibility on the adjustment periods, it takes a "take-it-or-leave-it attitude[1] over the nature and structure of the EU itself" (Ethier, 2001, p.5). As a result, trade liberalization of RIAs is mainly the result of the concessions made by smaller countries, not by their developed partners. Moreover, there is a little evidence supporting the argument that agreement on matters of the so-called deeper integration issues could be attained more easily at the regional scale, when it is considered that even the ultimate example of RIAs, the EU, has experienced difficulty in liberalizing the agricultural sector (Ravenhill, 2005, p.141).

The arguments of political economy approach

Academic writings focusing on the political-economy models of regional integration like Levy (1997) and Krishna (1998), on the other hand, conclude that the formation of RIAs lessens the motivation of member countries for multilateral trade liberalization. Such a shift in the incentives of member countries derives from the fear of losing the prefential access that they have in the regional market. In addition to this, RIAs are also used by politicians as a cover for not advancing multilateral trade liberalization ("Doing Doha down", The Economist, 2009, p.14).

[1] Some authors call it "one-size-fits-all" and regard it one of the defects of WTO principles.

Governments' distraction in the efforts for multilaterism mainly stems from the actions of domestic pressure groups. While trade creation leads domestic producers lose their markets to the producers of other member countries, producer lobbies try to induce governments to employ protection measures that would result in trade diversion. The resulting trade diversion is intended to compensate such a market loss by transmitting these costs onto the the producers of non-member countries. Consequently, as Krishna (1998, p.229) emphasizes, the degree of trade-diversion in an RIA would determine, the likelihood of adoption of this agreement by the political process that is significantly governed by the pressure groups. Hence, the weight of non-economic interests (producer lobbies) in the domestic/foreign policies will make the RIAs as obstacles in front of the global free trade. In other words, multilateral liberalism can slow down as producers can get most of what they are willing to take by regional agreements.

This role of special interest groups and lobbying is significant both in the working of WTO system and of RIAs. Even before the establishment of WTO, there was significant influence of the interest groups on the ruling of international trade. Since the mid-1980s, the new rule-making on a neo-liberal stance significantly restricted governments on employing interventionist policies in order to control or discriminate against foreign firms in the domestic economies and advanced the interests of transnational corporations (Nesadurai, 2002, p.9). Hence, these firms gained privileged positions against national governments and demanded several concessions (like tax concessions) on their behalf, instead of obeying domestic restrictions. On the other hand, at that time, the supremacy of foreign firms further backed-up by the financial markets. As such, the financial markets, another by-product of the neo-liberalism-based global order, were very responsive to punish governments that followed inward-looking or interventionist policies (Ravenhill, 2005, p.128). Since the overall situation is not so different from the one of the early 1980s, except the establishment of WTO, the special interest groups are still significant actors of the international trading system.

It is also the case that the pressures of large corporations have significantly affected the drafting of the texts of international economic agreements –multilateral, regional and bilateral– in order to promote the interests of these producers (Deardorff, 2004, p.4).

Especially the Uruguay Round highlighted the importance of multinational corporations in multilateral trade negotiations, as these corporations played an intensely active role on the negotiations that were crucial for their special interests. For example, this was the case for the inclusion of TRIPs and GATS to the WTO system. While the large corporations especially in the pharmaceutical industry were the demanders of the inclusion of TRIPs in the Uruguay Round negotiations, the pressures coming from some of the American service suppliers resulted the introduction of GATS.

This situation is not different in the regional case. The lobbying constitutes a significant problem especially in the North-South agreements, in which developed countries have primacy, as special interest groups in these countries are better organized and funded. Starting with the 1980s, the US' and European firms have established subsidiaries in the countries with relatively low labor costs to cut down competitiveness of the East Asian countries in their home markets. Hence, the North-South agreements like the Euro-Med agreements[1] and NAFTA have further facilitated this corporate strategy (Ravenhill, 2005, p.134). On the other hand, the role of special interest groups is increased tremendously since the establishment of the EU as the number of lobbyists in Brussels was 300 in 1970, it became 13,000 in 1998 (Schiff & Winters, 2003, p.93). Recently, the number of lobbyists is expected to be more than 15,000.

While within the specified regional agreement, determination of the industrial scope and the extend of the coverage are mainly manipulated by the special interest groups, it is also true that the lobbying in non-member countries may push outside countries to involve in existing RIAs or create their own RIAs that will serve to their own benefits. For example, as Japanese firms found themselves at a competitive disadvantage in the Mexican market following the establishment of NAFTA and the initiation of the EU-Mexico FTA, the main business organization –Keidanren– of Japan lobbied the government to sign an FTA with Mexico that would equate the competitiveness of Japanese firms with the one of their competitors (Ravenhill, 2005, p.130). As a result, Japan-Mexico FTA came into force in 2005.

[1] Euro-Med agreements include FTAs that the EU signed with several Mediterranean countries.

As it is stated before, while special interest groups will affect significantly the extent of policy determining the level of external tariffs, these groups will also be effective on the introduction of new protection measures. For example, rules of origins (RoOs) applied in FTAs are one of these measures that aim to protect the producers of member countries. These rules are mainly used as the guard against the trade deflection that would arise as a result of penetration of non-members' inputs into regional market via the borders of the member country that has the lowest-tariff levels. For example, RoOs of NAFTA require that 62 per cent of the production of automobile to be done within the region and all of the inputs of and the production of clothing (100 per cent) to be handled in NAFTA.

The existence of RoOs would result in further trade diversion if the most efficient extra-regional inputs are substituted with the intra-regional inputs due to the tariffs preferences granted within the integration. If there were no rules of origin employed, the importation of each product from the member with the lowest tariff level would "minimize the trade diversion effect of internal preference in higher-tariff member countries by lowering the effective external tariff down to the level of the member with the lowest tariff on the product" (Panagariya, 1999, p.488).

In addition to RoOs problem of FTAs, there are also additional problems that will emerge as a result of regional integration. For example, Wonnacott (1996) explains one of these problems with the hub-and-spoke analysis of overlapping FTAs. In this analysis, while the hub is the center of agreements like the EU and the US in North-South agreements, the spokes are developing members. As a result of such formation, the hub constitutes the advantageous side because of preferences it attain in each spoke market and "because of its advantage in attracting investment as the only location with duty-free access to all participating countries" (Wonnacott, 1996, p.64). While this framework is mostly used method in liberalizing trade in Europe (except the EU or EEA) and in Americas (except NAFTA), this analysis also shows that since each spoke diverts some of its imports to the hub, the overlapping FTAs will further multiply trade-diversion effect. In addition to this, the existing situation will increase the extent of trade distortions as import flows from each spoke to other spokes will be made through the duty-free hub. For example, it is noted that FTAs that the EU has signed with the third countries negatively affect the Turkish

production sector as the members of these FTAs can export to the Turkish market duty-free via the EU due to the Turkey-EU CU, but Turkey faces 30 to 40 per cent tariff levels on its exports to these countries ("AB'nin STA'ları", Cumhuriyet, 2009, p.14).

8.4 The Worldwide Situation: The "Spaghetti Bowls[1]"

Overall, the result of the increasing number of RIAs that are governed by corporate interests is "…the spaghetti bowl[2] phenomenon of numerous and crisscrossing *RIA*s and innumerable applicable tariff rates depending on arbitrarily-determined and often a multiplicity of sources of origin" (Bhagwati et al., 1998, p.1139). Hence, the existence of many RIAs that differ in tariff elimination schedules, rules of origin and excluded products makes regionalism as a genuine problem in front of the globalization. According to Baldwin (2006a, p.1452), the spaghetti bowl of the rules of origin would inevitably result in multilateralization of these rules that will cause another ground to call RIAs as building blocs. However, there is no attempt of this kind of unification and the complexity still lets itself to further complexities. Hoekman et al. (2003b, p.11) state that while the concerns over the liberalization of rules of origin date back to 1960s and 1979s, there is no progress on simplification and harmonization of these rules. Figures 8.1, 8.2 and 8.3 are shown to clarify the criss-crossing RIAs from the viewpoint of three important trading actors of the world, namely America, East Asia and Europe[3], respectively.

In Figure 8.1, each circle represents different RIAs that are established or on the negotiation level. While the US is the center of regional integration trend in Americas, NAFTA (not shown in the figure) is accompanied by ALADI, Andean Community, CACM, CARICOM and MERCOSUR. On the other hand, bilateral agreements of the continent make this figure more complex.

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[1] Some authors like Baldwin (2006b) use 'noddle bowl' term in order to emphasize the incrasing complexity of RIAs.

[2] It is also noted that the 'spaghetti bowl' concept is generally not as visible for the case of non-tariff measures as for the case of tariff regimes supplemented by the RoOs (Baldwin, Evenett & Low, 2009; cited in Baldwin & Low, 2009, p.4).

[3] When the structure of the agreements is examined, it can be stated that the approaches of the EU-centered and the US-centered regional integration are similar. The underlying principles of these agreements originate from the Organization for European Economic Co-operation (OEEC, later OECD) that started to develop several concepts on the subjects like investments (in 1960s), services and competition (in the 1980s) (Woolcock, 2003, p.332).

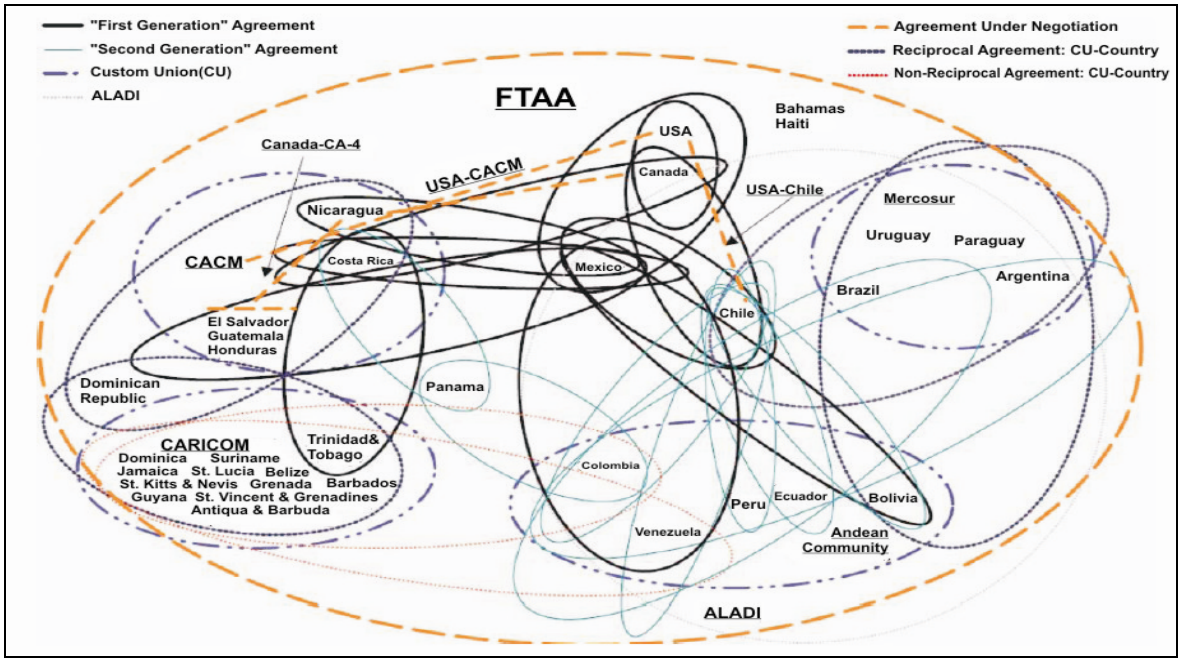

Figure 8.1 The spaghetti bowl in Americas (Source: Gallagher, 2008, p.38)

It is stated that although the spaghetti bowl of the Americas should have provided 80 per cent of trade without duties by 2013, there exist several exceptions to the openness conditions of the region, like agricultural products, textiles and apparel, food, chemicals and footwear (Estevadeordal, Shearer & Suominen, 2009; cited in Baldwin & Low, 2009, p.8). Moreover, the US further complicates the existing spaghetti bowl of Americas (and of the world) through several new RIA negotiations that will serve its own priorities, the situation what Bhagwati (1994, p.284) calls as a model of "selfish hegemon".

Figure 8.2, on the other hand, shows increasing number of RIAs in East Asia. The main elements of this integration are ASEAN (AFTA) and FTA extensions of ASEAN like ASEAN-Japan and ASEAN-China. If FTAs of these countries with New Zealand and Australia were added to the figure, this would further depict the increasing intensity of RIAs in the region.

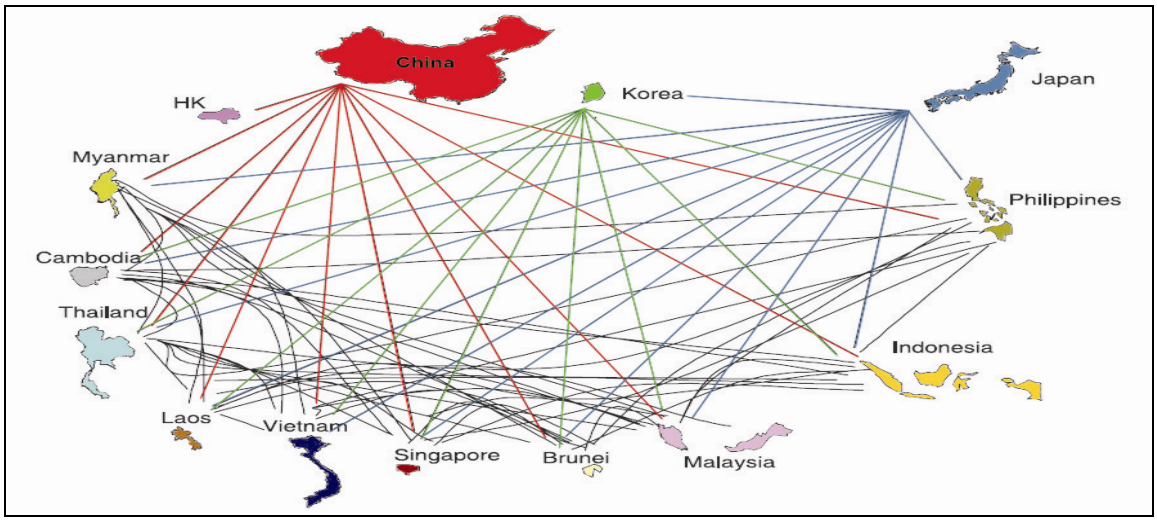

Figure 8.2 The spaghetti bowl in East Asia (Source: Baldwin, 2006b, p.3)

According to the Economist ("The noddle bowl", 2009, p.64), while especially the number of bilateral agreements has increased significantly in Asia recently, the bilateral FTA signed in September 2009 between India and South Korea is the first between two of Asia's four biggest economies (India, China, Japan and South Korea). Nevertheless, the spaghetti bowl concept is relatively a recent phenomenon in the region as the number of RIAs was 6 in 1991. While it was 42 in 1999, since that time, the number of these agreements has increased to 166 according to the Asian Development Bank (cited in ibid., p.64). However, it should be noted that Asia-Pacific region has higher level of trade openness (extra-regional exports/GDP) relative to Europe and North America, as these countries follow export-oriented development strategies (Koopmann and Vogel, 2008, p.301).

The spaghetti bowl in Europe is shown in Figure 8.3. This figure shows the existing complexity prevailing in Europe due to many RIAs centered on the EU and extending towards EFTA, Central and Eastern European Countries and North Africa. With addition of more than seventy EPAs signed with ACP countries and FTAs with third countries like Mexico and Chile, the resulting view would emphasize the EU's role on the increasing importance of regional economic integration.

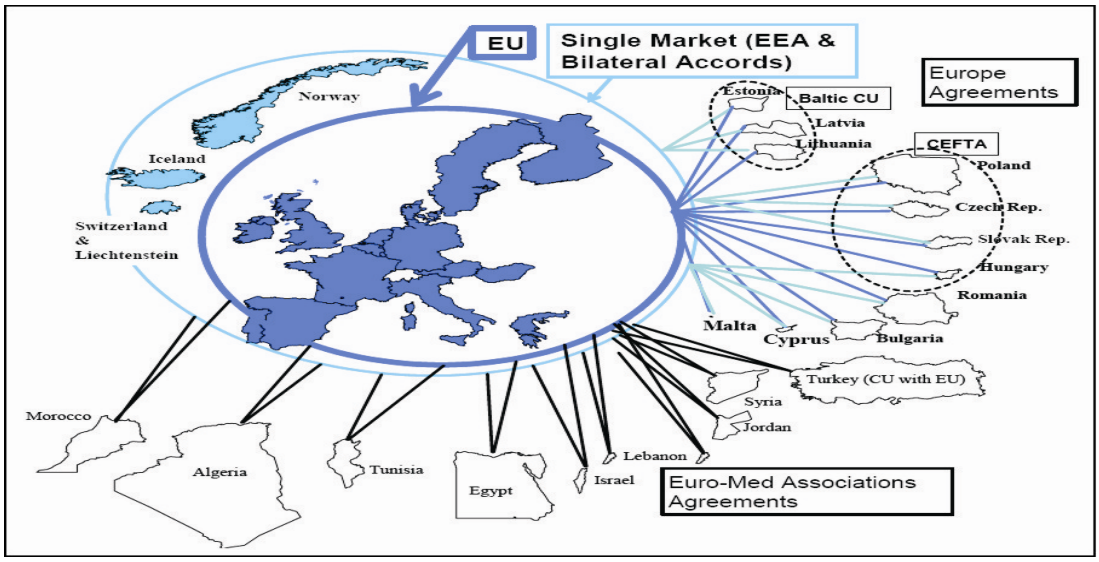

Figure 8.3 The spaghetti bowl in Europe (circa 1995) (Source: Baldwin, 2008, p.3)

As a result, the increased regional ties in these regions, especially in North America, Western Europe and South and South-East Asia, causes global trade centered on these three. While the sum of international trade shares of Africa, Middle East, Russia, Eastern Europe and Latin America was 39.2 per cent in 1970, it declined to 26.4 per cent in 1990 and is expected to be 5 per cent in 2020 (Adriana, 2008, p.317). While the arguments favoring globalization process highlight the importance of the increased international trade ties between nation states, international trade shares (or weights) of the countries constitue the crucial point of globalization. The most developed countries (OECD countries, the US and Japan) and integrated blocs like the EU trade mainly with each other, and as a result, the increase in international trade flows is more a process of deepening regional integration of developed countries/blocs rather than a worldwide increase in trade flows (Chortareas & Pelagidis, 2004, p.263). This situation is line with what Myrdal (1957) inserts about international trade (cited in Haberler, 1964, p.15): "Trade operates (as a rule) with a fundamental bias in favor of the richer and progressive regions (and countries) and in disfavor of the less developed countries."

Moreover, as Gavin and van Langenhove (2003, p.278) state while trade policy was the outcome of "two-level game determined by the interaction of special interest groups in the domestic economy with governments negotiating at the international level" up until the 1990s, in the present day, it is determined by a more complicated "three-level game

determined by the interaction of networks of stakeholders, including private industry and non-governmental organizations, with governments operating at the regional and global levels".

In sum, the world trade system presently shows an extremely complex structure. On the one hand, WTO is struggling to arrange international trading system according to the principles of non-discrimination and reciprocity; on the other hand, nation states are trying to protect the interests of national pressure groups, sometimes overtly and sometimes covertly. Despite to these two opposing tendencies, it is possible to argue that world trade is becoming more liberal successively.

CHAPTER 9 TRADE EFFECTS OF RIAs: AN EMPIRICAL ANALYSIS

The effects of the formation of RIAs on member and non-member countries have also necessitated measuring the degree of these effects on empirical ground. There are several studies that attempt to measure the effect of regional economic integration on intra-regional or extra-regional trade flows. The literature mainly focuses on two different models. These are gravity model and computable general equilibrium (CGE) model. CGE model "simulates rather than predicts the level of consumption, production and trade, among other variables, for one or more trading countries using a large system of simultaneous equations" (DeRosa & Gilbert, 2005, p.6). This model is constrained to sample large number of countries into arbitrary or selected regions due to data and modeling availability. On the other hand, the gravity model, while providing an empirically tractable general equilibrium framework for assessing bilateral trade flows, has proved its usefulness in various applications (Brada & Méndez, 1985, p.549).

This chapter will try to assess the effects of the formation of RIAs on intra-regional and extra-regional trade flows through gravity model, as it is the mostly used theoretical model in the literature. In the first section, theoretical development of this model and some of the literature that tries to estimate the trade effects of RIAs will be studied. In this section, the basic lines of econometric method that will be employed in this study are determined. In the second section, the main components of the gravity model specification are examined. This specification includes the modification of the standard gravity model with additional variables like bilateral exchange rates, intra-regional and extra-regional dummy variables. As the panel data analysis covers both cross-section dimension and time dimension, it has relatively more empirical power than time-series and cross-section analysis. Hence, the analysis employed in this chapter stems from the panel data analysis. In the third section, the models employed to estimate specified gravity equation will be studied. The fixed effects model is the first model that is studied, as most of the literature depends on this

model. In addition to this model, this chapter will try to employ panel data unit root and cointegration tests, as these tests have started to draw significant attention, recently.

The following section will give details on the selected data that include the EU (15), NAFTA, MERCOSUR and AFTA (ASEAN-5) as RIAs, and Australia, Chile, China, Hong Kong, India, Japan, Korea, Peru, Turkey and Venezuela as non-member countries. In the analysis, the sample period covers the years from 1980 to 2008. In the fifth section, estimations results of econometric analysis will be presented. All the necessary estimations of the gravity equation are performed by using the econometric package of EViews 7.0. This section will give details in what extent the formation of these RIAs affected the bilateral trade flows of these countries, both from the perspective of intra- and extra-regional trade flows. The final section, on the other hand, notes the limitations on the estimation of the effects of RIAs on trade flows.

9.1 Gravity Model: Theoretical Foundations and Empirical Studies

The gravity model was developed by the independent studies of Tinbergen (1962) and Pöyhönen (1963). Tinbergen (1962) states volume of bilateral trade as proportional to the products of variables that measure economic size of the trading pair. He also signifies the rate of this proportionality as depending on the measures of trade resistance between these countries. In the study, he employs geographic distance, dummies for memberships in Commonwealth and Benelux and a dummy for common border as the measures of trade resistance. However, the generally accepted simple model of gravity model is centred on the equation which states that exports (imports or total trade) between two countries are an increasing function of countries' size represented by national incomes and a decreasing function of the cost of transportation which is represented by distance between these two countries.

Since 1962, the basic model has been evolving in order to better explain the ongoing mechanisms in international trade. For example, Linnemann (1966) proposes to add population into the model to emphasize the importance of the country size. Linnemann (1966) also employs the dummy variable approach in the gravity equation in order to

estimate the effects of regional economic integration on bilateral trade flows. Accordingly, as the gravity model tries to determine a normal level of bilateral trade between two countries, the introduction of the dummy variables for RIAs would capture the deviations (above or below) from this normal level. Aitken (1973), on the other hand, employs model developed by Tinbergen (1962) and Linnemann (1966) that include income, population, dummy for common border, dummy for regional integration variables to estimate the impact of the EEC and EFTA on members' trade for the period 1951-1967.

As Greenaway and Milner (2002, p.6) note there was "no formal representation of the role of technology, factor endowments, demand differences or any of the underlying structural differences that are associated with the determinants of trade" until the end of the 1970s. Initial attempt was the study of Anderson (1979). This study takes product differentiation into account in the gravity model. While the study starts with outlining the theoretical explanation of the gravity equation, the aggregate and the final model specification have been formed through taking into account many commodity trade and distance as a proxy for transport costs. He starts with a basic gravity equation that is derived from Cobb-Douglas expenditure system in which each country is specialized for production of one good, the so-called Armington assumption.

Bergstrand (1985), on the other hand, states the lack of strong theoretical foundation of the gravity model. He states that the general equilibrium framework of gravity model is not plausible due to its unrealistic assumptions like perfect international product substitutability and perfect commodity arbitrage. Rather, Bergstrand proposes partial equilibrium framework for the gravity model that takes into account the price and exchange rate variables, as well as the nationally differentiated products. His empirical estimates supported the assumption that the substitution of imports for domestic goods was less likely relative to the one for imported goods. In another study, Bergstrand (1989) included per capita income variables for exporting and importing countries as proxies for the capital/labor ratios of these countries in order to further develop his earlier attempt on extending the microeconomic foundations of the gravity model. The underlying principle for the introduction of per capita income variables was first introduced by Linder (1961) that used similarity between demand structures of the trading partners in order to explain

trade flows between any pair of countries (cited in Stack, 2009, p.774). In Bergstrand (1989, p.152), while the changes in importing country's GDP and GDP per capita are taken as "alterations of expenditure capabilities and taste preferences á la Linder, respectively ", those of the exporting country are interpreted as "national output in terms of units of capital and the country's capital-labor endowment ratio, respectively".

Deardorff (1998), on the other hand, tries to show that even with two extreme cases of frictionless trade and impeded trade in which each country produces different goods (as in the study of Anderson (1979)), it is possible to derive simple gravity equation in Heckscher-Ohlin framework. As a result, the author dubs the gravity model as a model that could characterize a large class of economic models (like standard trade theory, new trade theory etc.). Incomplete specialization in which there exist multiple suppliers of homogenous goods has been incorporated to the gravity equation in the study of Evenett and Keller (2002) that emphasizes the dependency of bilateral trade not only on incomes of the two countries, but also on the share of the two goods in countries' production within two goods, two factors, and two countries model.

Anderson and Van Wincoop (2003) also use product differentiation as a starting point, they further employ three trade resistance terms, namely, the trade barrier between two countries, exporting country's resistance to trade with all regions and importing country's resistance to trade with all regions. As a result, the study concludes that "trade between two regions depends on the bilateral barrier relative to average trade barriers that both regions face with all their trading partners" (ibid., p.176). Recently, the work of Anderson and van Wincoop (2003) has been generalized by the modified gravity model of Helpman, Melitz and Rubinstein (2008) that takes into account heterogeneous firms model of trade. Firm heterogeneity derived from the fact that "the characteristics of the marginal exporters to different destinations can be identified from the variations in features of the destination countries and of observable bilateral trade costs" (ibid., p.444).

The rest of the section will try to outline some of the empirical studies that estimate the impact of RIAs on bilateral trade flows. As the model selection differs for each study, the results of these studies are also differing. The selected variables and the preferred method

of estimation significantly affect the overall effect of the RIA for the given period. Although most of the literature tries to estimate the effects of RIAs for the given sample, there are also studies that compare the effectiveness of the selected methods, like gravity model versus computable general equilibrium model, linear versus nonlinear specification of the model, or the effects of variable selection on evaluating the effects of RIAs.

Frankel et al. (1996) use gravity model to analyze bilateral trade data for EC, MERCOSUR, Andean Pact, ASEAN, and ANZCERTA countries between 1965 and 1992, and find statistically significant effect of log distance beside significant intrabloc biases. Alho (2003) focuses on the EU and its extensions and tries to measure the impact of regionalism on the intensity of mutual integration throughout trade in Europe. Regional economic agreements in Europe are specified as the EU with its internal market, EMU with a single currency, Europe Agreements between the EU and the Central and Eastern European countries, the free trade agreement between the EFTA countries and the EU, and the Partnership and Cooperation Agreement between Russia and the EU. Applying gravity model as a tool, study concludes that regional agreements significantly affect the European trade.

Managi, Kawajiri and Tsurumi (2005), on the other hand, employ gravity model for NAFTA and the EU countries and use specific ninety three commodity-level trade flows (rather than aggregate commodity flows that are commonly used in the literature) over 1996 to 2001. Their results indicate that NAFTA is more effective in increasing bilateral exports than the EU and the effects of these RIAs on agricultural products are more significant than the ones on non-agricultural products. Moreover, Tang (2005) employs modified gravity model in order to estimate the effects of NAFTA, ANZCER and ASEAN on trade via the methods of ordinary least squares (OLS) and two stage least squares (2SLS). The results show significant trade creation for all three RIAs, trade diversion for NAFTA and ANZCER.

Coulibaly (2007) focuses on seven RIAs (ECOWAS, SADC, AFTA, SAPTA, CACM, CAN and MERCOSUR) and examines the unbalanced panel data of 56 exporter and 90 importer countries from 1960 to 1999. Rather than using dummy variables for RIAs, the

study employs the number of years of membership in order to asses the impact of RIAs on members' trade. The positive impact of being a member of an RIA on intra-trade is found for all the RIAs, but SAPTA. On the other hand, the study of Martínez-Zarzoso, Felicitas and Horsewood (2009) try to estimate the effects of EU-15, NAFTA, CARICOM, the Magreb Union and Euro-Mediterranean Agreements for the period of 1980-1999. The study takes into account the time-varying multilateral resistance terms that show dependency of bilateral trade not only on bilateral trade barriers but also on trade barriers existing across all other partners in the static model. The authors also employ Generalized Method of Moments (GMM) that incorporates lagged dependent variable into the gravity equation in order to estimate the effects of regional integration in a dynamic framework. Their results indicate that the existence of trade creation for the EU, NAFTA and CACM, import trade diversion for the EU and export trade diversion for Euro-Mediterranean agreements.

Rather than sole motive of determining the effects of RIAs on bilateral trade, some of the literature focuses on comparing the model and variable selection of the estimations. DeRosa and Gilbert (2005) apply the single equation gravity model and the multiequation computable general equilibrium model (CGE) to three trade liberalization agreements, namely, Mercosur, NAFTA and Uruguay Round agreement. The study concludes that naïve versions of CGE model are likely to underpredict, those of gravity model are likely to overpredict when estimating the ex-post analysis of the given agreements. Suárez-Burguet et al. (2005) try to compare linear and non-linear specifications of the gravity model for a cross-country sample of 62 countries (CACM, CARICOM, Mercosur, NAFTA, Andean Nations Community, and the EU) for the year 1999. Their econometric specification favors log-linear type of the gravity equation rather than the non-linear one.

On the other hand, Cheng and Tsai (2008) employ modified gravity model that includes real exchange rate as a price-effect variable to the conventional gravity variables and compares several versions of the model specification. The study emphasizes the superiority of a model that takes into account heterogeneity issue (through inclusion of time-specific and country-pair specific effects) over the standard model. Similarly, for the panel data that cover 12 EU countries and 20 OECD trading partners, Stack (2009) employs various fixed

effects models (one including country-specific effects, one including country-pair-specific effect, one including country- and country-pair specific effects, and the generalized model that include country-time interactions in addition to country- and country-pair effects, as in the study of Baltagi et al. (2003)). Through these specification, the study compares traditional determinants of gravity model with the determinants of a gravity model in new trade theory (like countries' sizes, an index of similarity in size, and relative income per capita variable).

9.2 Specification of Gravity Equation

The gravity model has attained its name from its resemblance to the Newton's Law of Universal Gravitation that states the attractive force between any two particles will depend on masses of these particles positively and the distance between them negatively. From this underlying principle, the basic gravity model of international trade[1] has been formulized as:

$$X_{ij} = A * \left(\frac{Y_i^{\alpha_1} Y_j^{\alpha_2}}{D_{ij}^{\alpha_3}} \right) \tag{9.1}$$

As the subscript *i* will be used to denote the exporting country and the subscript *j* will be used to denote the variable that is relevant to the importing country, Equation 9.1, in which A denotes the constant term, states that bilateral export flows (X_{ij}) between origin country (i) and destination country (j) are the positive function of these countries' income levels (Y_i and Y_j) and the negative function of the distance (D_{ij}) between these countries.

Rather than the non-linear specification of Equation 9.1, the gravity equation of bilateral trade is generally studied in the log-linear form for the ease of estimation. Moreover, the econometric analyses of the gravity model are based on either cross-section or panel data estimations. The panel estimation results in the preferred way of estimation "by exploiting

[1] This study will focus on the export-oriented gravity equation due to the most of the empirical studies concentrate on this kind of specification. However, there exist studies that employ import-flows, the average of exports and imports or the sum of export and import flows in the specification of the gravity model like Faruqee (2004), Bussière and Schnatz (2009), Fidrmuc (2009).

changes in adherence in time dimension without discarding identifying variance for gravity characteristics in cross section" (Estevadeordal et al., 2003, p.373). Furthermore, as Egger (2002, p.298) argues the panel framework for the gravity model is the most convenient way to separate time invariant and country specific effects. When the panel data estimation is employed, the proposed gravity equation takes the subscript t for time-varying variables. In the log-linear form, for N cross-section units and for T years, Equation 9.1 becomes:

$$\ln X_{ijt} = A + \alpha_1 \ln Y_{it} + \alpha_2 \ln Y_{jt} + \alpha_3 \ln D_{ijt} + u_{ijt} \quad \text{i, j: 1, …, N; t: 1, …, T} \tag{9.2}$$

Equation 9.2 is further generalized through the introduction of the idiosyncratic factors that support or impede the bilateral trade flows between any pair of countries. These idiosyncratic factors of the bilateral trade can be categorized into three factors as:

- geographic factors (common border, being island),
- cultural factors (common religion, common language, colonial ties), and
- institutional factors (the membership in an RIA, common currency).

These factors are added to the gravity equation through the dummy variables. For the time being, the variable I_{ij} is used to represent these variables. Additionally, to catch the price effects, bilateral exchange rate variable is also incorporated to the equation. Adding the vector of idiosyncratic factors (I_{ij}) and the exchange rate variable (ER_{ij}) into Equation 9.2 will result in:

$$\ln X_{ijt} = A + \alpha_1 \ln Y_{it} + \alpha_2 \ln Y_{jt} + \alpha_3 \ln D_{ijt} + \alpha_4 I_{ijt} + \alpha_5 \ln ER_{ijt} + u_{ijt} \tag{9.3}$$

Hence, the log-linear specification shown in Equation 9.3 depicts that a trade flow from origin country i to destination country j can be explained through three interacting elements. These are economic forces at the country i, economic forces at the country j and other factors (economic or non-economic) either contributing or resisting the flow's movement from i to j (Bergstrand, 1985, p.474).

The dummy variables of the idiosyncratic factors generally take the value of one for the existence of the specified relationship and zero in the case of not fulfillment. As the main motive of this study is to assess the effects of RIAs, the only idiosyncratic factor that will be incorporated to the gravity equation is the membership in an RIA. The related dummy variables will represent the membership in a specified RIA or not. The mostly used method is assigning the value of one when exporting and importing countries are both members of a specified RIA, otherwise letting the variable take value of zero. The magnitude of the coefficient of regional integration dummy, in this case, represents the volume of bilateral trade relative to non-preferential trade. This kind of estimation is originated from the studies of Tinbergen (1962), Linnemann (1966) and Aitken (1973)[1]. With the introduction of regional integration dummy, Equation 9.3 will be:

$$\ln X_{ijt} = A + \alpha_1 \ln Y_{it} + \alpha_2 \ln Y_{jt} + \alpha_3 \ln D_{ijt} + \alpha_4 RIA_{ijt} + \alpha_5 \ln ER_{ijt} + u_{ijt} \qquad (9.4)$$

Equation 9.4 is further extended with the introduction of the population variables-populations of the home country (Pop_i) and of the foreign country (Pop_j). Moreover, in order to separate the intra and extra-union effects (following Soloaga and Winters (2001); Tang (2005); Cheng and Tsai (2008); Martínez-Zarzoso et al. (2009)), the new dummy variables $XRIA_{ij}$ and $MRIA_{ij}$ will be introduced, in addition to the RIA_{ij} variable. While the former variable takes the value of one when exporting country (i) is a member of the specified regional group, the latter will be one when importing country (j) is a member of the specified group. As a result, in this framework, the coefficient of RIA_{ij} gives the extent of change from the normal level of bilateral trade if both countries are members of the same integration, the coefficient of $XRIA_{ij}$ gives the extent that members' exports to non-members are higher than the normal level, and the coefficient of $MRIA_{ij}$ depicts the change in the level of imports arriving into the integration scheme from its normal level. As a result, while the coefficient of RIA gives the extent of trade creation effect, the other coefficients can be interpreted as a measure for trade diversion together with the openness effect (Martínez-Zarzoso et al., 2009, p.53). Hence the new equation becomes:

[1] Another approach on the gravity equation that is not used much due to heterogeneity restraints derives from ex-ante analysis. In this methodology, gravity equation that is derived from pre-integration period is projected to expect bilateral trade after the integration. The difference between actual and expected volume of trade represents the effect of integration agreement.

$$\ln X_{ijt} = A + \alpha_1 \ln Y_{it} + \alpha_2 \ln Y_{jt} + \alpha_3 \ln D_{ijt} + \alpha_4 RIA_{ijt} + \alpha_5 XRIA_{ijt} + \alpha_6 MRIA_{ijt} + \alpha_7 \ln ER_{ijt} + \alpha_8 \ln Pop_{it} + \alpha_9 \ln Pop_{jt} + u_{ijt} \quad (9.5)$$

The coefficients α_1, α_2 and α_3 depict the elasticities, in other words, percentage changes in the exports for one percentage change in income and distance. As higher income level in the exporting country signifies increased production, which in turn increases the amount of goods that are available for export, the coefficient of exporting country's income is expected to be positive. Similarly, as the increased income in the importing country will result in more importing, the coefficient of importing country's income is also expected to be positive. As distance variable is taken as a proxy for all possible trade costs, like transportation costs, differences in legal systems and market structures, its coefficient is expected to be negative. On the other hand, the coefficients α_4, α_5 and α_6 will determine the effects of RIAs on intra- and extra-integration trade and it is not possible to determine their effects a priori as the effects will differ depending on the selected integration scheme. The coefficient α_7 is expected to be positive as the currency depreciates against foreign currency (ER_{ij} increases), exports from country i to country j will increase. The last term, u_{ij}, represents the error term which is assumed to be normally distributed with zero mean and constant variance and has uncorrelated observations, i.e. $E(u_{ijt},u_{kjt})=0$, $E(u_{ijt},u_{ilt})=0$, and $E(u_{ijt},u_{ij,t-1})=0$ for all $i \neq k$ and $j \neq l$.

Determination of the sign of the population coefficients is, on the other hand, little bit ambiguous. The coefficient of population variables can take positive or negative values depending on the trade structure of the specified countries. As "higher populations would reduce capital-labor endowments ratios of the two and tend to reduce the capital-intensive industry's share of national output in both countries; if goods are capital intensive, goods trade should fall, and goods trade should increase in the case of labor intensive goods" (Baier and Bergstand, 2002, p.15). For the case of negative coefficient of domestic population and positive coefficient for foreign population, the intuition goes as follows (Brada & Méndez, 1985, p.550):

> Large countries have more diversified production and thus satisfy a greater proportion of domestic demand while small countries tend to be more specialized

and thus more dependent on trade, suggesting the coefficient of *exporting country's population* be negative. The population of the importing country should have a positive effect on the volume of trade, since a larger population permits a greater division of labor and diversity of production, enabling imports to compete with domestic goods at more stages of the production process.

However, the intuition for positive coefficient of importing country's population can also be suggested for the exporting country, as larger country can export more due to economies of scale effect, as well as the additional labor supply that will increase the labor-intensive tradable goods.

9.3 Model Specification

This section will study firstly the fixed effects model which is the mainly used method in the literature. In addition to the huge amount of applications of fixed effects model, consideration of the non-stationarity of the panel data has started to be a new extension on the estimation of gravity model after 2000 (Faruqee (2004); Bussière, Fidrmuc and Schnatz (2008); Bussière and Schnatz (2009); Fidrmuc (2009)). Hence, the second model specification will depend on the panel data counterpart of time-series non-stationarity and cointegration analysis.

9.3.1 Fixed effects model

As the first step, Equation 9.5 will be estimated through ordinary least squares (OLS). In the second step, as panel data estimation of the gravity equation is centered on the fixed effects and random effects models, the equation will be modified to take into account these effects. In the new specification, the unexplained error variable of the regression equation is assumed to have fixed or random unobservable elements. The crucial distinction between these effects is "whether the unobserved individual effect contains elements that are correlated with the regressors, not whether these effects are stochastic or not (Greene, 2008, p.183). Hence, in the random effects model the specific effects are estimated as a part of the error term, in the fixed effects model these effects are taken as parameters.

While the estimation in the random model should be done through generalized least squares (GLS), fixed effects model should be estimated via OLS.

When there is a correlation between individual effects and the explanatory variables, then only the fixed effects model is consistent. Moreover, due to their computational simplicity, the fixed effects estimation would be useful in capturing the omitted and mis-specified factors (Feenstra, 2003, p.167). While deciding whether to use fixed effects or random effects model, the criterion will be the Hausmann test in which the null hypothesis of no correlation between individual effects and independent variables is tested. The basic idea behind this test is that under the null hypothesis, both OLS and GLS are consistent, but OLS is relatively inefficient, on the other hand, under the alternative hypothesis, OLS estimation is consistent, however GLS estimation is not (Greene, 2008, p.208).

When fixed (random) effects are taken into consideration, the gravity equation is modified through the addition of country-pair effects (fixed or random) and time effects (fixed or random). While the variable of country-pair effects (β_{ij}) controls for the unmeasured country-specific market aspects or frictions on both markets, the variable of time-specific effects (β_t) controls for the unmeasured time effects on the exports of selected country-pairs. While ignoring the heterogeneity issue when the fixed effects model is suitable can result in the OLS estimator inconsistent (Greene, 2008, p.185), Cheng and Tsai (2008, p.392) state that "…failure to take account of falling transportation costs, declining multilateral trade barriers in recent decades under GATT and WTO [*namely, time-specific factors*], and specific preference between trading partners, namely the exclusion of pair-specific…factors from the standard gravity models, can cause the effects of *regional economic integration* to be overstated". In addition to reducing heterogeneity bias, employing country-pair specific effects reduces the endogeneity bias (like the high initial volumes of bilateral trade causing the establishment of an RIA) through taking into account whether the given two countries have traditionally traded a lot (Bussière, Fidrmuc & Schnatz, 2005, p.16).

As it is the case for the regional integration, these effects are introduced to the gravity equation through dummy variables. However, it should be noted that while the fixed

effects model is superior relative to direct inclusion of these specific factors on controlling for omitted variables bias, the use of such a model excludes the determination of individual contributions of these factors. As a result, with the introduction of the country-pair effects, the distance variable is not needed anymore, and dropped from the equation. Equation 9.5 becomes as follows[1]:

$$\ln X_{ijt} = \beta_{ij} + \beta_t + \alpha_1 \ln Y_{it} + \alpha_2 \ln Y_{jt} + \alpha_4 RIA_{ijt} + \alpha_5 XRIA_{ijt} + \alpha_6 MRIA_{ijt} + \alpha_7 \ln ER_{ijt} + \alpha_8 \ln Pop_{it} + \alpha_9 \ln Pop_{jt} + u_{ijt} \quad (9.6)$$

In the case of fixed effects model[2], the restrictions on the country-pair specific and time specific dummy variables are $\sum_{ij} \beta_{ij} = 0$ and $\sum_{t} \beta_t = 0$.

There is a growing literature on the use of fixed effects specification of the gravity equation that compares to include random and fixed effects of country-pair and country-specific effects, as well as time-specific effects. One of the initial users of country-pair effects was the study of Hummels and Levinsohn (1995) (cited in Baltagi, Egger & Pfaffermayr, 2003, p.392). Accordingly, fixed country-pair effects would stand for the impact of any time invariant geographical (e.g. distance), historical (e.g. colonial tie), political, cultural (e.g. common language) and other bilateral determinants that cause deviations from the normal levels of bilateral trade. On the other hand, time-specific effects account for the business cycle and changes in openness across all countries. There are also studies that include the variables β_i and β_j as countries' separate effects on the trade flows (suggested by Pöyhönen (1963), developed by Mátyás (1997)). In this case, the correlation between these variables of individual country effects with the independent variables is assumed. These individual country effects control for unobserved characteristics of the given countries that affect their propensity to trade. While Egger and Pfaffermayr (2003) favors the inclusion of country-specific, country-pair specific, and time-specific fixed effects in their specification of the gravity model, Baltagi et al. (2003) further enlarges this specification by taking fixed importer, exporter and time effects as

[1] The coefficients of the remaining variables are not changed with exclusion of the distance variable in order to stick to the explanations of the previous section.
[2] This model is also dubbed as the least square dummy variable (LSDV) model (Greene, 2008, p.195).

the main effects, country-pair effect, exporter-specific and importer-specific time-variant effects[1] as the interaction effects of their specified gravity equation.

9.3.2 Panel unit root tests and cointegration tests

The second model specification derives from the panel unit root and panel cointegration techniques that have been developed since 1990s (for a survey of the studies, see Banerjee (1999), Baltagi and Kao (2000), Baltagi (2001), and Breitung and Pesaran (2005)). Accordingly, if the variables of the gravity model are non-stationary, cointegration analysis would be more appropriate rather than other panel estimation techniques. The initial step will be the use of unit root tests that will determine the non-stationarity of the selected variables. If all of the specified variables are non-stationary then it is possible to perform cointegration test. In the following parts, the basics for panel unit root and panel cointegration tests will be presented. Moreover, the specified gravity equation will be estimated by dynamic OLS specification, following Kao and Chiang (2000), as DOLS estimator better performs relative to OLS and fully modified OLS (FMOLS) estimations in the case of cointegrated variables. Hence, DOLS estimations will constitute the final analysis for determining the effects of RIAs on bilateral trade flows.

Panel unit root tests

Panel cointegration tests are simple extensions of the cointegration analysis of time-series data developed by Engle and Granger (1987). As in the case of the time-series data, the first step in the cointegration analysis is to test the series for integration. If the series are not integrated, i.e. the series are stationary (do not have unit roots) then they cannot be cointegrated. A stochastic process is stationary in a weak sense if its mean, variance, and covariance are all invariant with respect to time. While in the time series analysis the approach recommended by Engle and Granger (1987) for the unit root test is Augmented Dickey Fuller (ADF) test, various forms of the ADF tests are employed for the panel unit root tests. Three of these tests that will be used for the determination of non-stationarity of

[1] The examples of exporter (importer)-specific time-variant effects are exporter (importer) country's business cycle, cultural, political or institutional features (Baltagi et al., 2003, p.393).

the selected variables are, Im, Pesaran and Shin (IPS) (1997), Hadri (2000) and Levin, Lin and Chu test (LLC) (2002).

When the following model is considered:

$$y_{it} = \rho_i y_{i,t-1} + z'_{it}\gamma + u_{it} \quad \text{i = 1, …, N; t = 1, …, T} \tag{9.7}$$

where z_{it} constitutes the deterministic part, the error term (u_{it}) is a stationary process. In this setting, the LLC test assumes that the error terms are iid$(0, \sigma_u^2)$ (independent identically distributed) and $\rho_i=\rho$ for all i. Hence, the coefficient of the lagged dependent variable is assumed to be homogenous over all cross-section units. The null hypothesis of test is that each series has a unit root (H_0 : $\rho=1$) against the alternative hypothesis (H_1 : $\rho<1$) that states all series are stationary. While the LLC performance may be problematic for panel data that have small time dimension, in addition to this, due to the homogeneity restriction that shows the possible speed of convergence, the LLC test is likely to reject the panel unit root (Fidrmuc, 2009, p.439).

Im, Pesaran and Shin (IPS) (1997), on the other hand, address the homogeneity problem through allowing heterogenous coefficient of lagged dependent variables. The study employs the method based on averaging of the augmented Dickey Fuller (ADF) tests when the error term (u_{it}) is serially correlated with different serial correlation properties across cross-sectional units such that (Baltagi, 2001, p.238):

$$u_{it} = \sum_{j=1}^{p_i} \varphi_{ij} u_{i,t-j} + \varepsilon_{it} \tag{9.8}$$

In this setting, Equation 9.7 becomes:

$$y_{it} = \rho_i y_{i,t-1} + z'_{it}\gamma + \sum_{k=1}^{p_i} \varphi_{ik} \Delta y_{i,t-k} + \varepsilon_{it} \tag{9.9}$$

where i=1,…,N; t=1,…,T.

As in the LLC test, the null hypothesis of the IPS test is that each series has a unit root ($H_0 : \rho_i=1$) for all cross-section units and the alternative hypothesis inserts that at least one unit of the panel is stationary ($H_0 : \rho_i<1$ for some i) rather than the more restrictive alternative hypothesis of the LLC test.

As the third unit root test, the one proposed by Hadri (2000) will be employed. This is a residual-based Lagrange multiplier test and the null hypothesis is taken as the reverse cases of the LLC and IPS tests. Hence, the null hypothesis is that the time series of each cross-section unit i are stationary around a deterministic trend against the alternative hypothesis of a non-stationarity (Baltagi, 2001, p.241). In the study, the model is formulated as:

$$y_{it} = z'_{it}\gamma + r_{it} + \varepsilon_{it} \tag{9.10}$$

While z_{it}, as in the previous studies, constitutes the deterministic part, the error term (ε_{it}) is a stationary process, and, differently from the other studies, r_{it} is a random walk component which can be formulated as:

$$r_{it} = r_{i,t-1} + u_{it} \tag{9.11}$$

given that $u_{it} \sim IID(0, \sigma_u^2)$.

Panel cointegration tests

As panel cointegration analysis is mainly derived from its time-series counterpart, it would be beneficial to give some introductory remarks on the time-series cointegration analysis. Engle and Granger (1987) states that the components of the vector x_t are said to be co-integrated of order d, b, denoted by $x_t \sim CI(d,b)$ if :

- all components of x_t are I(d); and
- there exists a vector α (≠0) so that $z_t = \alpha' x_t \sim I(d-b), b > 0$.

Hence, cointegration describes the existence of an equilibrium relationships among two or more time-series, each of which is individually non-stationary. Additionally, Engle and Granger (1987) show that if x_t has N components, it will be assumed that there are exactly r linearly independent co-integrating vectors with $r \leq N-1$. For example, if two series X_t and Y_t are found to be integrated of order 1 and there exists a constant φ such that $Z_t = X_t + \varphi Y_t$ with Z_t is I(0), then, X_t and Y_t are said to be cointegrated. Hence, cointegration implies that deviations from equilibrium are stationary, with finite variance, even though the series themselves are non-stationary and have infinite variance.

In case of the panel cointegration tests, the method employed in this study will be Pedroni (1999) cointegration tests which are residual-based cointegration tests[1]. Pedroni (1999) tests the null hypothesis of no cointegration through seven statistics, four for panel cointegration tests (the within-dimension approach) and three for group cointegration tests (the between-dimension approach), to test cointegration in a panel where there exist multiple regressors. Accordingly, "an important feature of these tests is that they allow not only the dynamics and fixed effects to differ across members of the panel, but also that they allow the cointegrating vector to differ across members under the alternative hypothesis" (ibid., p.655). While the panel cointegration statistics are based on estimators that pool the autoregressive coefficient across different cross-sections for the unit root tests on the estimated residuals, the group cointegration statistics take the average of the individually estimated coefficients for each cross-section unit. This distinction shows itself in the construction of the alternative hypothesis for the autoregressive coefficients (γ_i) of the estimated residuals. Such that, for the within-dimension statistics, the test for the null of no cointegration is formulated as a residual-based test with $H_0 : \gamma_i=1$ and $H_1 : \gamma_i=\gamma<1$ for all i. On the other hand, for the between-dimension statistics while the null hypothesis is the same, the alternative hypothesis is constructed as $H_1 : \gamma_i<1$ for all i, not assuming a common value ($\gamma_i=\gamma$) as in the case of the panel statistics. Hence, while homogeneity is assumed for the calculation of test statistics of the within-dimension based type, in the case of the between-dimension based statistics, heterogeneity across the units is considered.

[1] In Appendix E, the results for cointegration test of Kao (1999) are also reported. This study assumes that cointegrating vectors are homogeneous and tests the null hypothesis of no cointegration through Dickey-Fuller (DF) and augmented DF (ADF) tests.

The first panel cointegration statistic of Pedroni (1999) is a type of non-parametric variance ratio statistic. The second and the third statistics are non-parametric statistics and analogous to the Phillips and Perron rho-statistic and the Phillips and Perron t-statistic, respectively. The final panel cointegration statistic is, on the other hand, a parametric one which is analogous to the ADF t-statistic. The underlying tests for the last three statistics (the Phillips and Perron rho-statistic, the Phillips and Perron t-statistic and the ADF t-statistic) also constitute the three components of the between-dimension-based (group cointegration) statistics. As Pedroni (1997) notes panel-ADF and the group-ADF tests of these seven tests have better small sample properties (i.e. the case of shorter time spans) than the other statistics, the estimation results will depend on these two tests, although the estimation results for all the seven tests of Pedroni (1999) can be found in Appendix E. The model is given as follows:

$$y_{it} = \alpha_i + \delta_t + \sum_{k=1}^{M} \beta_{ki} x_{kit} + e_{it} \tag{9.12}$$

where the number of observations over time t ranges from 1 to T; the number of cross-sectional units i ranges from 1 to N and the number of regressors k ranges from 1 to M. In this formulation α_i and δ_t represent cross-section specific and time-specific fixed effects, respectively. Pedroni (1999, p.659) summarizes the necessary steps that should be taken for each test as follows:

- The above regression is estimated and the residuals of this estimation are named as $\hat{e}_{it}$.
- The differenced regression $\Delta y_{it} = \sum_{k=1}^{M} b_{ki} \Delta x_{kit} + \eta_{it}$ is estimated and the residual estimates are assigned as $\hat{\eta}_{it}$.
- The long-run variance ($\hat{L}_{11i}^2$) of $\hat{\eta}_{it}$ is calculated using any kernel estimator like the Newey-West estimator.

- The regression $\hat{e}_{it} = \hat{\gamma}_i \hat{e}_{i,t-1} + \sum_{k=1}^{K_i} \hat{\gamma}_{ik} \Delta \hat{e}_{i,t-k} + u_{it}^*$ is run[1], and the variance ($\hat{s}_i^{*2}$) of the residual estimates ($\hat{u}_{it}^*$) is calculated. The panel variance estimator is calculated from $\hat{s}_i^{*2}$ as $\tilde{s}_{N,T}^{*2} \equiv \frac{1}{N} \sum_{i=1}^{N} \hat{s}_i^{*2}$.

These steps lead to the following cointegration statistics for panel-ADF statistic and group-ADF statistic, respectively:

$$Z_{tN,T}^* \equiv \left(\tilde{s}_{N,T}^{*2} \sum_{i=1}^{N} \sum_{t=1}^{T} \hat{L}_{11i}^{-2} \hat{e}_{i,t-1}^{*2} \right)^{-1/2} \sum_{i=1}^{N} \sum_{t=1}^{T} \hat{L}_{11i}^{-2} \hat{e}_{i,t-1}^* \Delta \hat{e}_{i,t}^* \tag{9.13}$$

and

$$N^{-1/2} Z_{tN,T}^* \equiv N^{-1/2} \sum_{i=1}^{N} \left(\sum_{t=1}^{T} \hat{s}_i^{*2} \hat{e}_{i,t-1}^{*2} \right)^{-1/2} \sum_{t=1}^{T} \hat{e}_{i,t-1}^* \Delta \hat{e}_{i,t}^* \tag{9.14}$$

Asymptotic distribution of these statistics (panel-t and group-t) follows normal distribution and can be expressed as:

$$\frac{\tau_{N,T} - \mu\sqrt{N}}{\sqrt{\nu}} \Rightarrow N(0,1) \tag{9.15}$$

where $\tau_{N,T}$ is attained from appropriate standardization of selected tests with respect to the dimensions of N and T, and the values for μ and ν are referred as the mean and variance adjustment terms[2] respectively. As panel-t and group-t statistics diverge to negative infinity under the alternative hypothesis, the left tail of the normal distribution is used to reject the null hypothesis of no cointegration.

[1] Pedroni (1999, p.662) states that "truncation values (K_i) for the number of lagged differences in the parametric ADF regression are permitted to vary by individual member, and can be determined individually for each member using standard step-down procedures".

[2] Table 2 of Pedroni (1999, p.666) tabulates these adjustment terms.

Dynamic ordinary least squares (DOLS)

After determination of the cointegration in the panel, Kao and Chiang (2000) proposes a panel dynamic OLS (DOLS) that builds upon the studies of Saikkonen (1991) and Stock and Watson (1993). While Saikkonen (1991) develops simple estimators of cointegrating vectors for I(1) (integrated of order one) variables, Stock and Watson (1993) further develop this to simple estimators of cointegrating vectors for I(d) (integrated of order d) variables. Kao and Chang (2000), on the other hand, estimate Monte Carlo simulations in order to compare the sample properties of OLS, fully modified OLS (FMOLS) and DOLS for homogeneous and heterogeneous panels. The results show that (ibid., p.216):

- the OLS estimator has a non-negligible bias in finite samples,
- the FMOLS estimator does not improve over the OLS estimator in general, and
- the DOLS outperforms both the OLS and FMOLS estimators in estimating the cointegrated panel regressions.

Stock and Watson (1993) and Baltagi and Kao (2000) also state that the DOLS estimator can be more promising than OLS estimator in the case of cointegrated panel structure. Hence, this methodology will be followed as the final step of panel data estimations.

Panel DOLS estimation include leads and lags of the differenced independent variables as additional regressors in to the model. Through this, it takes into account two important issues related to the estimation: the potential endogeneity of the regressors and the serial correlation among error terms. This estimator derives from the following error decomposition:

$$e_{it} = \sum_{r=-p_1}^{p_2} \phi_r \Delta x_{i,t+r} + u_{it} \tag{9.16}$$

in which the summation is done over the specified number of leads (p_2) and lags (p_1) (the number of leads and lags can be equal or not). While u_{it} is orthogonal to all leads and lags

of $\Delta x_{i,t}$ (Breitung & Pesaran, 2005, p.33), for the DOLS estimation, the regression in Equation 9.12 can be reformulated as:

$$y_{it} = \alpha_i + \delta_t + \sum_{k=1}^{M} \beta_{ki} x_{kit} + \sum_{r=-p_1}^{p_2} \phi_r \Delta x_{i,t+r} + u_{it} \tag{9.17}$$

9.4 Data

The sample covers four integration schemes and thirty-six countries as EU (15) members (Austria, Belgium and Luxembourg[1], Denmark, France, Finland, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden and UK), NAFTA (Canada, Mexico and the US), MERCOSUR (Argentina, Brazil[2], Paraguay and Uruguay), five members of AFTA (Indonesia, Malaysia, Phillippines, Singapore and Thailand) and Australia, Chile, China, Hong Kong, India, Japan, Korea, Peru, Turkey[3] and Venezuela as non-member countries. The period of estimation consists of the years between 1980 and 2008. The permutation of thirty-six countries into country pairs yields 1260 bilateral trade flows, i.e. cross-section units. With N=1260 and T=29, the sample covers the balanced panel[4] data with N*T=36540 observations.

Export data are retrieved from IMF Direction of Trade Statistics (DOT). In order to exclude the price effects, the real variables are used. Hence, real exports[5] are calculated by dividing nominal export values X_{ij} (in terms of US $) by GDP deflator of the US (with base year 2000) as:

$$RX_{ij} = X_{ij} * 100 / GDP_{deflator\_US} \tag{9.18}$$

[1] Belgium and Luxembourg are counted as one country.
[2] National currency per US $ values for Brazil are taken from Centre for International Economy website: http://cei.mrecic.gov.ar/homeingles.htm.
[3] Turkey, due to the Turkey-EU CU, is regarded as member of the EU after 1996.
[4] The panel data is said to be balanced if each individual in the data set is observed the same number of times (Greene, 2008, p.184).
[5] Keeping in mind that zero trade flows can significantly distort the empirical estimations, this study employs the solution proposed in Eichengreen and Irwin (1998): "the dependent variable is taken as the log of 1 plus exports. Having censored data requires Tobit estimation, but for gravity models this has typically made little difference" (cited in Wall, 2003, p.16).

Real GDP (constant 2000 US $) (IRGDP for real GDP of the exporting country and JRGDP for real GDP of the importing country) and population values (IPOP for the exporting country and JPOP for the importing country) of the sample countries are taken from the World Development Indicators database of the World Bank. Distance variable, given in kilometers, represents great circle distance between capital cities of countries[1]. Exchange rates (ER_i and ER_j) (national currency per US $) and consumer price indeces (CPI with base year 2005)[2] values are taken from the IMF Financial Statistics (IFS). From these values, real exchange rates between any pair of countries (i,j) are calculated as:

$$RER_{ij} = \left(\frac{ER_i}{ER_j}\right) * \left(\frac{CPI_j}{CPI_i}\right) \tag{9.19}$$

Dummy variables for selected RIAs include EU_{ij}, XEU_{ij}, MEU_{ij}, NF_{ij}, XNF_{ij}, MNF_{ij}, MR_{ij}, XMR_{ij}, MMR_{ij}, AF_{ij}, XAF_{ij}, and MAF_{ij}. Table 9.1 shows on which conditions the given dummy will take the value of 1. Otherwise, this dummy will take zero value.

Table 9.1 Determination of the values for regional integration dummies

RIA	Membership of the exporting country (i) in year t	Membership of the importing country (j) in year t	The value of regional integration dummy
EU (intra-exports)	Yes	Yes	$EU_{ijt}=1$
EU (extra-exports)	Yes	No	$XEU_{ijt}=1$
EU (extra-imports)	No	Yes	$MEU_{ijt}=1$
NAFTA (intra-exports)	Yes	Yes	$NF_{ijt}=1$
NAFTA (extra-exports)	Yes	No	$XNF_{ijt}=1$
NAFTA (extra-imports)	No	Yes	$MNF_{ijt}=1$
MERCOSUR (intra-exports)	Yes	Yes	$MR_{ijt}=1$
MERCOSUR (extra-exports)	Yes	No	$XMR_{ijt}=1$
MERCOSUR (extra-imports)	No	Yes	$MMR_{ijt}=1$
AFTA (intra-exports)	Yes	Yes	$AF_{ijt}=1$
AFTA (extra-exports)	Yes	No	$XAF_{ijt}=1$
AFTA(extra-imports)	No	Yes	$MAF_{ijt}=1$

[1] Distance values are retrieved from http://www.chemical-ecology.net/java/capitals.htm.
[2] CPI values for China (from 1980 to 1985) and 1980 CPI value for Hong Kong are obtained from the data set of Ketenci and Uz (2010).

Belgium, France, Germany, Italy, Luxembourg and Netherlands are original founders of the EU (1957), the membership of Denmark, the UK and Ireland dates back to 1973, and the membership enlargements within the studied period include Greece (1981), Portugal and Spain (1986), and Austria, Finland and Sweden (1995). The dates of entry into force for other RIAs of data are 1991 for MERCOSUR, 1992 for AFTA, and 1994 for NAFTA.

With all variables expressed in natural logarithms (except the dummy variables), the first gravity equation employed in the study becomes as (C is the constant variable):

$$\begin{aligned} RX_{ijt} &= C + \alpha_1 IRGDP_t + \alpha_2 JRGDP_t + \alpha_3 IPOP_t + \alpha_4 JPOP_t + \alpha_5 RER_{ijt} + \alpha_6 DIS_{ij} + \\ &\delta_1 EU_{ijt} + \delta_2 XEU_{ijt} + \delta_3 MEU_{ijt} + \delta_4 NF_{ijt} + \delta_5 XNF_{ijt} + \delta_6 MNF_{ijt} + \delta_7 MR_{ijt} + \\ &\delta_8 XMR_{ijt} + \delta_9 MMR_{ijt} + \delta_{10} AF_{ijt} + \delta_{11} XAF_{ijt} + \delta_{12} MAF_{ijt} + u_{ijt} \end{aligned} \quad (9.20)$$

In the second type of gravity equation, the dummies for country-pair specific and time-specific effects are included to Equation 9.20. Dropping the distance variable and adding these dummies yields:

$$\begin{aligned} RX_{ijt} &= \beta_{ij} + \beta_t + \alpha_1 IRGDP_t + \alpha_2 JRGDP_t + \alpha_3 IPOP_t + \alpha_4 JPOP_t + \alpha_5 RER_{ijt} + \\ &\delta_1 EU_{ijt} + \delta_2 XEU_{ijt} + \delta_3 MEU_{ijt} + \delta_4 NF_{ijt} + \delta_5 XNF_{ijt} + \delta_6 MNF_{ijt} + \delta_7 MR_{ijt} + \\ &\delta_8 XMR_{ijt} + \delta_9 MMR_{ijt} + \delta_{10} AF_{ijt} + \delta_{11} XAF_{ijt} + \delta_{12} MAF_{ijt} + u_{ijt} \end{aligned} \quad (9.21)$$

On the other hand, for the DOLS estimation, the required gravity equation takes the following form:

$$\begin{aligned} RX_{ijt} &= \beta_{ij} + \beta_t + \alpha_1 IRGDP_t + \alpha_2 JRGDP_t + \alpha_3 IPOP_t + \alpha_4 JPOP_t + \alpha_5 RER_{ijt} + \\ &\sum_{r=-p_1}^{p_2} \phi_r \Delta x_{i,t+r} + \delta_1 EU_{ijt} + \delta_2 XEU_{ijt} + \delta_3 MEU_{ijt} + \delta_4 NF_{ijt} + \delta_5 XNF_{ijt} + \delta_6 MNF_{ijt} + \\ &\delta_7 MR_{ijt} + \delta_8 XMR_{ijt} + \delta_9 MMR_{ijt} + \delta_{10} AF_{ijt} + \delta_{11} XAF_{ijt} + \delta_{12} MAF_{ijt} + u_{ijt} \end{aligned} \quad (9.22)$$

where $\sum_{r=-p_1}^{p_2} \phi_r \Delta x_{i,t+r}$ is the sum of the leads (p_2) and lags (p_1) of the differenced regressors (IRGDP, JRGDP, IPOP, JPOP and RER).

9.5 Estimation Results

The initial step is to determine the non-stationarity of the variables through aforementioned panel unit root tests. Table 9.2 shows the results of these tests[1]. In the unit root tests, appropriate lag lengths are determined with the automatic selection of the Akaike Information Criteria (AIC) that tests down from maximum number of six lags.

Table 9.2 Panel unit root tests

	LLC	IPS	Hadri
RX_{ij}	-2.289	4.700	80.867
IRGDP [JRGDP]	-2.743	46.605	122.518
IPOP [JPOP]	-46.231	11.549	124.456
RER_{ij}	-8.667	0.077	91.074

As calculated values for IPS test are greater than the 5 per cent critical value of -1.645 (1 per cent critical value of -2.326) from the standard t-table, the null of non-stationarity (unit root) cannot be rejected. Hadri test strongly rejects the null hypothesis of stationarity and confirms again the non-stationarity of the selected variables. LLC test, on the other hand, rejects the null of non-stationarity for all variables. Although LLC test is shown in the table, it should be noted that as homogeneity assumption of LLC test does not fit into the sample of the study, the results are just illustrative.

If the series are not integrated (do not have unit roots) then they cannot be cointegrated. Since all of the series (RX_{ij}, IRGDP, JRGDP, IPOP, JPOP and RER_{ij}) are non-stationary –integrated of order one, I(1) (according to IPS test[2] at 5 per cent critical value)– the suggested cointegration tests can be applied. The cointegration tests that make use of these variables will detect the existence of any long-run relationship among the variables. The number of lags applied in the cointegration tests is again based on the automatic selection of the AIC.

[1] The estimation outputs for panel unit root and cointegration tests, Hausman test, OLS estimations, DOLS estimations and predictive accuracy of models are reported in Appendix E.
[2] Unit root test results for the first differences of given variables are reported in Appendix E.1.

Table 9.3 Panel cointegration tests[1]

Study	Statistics	Null Hypothesis	Test result
Pedroni (1999)	Panel-t Statistics	No cointegration	-63.384
	Group-t Statistics	No cointegration	-53.302

Pedroni (1999) panel-t and group-t cointegration tests are one-sided tests with a critical value of -1.645 (at 5 per cent significance level). Hence, as the reported values of these tests in Table 9.3 are less than the critical value, this implies rejection of the null hypothesis of no cointegration. Hence, evidence from panel-t and group-t tests of Pedroni (1999) implies the existence of a cointegrating relationship among real export, real GDP (of exporting and importing countries), population (of exporting and importing countries) and real exchange rate variables of the specified gravity equation.

For the inclusion of fixed or random effects into the gravity equation, the Hausman test is perfomed. In the test, the null of there is no misspecification for the cross-section and period random effects is strongly rejected with χ^2 (chi-square) distribution statistic of 710.1. Hence, the results suggest the fixed effects model is appropriate for the gravity equation employed.

Panel OLS (with and without fixed effects) estimates and DOLS estimates that take into account non-stationarity of and cointegration among the selected variables are given in Table 9.4. For the DOLS estimations given in Table 9.4, since maximum number of lags and leads is "some function of the sample size that increases at polynomial rate, e.g. $T^{1/4}$," (Kejriwal and Perron, 2008, p.1430), this maximum number is selected as 3 in this study. According to AIC, the appropriate number of lags (leads) is found to be 3 (1).

[1] Kao (1999) test also rejects the null of no cointegration and can be found in Appendix E.2.

Table 9.4 Coefficient estimates of the gravity equation

Variable	OLS	OLS_{FE}	DOLS
IRGDP	1.461***	1.849***	1.813***
	(0.014)	(0.071)	(0.094)
JRGDP	1.163***	1.799***	1.658***
	(0.015)	(0.072)	(0.094)
IPOP	-0.377***	3.093***	2.778***
	(0.013)	(0.204)	(0.278)
JPOP	-0.234***	2.357***	2.015***
	(0.013)	(0.203)	(0.277)
RER_{ij}	-0.026***	0.017**	0.004
	(0.004)	(0.008)	(0.010)
DIS_{ij}	-1.131***	—	—
	(0.020)		
EU_{ij}	-0.723***	1.066***	0.814***
	(0.062)	(0.087)	(0.097)
XEU_{ij}	-0.271***	0.221***	0.187***
	(0.040)	(0.064)	(0.071)
MEU_{ij}	-0.045	0.364***	0.152**
	(0.040)	(0.063)	(0.071)
NF_{ij}	-0.566**	0.211	0.259
	(0.272)	(0.288)	(0.302)
XNF_{ij}	-1.160***	-0.664***	-0.491***
	(0.073)	(0.077)	(0.080)
MNF_{ij}	-0.203***	0.161**	0.118
	(0.073)	(0.077)	(0.080)
MR_{ij}	1.536***	0.124	0.158
	(0.179)	(0.213)	(0.235)
XMR_{ij}	-0.297***	0.171**	0.076
	(0.058)	(0.073)	(0.081)
MMR_{ij}	0.032	0.846***	0.854***
	(0.058)	(0.073)	(0.081)
AF_{ij}	1.462***	-0.698***	-0.356*
	(0.148)	(0.173)	(0.186)
XAF_{ij}	1.535***	-0.246***	-0.187**
	(0.055)	(0.071)	(0.077)
MAF_{ij}	0.950***	0.314***	0.360***
	(0.055)	(0.071)	(0.077)

Notes: Standard errors are given in parentheses. * indicates significance at 10 per cent level, ** indicates significance at 5 per cent level, *** indicates significance at 1 per cent level.

Table 9.5 shows the adjusted R^2 and root mean squared error (RMSE)[1] values. These values will be informative on the predictive power of the given model. According to adjusted R^2 values given, the performances of OLS_{FE} and DOLS in terms of goodness of fit

[1] Theil Inequality Coefficient which takes into account scaling problem inherited in RMSE (Greene, 2008, p.101) also in line with the given results.

are highly satisfactory due to the fact that the right-hand side variables explain a significant portion of the variance of the dependent variable. This result is also in line with the literature that emphasizes the ignorance of fixed effects would result in inconsistent OLS estimations. Furthermore, since the smaller RMSE value indicates the better predictive accuracy of the model, the results again confirms the superiority of DOLS model relative to the others.

Table 9.5 Predictive powers of the selected models

	OLS	OLS_{FE}	DOLS
Adjusted R^2	0.511	0.732	0.737
RMSE	2.541	1.848	1.733

Hence, the simple OLS can be informative only for the distance variable that is dropped from other two estimation specifications due to the fixed effect model restrictions. The coefficient of -1.131 confirms that, as it is expected, bilateral distance affects exports between any given country-pair negatively. For the independent variables, the coefficient estimates of OLS_{FE} tend to be overvalued relative to the ones of DOLS which takes into account non-stationarity and cointegration of the selected variables. Real GDP variables of both countries are, in line with the expected sign, positive in both estimations. As these coefficients indicate percentage changes in bilateral exports for one percentage change in income, the coefficients can be interpreted as follows: In the OLS_{FE} model, 1 per cent change in real GDP of exporting country causes a rise of approximately 1.85 per cent in bilateral exports; similar change in real GDP of importing country causes an increase of 1.80 per cent in bilateral exports. On the other hand, DOLS estimations indicate that these changes will be 1.81 and 1.66, respectively. Population variables indicate that in the OLS_{FE} (DOLS) model 1 per cent change in population of exporting country is associated with a rise in bilateral exports with 3.09 (2.41) per cent, 1 per cent change in population of importing country is associated with a rise of 2.36 (1.68) per cent in bilateral exports. The results indicate that increase in population variables contributes to bilateral export flows positively for the given sample of countries. Although, real exchange rate variable is

significant (1 per cent change in RER is associated with 0.02 per cent increase in RX, as it is expected) in the OLS_{FE} model, it becomes insignificant in the case of DOLS model.

The interpretation of the coefficients of the dummy variables is done through calculating their marginal effects via the formula $((e^{\delta}-1)*100)$ where δ denotes the coefficient of the selected RIA. Marginal effects are computed and shown in Table 9.6. These values will shed light on the diversion of the bilateral exports from the normal levels of trade that would have been expected if the specified agreement were not signed.

Table 9.6 Marginal effects of dummy variables for the OLS_{FE} and DOLS estimations

	EU_{ij}	XEU_{ij}	MEU_{ij}	NF_{ij}	XNF_{ij}	MNF_{ij}
Marginal effects ($OLS_{FE)}$	190.3	24.8	44.0	23.5	-48.5	17.5
Marginal effects (DOLS)	125.6	20.6	16.4	29.6	-38.8	12.6
	MR_{ij}	XMR_{ij}	MMR_{ij}	AF_{ij}	XAF_{ij}	MAF_{ij}
Marginal effects (OLS_{FE})	13.2	18.7	133.0	-50.2	-21.8	36.9
Marginal effects (DOLS)	17.1	7.9	134.8	-29.9	-17.0	43.2

Dummies for RIAs enter significantly except NF_{ij} and MR_{ij} in the case of OLS_{FE}, NF_{ij}, MNF_{ij}, MR_{ij} and XMR_{ij} in the case of DOLS estimations. The coefficient estimates of dummy variables (similar to the case in explanatory variables) are overestimated (for 9 dummies out of 12) by the OLS_{FE} specification. The interpretations for the estimates of the dummies will be derived from the results of DOLS model that has better explanatory power.

The EU intra-union dummy is significant and states that intra-union exports are 125.6 per cent higher than the expected normal levels. This indicates significant trade creation in the case of the EU. The extra-bloc exports and extra-bloc imports are also significant and estimates show that they are 20.6 per cent and 16.4 per cent higher than the expected normal levels. Although these effects are positive, when they are compared to the one of intra-union, the extent of increase in extra-union levels becomes relatively small.

The dummy variable for the intra-union trade of NAFTA is positive, but insignificant. This can be attributed to the fact that the US, Canada and Mexico have realized high trade liberalization in the early 1980s through US-Canada FTA and GSP schemes granted to Mexico (Tang, 2005, p.243). As a result, the establishment of NAFTA did not result in significant effect in the bilateral trade of these countries. While the imports originating from the non-member countries are not significantly affected, the estimate of extra-union exports of NAFTA, on the other hand, is significant and depict that they are 38.8 per cent lower than the normal levels.

In the case of MERCOSUR, the intra-union dummy and the dummy for extra-union exports (XMR) are insignificant. Hence, for Argentina, Brazilia, Paraguay and Uruguay, this integration has not affected considerably bilateral export flows within the region and to the outside countries. This is one of the anticipated outcomes of the South-South agreements that involve developing countries as members. Moreover, the main driving force for the establishment of the MERCOSUR was not the expected increase in trade flows, rather the reaction to the failed bilateral trade talks with the US. The dummy for the import flows of non-members is highly significant. The estimation indicates that this value is 134.8 per cent more than the expected normal levels of the gravity equation.

The dummy variables for the ASEAN FTA are all statistically significant. Contrary to the general tendency for positively-valued intra-union dummy, the one for AFTA shows that intra-union bilateral exports are 29.9 per cent lesser than the expected normal flows. The extra-export flows also indicate lower amount (17 per cent) then the normal levels of the non-AFTA case. The establishment of AFTA, on the other hand, has increased extra-union import flows by 43.2. This significant increase is due to the inclusion of the major import sources of this group (the US, the EU and Japan) in the sample of countries.

When the classification in Table 9.7 is considered, the following points can be stated about the static effects of the EU, NAFTA, MERCOSUR and AFTA. Accordingly, the EU case results in pure trade creation in terms of both exports and imports, as all of the dummies of the EU have positive values. The AFTA case on the other hand shows extra-bloc import

expansion and export diversion. While NAFTA shows significant export diversion, MERCOSUR results in pure trade creation in terms of exports.

Table 9.7 Trade effects of RIAs (Source: Martínez-Zarzoso et al., 2009, p.53)

Coefficient of intra-bloc	Extra-bloc imports (the coefficient of MRIA)		Extra-bloc exports (the coefficient of XRIA)	
	Positive	Negative	Positive	Negative
Positive	Pure trade creation in terms of imports	If the coefficient of RIA is greater than the coefficient of RIAM than trade creation and import diversion. Vice versa, import diversion.	Pure trade creation in terms of exports	If the coefficient of RIA is greater than the coefficient of RIAX than trade creation and export diversion. Vice versa, export diversion.
Negative	Extra-bloc import expansion	Import diversion and import contraction	Export expansion	Export diversion and export contraction

9.6 Final Remarks on the Analysis

Before finalizing this chapter, it would be useful to present some remarks on the deficiencies of the econometric analysis employed to estimate the effects of RIAs. First of all, the inclusion of dummy variables for the assessment of RIAs is not sufficient to fully picture the preferences granted, the coverage and the extent of the agreements. Secondly, as the most of the RIAs have time-schedules for the implementation of the policies or the elimination of tariff/non-tariff barriers, and these schedules are flexible in terms of timing, the date of entry into force does not have significance for most of these RIAs. Hence, the dummy variable that takes the value of 1 right after the year of entering into force can not measure the exact effect of the RIA on trade flows. This brings the issue of data availability. One of the stumbling effect of RIAs over globalization stems from the lack of transparency in these agreements. Thirdly, as tariff levels are important determinant of bilateral trade and are significantly affected from the formation of the RIA, these levels should also be incorporated to the model. Nevertheless, for the time being, limitations on data do not allow such a modification in the gravity model for most of the RIAs. Finally, as

it is emphasized in Chapter 8, the existing spaghetti bowls of RIAs make econometric estimation more difficult. As each piece of the spaghetti has its own conditions for preferential access, the quantification of these preferences in a coherent way becomes impossible. With increased transparency of RIAs, this problem can also be solved.

Nevertheless, this analysis will contribute to the existing literature from two points. First of all, the data involve the important trading nations throughout the world and have a larger sample period than the previous studies. Secondly, the application of panel unit root tests and panel cointegration tests in gravity models is newly developing concept and for the selected RIAs, there is no study that employed these techniques to estimate the trade effects of the formation of RIAs.

CHAPTER 10 CONCLUSIONS

Regional integration agreements have been important elements of both political and economic policies of nation states for hundreds of years. However, since the advent of the WTO, the globalized world has been experiencing the enormous profileration of these agreements. While the number of notified agreements was 123 in the period 1948-1994, this number has rapidly increased approximately to 470 agreements according to the WTO data. On the other hand, the second problem related to the existence of such agreements stems from their discriminatory nature. While the GATT/WTO system tries to provide non-discriminatory trading system in the multilateral level, it further allows loopholes for discrimination through the GATT Article XXIV, the Enabling Clause and the GATS Article V that specify requirements for the formation of RIAs. Hence, this study has taken these important points into consideration from the standpoint of the relationship between regional economic integration and globalization.

The first question that this study tried to answer is whether the process of regional economic integration is complementary or contradictory to the globalization process. The basic characteristics of these agreements that can complement globalization derive from liberalization of the regional market and policy reforms included in these agreements. However, experiences show that for most of the RIAs the scope of internal liberalization is limited, as several sensitive sectors are excluded from this liberalization. On the other hand, the policy reforms involved in these countries do not mean that they are beneficial to all member countries. This kind of integration does not take into account the underlying economic differences between the member countries. The developing countries have to face with a situation that resembles ‘single-undertaking’ of the GATT/WTO system, as developed partners determine the terms of conditions in these agreements.

Even if the internal structure of RIAs is kept aside, what makes these agreements a real problem in front of globalization is their discriminatory nature. Regional integration

provides secure and preferential market access within the boundaries of integration that most member countries do not want to lose. But, this preferential access is granted at the expense of third countries. Resulting discrimination further pushes excluded countries to search for regional agreements in which they can determine main lines. Hence, the existing discrimination results in further discrimination through addition of new RIAs. Moreover, discrimination inherited in these agreements is not limited to the conditions specified by the GATT/WTO system. The level of discrimination in each agreement is subject to intervention of special interest groups. As special interest groups of developed countries are more organized and financially better relative to ones of developing countries, the conditions of outside protection are mainly determined with these groups. This issue brings developed countries to the top of regionalism issue as these countries determine and direct the present trend of regional economic integration.

The increasing number of bilateral or plurilateral trade links of the EU and the US makes these two as the major actors of regional economic integration. These agreements are further coupled with the ones of East Asian countries who are relatively new actors of the issue. Consequently, the trend in regionalism results in the web of regional agreements that are centred on these three actors. As the main lines of multilateral trading system are determined with these countries (especially with the US and the EU), then this outcome suggests that developed countries are using every possible channel (regional or multilateral) that would satisfy their own interests. Hence, regional economic integration is an impediment in front of globalization, but this is not constitute a real problem in terms of the 'world' as developed partners can use both sides for their self-interests. However, it is also possible that the increased regional ties would result in a catastrophic problem for the global world if regional integration yields political clashes among these countries.

The second question that this study tried to find an answer is whether the deficiencies inherited in the GATT/WTO system further contribute to the increasing trend of regionalism. In 1947, the GATT, with the key principles of non-discrimination, reciprocity and transparency, was introduced to the system in order to provide systematic rules that would govern international trade relations. However, political concerns over the afterwar reconstruction of Europe resulted in the introduction of an open-door to the principle of

non-discrimination, i.e. the GATT Article XXIV. This has been followed by additional leakages: the Enabling Clause and the GATS Article V. These clauses have one common characteristic that they are completely unclear. With this limitation, it is impossible to determine whether the given agreement is GATT/WTO-compatible or not. Even it is found that this agreement contains conditions that are contradictory to the article requirements, the GATT/WTO lacks the power to implement any prohibitive measures. The initial case was the Treaty of Rome (1957) that established the European Economic Community. Now, the result of GATT-incompatible Treaty of Rome is the most developed type of regional economic integration: the EU. Another strand that arises from the GATT/WTO system and contributes to the increased interest in regionalism is the extended subject areas proposed with single-undertaking umbrella since the establishment of the WTO. As the main lines of these subjects are, again, determined with developed countries, this makes arriving unanimous decisions on these subjects impossible, as the 9-year long still continuing Doha Round proves. The experience shows that one-size-fits-all attitude of the GATT/WTO system does not fit into the world with so many countries that are at different development levels. Hence, the inefficiency of the GATT/WTO system further directs countries to search for regional solutions.

The third question of this study was what the gravity model estimation indicates for the effects of RIAs on intra-regional and extra-regional trade flows. Examination of the trade effects for the given sample of countries does not yield clear cut outcomes. While in the most developed type of the RIA, that is the EU, although intra-union trade-creation effect is approximately ten times larger than extra-union effects, the effects are positive from both intra- and extra-union perspective, but in NAFTA, exports to outside countries are significantly diverted. For MERCOSUR, the integration has not contributed to intra-union trade. The members are still significantly depended on extra-union imports, as the members of AFTA. Moreover, the formation of AFTA has not provided the expected trade creation effects within the union. This outcome can be attributed to the fact that South-South agreements, like AFTA and MERCOSUR, generally follow a slow pace on trade liberalization. Hence, for the period of analysis, it can not be stated that the trade-creation effects dominate the trade-diversion effects, or vice versa. But, it suggests that the effects of RIAs on bilateral trade flows differ significantly for each RIA.

In sum, this study tries to show that although there are many expected economic and political gains of RIAs, there are many grounds that, as Bhagwati (1993) argues, these agreements constitute 'stumbling blocs' in front of globalization. The main factors that make RIAs stumbling blocs of international trading system are increased external protection and increased number of criss-crossing RIAs. More important point is that the characteristics of the GATT/WTO system contribute to this trend significantly.

APPENDIX A: GATT ARTICLE XXIV

THE 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.

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.

Ad Article XXIV

Paragraph 9

It is understood that the provisions of Article I would require that, when a product which has been imported into the territory of a member of a customs union or free-trade area at a preferential rate of duty is re-exported to the territory of another member of such union or area, the latter member should collect a duty equal to the difference between the duty already paid and any higher duty that would be payable if the product were being imported directly into its territory.

Paragraph 11

Measures adopted by India and Pakistan in order to carry out definitive trade arrangements between them, once they have been agreed upon, might depart from particular provisions of this Agreement, but these measures would in general be consistent with the objectives of the Agreement.

Understanding on the interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994

Members,

Having regard to the provisions of Article XXIV of GATT 1994;

Recognizing that customs unions and free trade areas have greatly increased in number and importance since the establishment of GATT 1947 and today cover a significant proportion of world trade;

Recognizing the contribution to the expansion of world trade that may be made by closer integration between the economies of the parties to such agreements;

Recognizing also that such contribution is increased if the elimination between the constituent territories of duties and other restrictive regulations of commerce extends to all trade, and diminished if any major sector of trade is excluded;

Reaffirming that the purpose of such agreements should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other Members with such territories; and that in their formation or enlargement the parties to them should to the greatest possible extent avoid creating adverse effects on the trade of other Members;

Convinced also of the need to reinforce the effectiveness of the role of the Council for Trade in Goods in reviewing agreements notified under Article XXIV, by clarifying the criteria and procedures for the assessment of new or enlarged agreements, and improving the transparency of all Article XXIV agreements;

Recognizing the need for a common understanding of the obligations of Members under paragraph 12 of Article XXIV;

Hereby *agree* as follows:

1. Customs unions, free-trade areas, and interim agreements leading to the formation of a customs union or free-trade area, to be consistent with Article XXIV, must satisfy, *inter alia*, the provisions of paragraphs 5, 6, 7 and 8 of that Article.

Article XXIV:5

2. The evaluation under paragraph 5(a) of Article XXIV of the general incidence of the duties and other regulations of commerce applicable before and after the formation of a customs union shall in respect of duties and charges be based upon an overall assessment of weighted average tariff rates and of customs duties collected. This assessment shall be based on import statistics for a previous representative period to be supplied by the customs union, on a tariff-line basis and in values and quantities, broken down by WTO country of origin. The Secretariat shall compute the weighted average tariff rates and customs duties collected in accordance with the methodology used in the assessment of tariff offers in the Uruguay Round of Multilateral Trade Negotiations. For this purpose, the duties and charges to be taken into consideration shall be the applied rates of duty. It is recognized that for the purpose of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected may be required.

3. The "reasonable length of time" referred to in paragraph 5(c) of Article XXIV should exceed 10 years only in exceptional cases. In cases where Members parties to an interim agreement believe that 10 years would be insufficient they shall provide a full explanation to the Council for Trade in Goods of the need for a longer period.

Article XXIV:6

4. Paragraph 6 of Article XXIV establishes the procedure to be followed when a Member forming a customs union proposes to increase a bound rate of duty. In this regard Members

reaffirm that the procedure set forth in Article XXVIII, as elaborated in the guidelines adopted on 10 November 1980 (BISD 27S/26-28) and in the Understanding on the Interpretation of Article XXVIII of GATT 1994, must be commenced before tariff concessions are modified or withdrawn upon the formation of a customs union or an interim agreement leading to the formation of a customs union.

5. These negotiations will be entered into in good faith with a view to achieving mutually satisfactory compensatory adjustment. In such negotiations, as required by paragraph 6 of Article XXIV, due account shall be taken of reductions of duties on the same tariff line made by other constituents of the customs union upon its formation. Should such reductions not be sufficient to provide the necessary compensatory adjustment, the customs union would offer compensation, which may take the form of reductions of duties on other tariff lines. Such an offer shall be taken into consideration by the Members having negotiating rights in the binding being modified or withdrawn. Should the compensatory adjustment remain unacceptable, negotiations should be continued. Where, despite such efforts, agreement in negotiations on compensatory adjustment under Article XXVIII as elaborated by the Understanding on the Interpretation of Article XXVIII of GATT 1994 cannot be reached within a reasonable period from the initiation of negotiations, the customs union shall, nevertheless, be free to modify or withdraw the concessions; affected Members shall then be free to withdraw substantially equivalent concessions in accordance with Article XXVIII.

6. GATT 1994 imposes no obligation on Members benefiting from a reduction of duties consequent upon the formation of a customs union, or an interim agreement leading to the formation of a customs union, to provide compensatory adjustment to its constituents.

Review of Customs Unions and Free-Trade Areas

7. All notifications made under paragraph 7(a) of Article XXIV shall be examined by a working party in the light of the relevant provisions of GATT 1994 and of paragraph 1 of this Understanding. The working party shall submit a report to the Council for Trade in Goods on its findings in this regard. The Council for Trade in Goods may make such recommendations to Members as it deems appropriate.

8. In regard to interim agreements, the working party may in its report make appropriate recommendations on the proposed time-frame and on measures required to complete the formation of the customs union or free-trade area. It may if necessary provide for further review of the agreement.

9. Members parties to an interim agreement shall notify substantial changes in the plan and schedule included in that agreement to the Council for Trade in Goods and, if so requested, the Council shall examine the changes.

10. Should an interim agreement notified under paragraph 7(a) of Article XXIV not include a plan and schedule, contrary to paragraph 5(c) of Article XXIV, the working party shall in its report recommend such a plan and schedule. 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. Provision shall be made for subsequent review of the implementation of the recommendations.

11. Customs unions and constituents of free-trade areas shall report periodically to the Council for Trade in Goods, as envisaged by the CONTRACTING PARTIES to GATT 1947 in their instruction to the GATT 1947 Council concerning reports on regional agreements (BISD 18S/38),

on the operation of the relevant agreement. Any significant changes and/or developments in the agreements should be reported as they occur.

Dispute Settlement

12. The provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked with respect to any matters arising from the application of those provisions of Article XXIV relating to customs unions, free-trade areas or interim agreements leading to the formation of a customs union or free-trade area.

Article XXIV:12

13. Each Member is fully responsible under GATT 1994 for the observance of all provisions of GATT 1994, and shall take such reasonable measures as may be available to it to ensure such observance by regional and local governments and authorities within its territory.

14. The provisions of Articles XXII and XXIII of GATT 1994 as elaborated and applied by the Dispute Settlement Understanding may be invoked in respect of measures affecting its observance taken by regional or local governments or authorities within the territory of a Member. When the Dispute Settlement Body has ruled that a provision of GATT 1994 has not been observed, the responsible Member shall take such reasonable measures as may be available to it to ensure its observance. The provisions relating to compensation and suspension of concessions or other obligations apply in cases where it has not been possible to secure such observance.

15. Each Member undertakes to accord sympathetic consideration to and afford adequate opportunity for consultation regarding any representations made by another Member concerning measures affecting the operation of GATT 1994 taken within the territory of the former.

APPENDIX B: ENABLING CLAUSE

DIFFERENTIAL AND MORE FAVOURABLE TREATMENT RECIPROCITY AND FULLER PARTICIPATION OF DEVELOPING COUNTRIES (THE ENABLING CLAUSE)

Decision of 28 November 1979 (L/4903)

Following negotiations within the framework of the Multilateral Trade Negotiations, the CONTRACTING PARTIES decide as follows:

1. Notwithstanding the provisions of Article I of the General Agreement, contracting parties may accord differential and more favourable treatment to developing countries[1], without according such treatment to other contracting parties.

2. The provisions of paragraph 1 apply to the following[2]:

a) Preferential tariff treatment accorded by developed contracting parties to products originating in developing countries in accordance with the Generalized System of Preferences[3],

b) Differential and more favourable treatment with respect to the provisions of the General Agreement concerning non-tariff measures governed by the provisions of instruments multilaterally negotiated under the auspices of the GATT;

c) Regional or global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which may be prescribed by the CONTRACTING PARTIES, for the mutual reduction or elimination of non-tariff measures, on products imported from one another;

d) Special treatment on the least developed among the developing countries in the context of any general or specific measures in favour of developing countries.

3. Any differential and more favourable treatment provided under this clause:

a) shall be designed to facilitate and promote the trade of developing countries and not to raise barriers to or create undue difficulties for the trade of any other contracting parties;

b) shall not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a most-favoured-nation basis;

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[1] The words "developing countries" as used in this text are to be understood to refer also to developing territories.

[2] It would remain open for the CONTRACTING PARTIES to consider on an ad hoc basis under the GATT provisions for joint action any proposals for differential and more favourable treatment not falling within the scope of this paragraph.

[3] As described in the Decision of the CONTRACTING PARTIES of 25 June 1971, relating to the establishment of "generalized, non-reciprocal and non discriminatory preferences beneficial to the developing countries" (BISD 18S/24).

c) shall in the case of such treatment accorded by developed contracting parties to developing countries be designed and, if necessary, modified, to respond positively to the development, financial and trade needs of developing countries.

4. Any contracting party taking action to introduce an arrangement pursuant to paragraphs 1, 2 and 3 above or subsequently taking action to introduce modification or withdrawal of the differential and more favourable treatment so provided shall[1]:

a) notify the CONTRACTING PARTIES and furnish them with all the information they may deem appropriate relating to such action;

b) afford adequate opportunity for prompt consultations at the request of any interested contracting party with respect to any difficulty or matter that may arise. The CONTRACTING PARTIES shall, if requested to do so by such contracting party, consult with all contracting parties concerned with respect to the matter with a view to reaching solutions satisfactory to all such contracting parties.

5. The developed countries do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of developing countries, i.e., the developed countries do not expect the developing countries, in the course of trade negotiations, to make contributions which are inconsistent with their individual development, financial and trade needs. Developed contracting parties shall therefore not seek, neither shall less-developed contracting parties be required to make, concessions that are inconsistent with the latter's development, financial and trade needs.

6. Having regard to the special economic difficulties and the particular development, financial and trade needs of the least-developed countries, the developed countries shall exercise the utmost restraint in seeking any concessions or contributions for commitments made by them to reduce or remove tariffs and other barriers to the trade of such countries, and the least-developed countries shall not be expected to make concessions or contributions that are inconsistent with the recognition of their particular situation and problems.

7. The concessions and contributions made and the obligations assumed by developed and less-developed contracting parties under the provisions of the General Agreement should promote the basic objectives of the Agreement, including those embodied in the Preamble and in Article XXXVI. Less-developed contracting parties expect that their capacity to make contributions or negotiated concessions or take other mutually agreed action under the provisions and procedures of the General Agreement would improve with the progressive development of their economies and improvement in their trade situation and they would accordingly expect to participate more fully in the framework of rights and obligations under the General Agreement.

8. Particular account shall be taken of the serious difficulty of the least-developed countries in making concessions and contributions in view of their special economic situation and their development, financial and trade needs.

9. The contracting parties will collaborate in arrangements for review of the operation of these provisions, bearing in mind the need for individual and joint efforts by contracting parties to meet the development needs of developing countries and the objectives of the General Agreement.

[1] Nothing in these provisions shall affect the rights of contracting parties under the General Agreement.

APPENDIX C: GATS ARTICLE V

THE GATS ARTICLE V: ECONOMIC INTEGRATION

1. This Agreement shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement, provided that such an agreement:

(a) has substantial sectoral coverage[1], and

(b) provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII, between or among the parties, in the sectors covered under subparagraph (a), through:
(i) elimination of existing discriminatory measures, and/or
(ii) prohibition of new or more discriminatory measures,
either at the entry into force of that agreement or on the basis of a reasonable time-frame, except for measures permitted under Articles XI, XII, XIV and XIV bis.

2. In evaluating whether the conditions under paragraph 1(b) are met, consideration may be given to the relationship of the agreement to a wider process of economic integration or trade liberalization among the countries concerned.

3. (a) Where developing countries are parties to an agreement of the type referred to in paragraph 1, flexibility shall be provided for regarding the conditions set out in paragraph 1, particularly with reference to subparagraph (b) thereof, in accordance with the level of development of the countries concerned, both overall and in individual sectors and subsectors.

(b) Notwithstanding paragraph 6, in the case of an agreement of the type referred to in paragraph 1 involving only developing countries, more favourable treatment may be granted to juridical persons owned or controlled by natural persons of the parties to such an agreement.

4. Any agreement referred to in paragraph 1 shall be designed to facilitate trade between the parties to the agreement and shall not in respect of any Member outside the agreement raise the overall level of barriers to trade in services within the respective sectors or subsectors compared to the level applicable prior to such an agreement.

5. If, in the conclusion, enlargement or any significant modification of any agreement under paragraph 1, a Member intends to withdraw or modify a specific commitment inconsistently with the terms and conditions set out in its Schedule, it shall provide at least 90 days advance notice of such modification or withdrawal and the procedure set forth in paragraphs 2, 3 and 4 of Article XXI shall apply.

6. A service supplier of any other Member that is a juridical person constituted under the laws of a party to an agreement referred to in paragraph 1 shall be entitled to treatment granted under such agreement, provided that it engages in substantive business operations in the territory of the parties to such agreement.

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

7. (a) Members which are parties to any agreement referred to in paragraph 1 shall promptly notify any such agreement and any enlargement or any significant modification of that agreement to the Council for Trade in Services. They shall also make available to the Council such relevant information as may be requested by it. The Council may establish a working party to examine such an agreement or enlargement or modification of that agreement and to report to the Council on its consistency with this Article.

(b) Members which are parties to any agreement referred to in paragraph 1 which is implemented on the basis of a time-frame shall report periodically to the Council for Trade in Services on its implementation. The Council may establish a working party to examine such reports if it deems such a working party necessary.

(c) Based on the reports of the working parties referred to in subparagraphs (a) and (b), the Council may make recommendations to the parties as it deems appropriate.

8. A Member which is a party to any agreement referred to in paragraph 1 may not seek compensation for trade benefits that may accrue to any other Member from such agreement.

APPENDIX D: THE LIST OF RIAs

Table D.1 RIAs notified to the GATT/WTO system and in force as of March 2010 (Source: The WTO database)

RIA Name	Coverage	Type	Date of notification	WTO Legal Cover	Date of entry into force
Andean Community (CAN)	Goods	CU	01-Oct-1990	Enabling Clause	25-May-1988
Armenia - Kazakhstan	Goods	FTA	17-Jun-2004	GATT Art. XXIV	25-Dec-2001
Armenia - Moldova	Goods	FTA	17-Jun-2004	GATT Art. XXIV	21-Dec-1995
Armenia - Russian Federation	Goods	FTA	17-Jun-2004	GATT Art. XXIV	25-Mar-1993
Armenia - Turkmenistan	Goods	FTA	17-Jun-2004	GATT Art. XXIV	07-Jul-1996
Armenia - Ukraine	Goods	FTA	17-Jun-2004	GATT Art. XXIV	18-Dec-1996
ASEAN - China (G)	Goods	PTA	24-Nov-2004	Enabling Clause	01-Jul-2003
ASEAN - China (S)	Services	EIA	26-Jun-2008	GATS Art. V	01-Jul-2007
ASEAN - Japan	Goods	FTA	23-Nov-2009	GATT Art. XXIV	01-Dec-2008
ASEAN Free Trade Area (AFTA)	Goods	FTA	30-Oct-1992	Enabling Clause	28-Jan-1992
Asia Pacific Trade Agreement (APTA)	Goods	PTA	02-Nov-1976	Enabling Clause	17-Jun-1976
Asia Pacific Trade Agreement (APTA) - Accession of China	Goods	PTA	30-Apr-2004	Enabling Clause	01-Jan-2002
Australia - Chile	Goods & Services	FTA & EIA	03-Mar-2009	GATT Art. XXIV & GATS V	06-Mar-2009

Appendix.D (continued)					
Australia - New Zealand (ANZCERTA) (G)	Goods	FTA	14-Apr-1983	GATT Art. XXIV	01-Jan-1983
Australia - New Zealand (ANZCERTA) (S)	Services	EIA	22-Nov-1995	GATS Art. V	01-Jan-1989
Australia - Papua New Guinea (PATCRA)	Goods	FTA	20-Dec-1976	GATT Art. XXIV	01-Feb-1977
Brunei Darussalam - Japan	Goods & Services	FTA & EIA	31-Jul-2008	GATT Art. XXIV & GATS V	31-Jul-2008
Canada - Chile	Goods & Services	FTA & EIA	30-Jul-1997	GATT Art. XXIV & GATS V	05-Jul-1997
Canada - Costa Rica	Goods	FTA	13-Jan-2003	GATT Art. XXIV	01-Nov-2002
Canada - EFTA	Goods	FTA	04-Aug-2009	GATT Art. XXIV	01-Jul-2009
Canada - Israel	Goods	FTA	15-Jan-1997	GATT Art. XXIV	01-Jan-1997
Canada - Peru	Goods & Services	FTA & EIA	31-Jul-2009	GATT Art. XXIV & GATS V	01-Aug-2009
CARICOM (G)	Goods	CU	14-Oct-1974	GATT Art. XXIV	01-Aug-1973
CARICOM (S)	Services	EIA	19-Feb-2003	GATS Art. V	01-Jul-1997
Central American Common Market (CACM)	Goods	CU	24-Feb-1961	GATT Art. XXIV	04-Jun-1961
Central European Free Trade Agreement (CEFTA) - Accession of Croatia	Goods	FTA	23-Feb-2004	GATT Art. XXIV	01-Mar-2003
Central European Free Trade Agreement (CEFTA) 2006	Goods	FTA	26-Jul-2007	GATT Art. XXIV	01-May-2007

Appendix.D (continued)					
Chile - China	Goods	FTA	20-Jun-2007	GATT Art. XXIV	01-Oct-2006
Chile - Colombia	Goods & Services	FTA & EIA	14-Aug-2009	GATT Art. XXIV & GATS V	08-May-2009
Chile - Costa Rica (Chile - Central America)	Goods & Services	FTA & EIA	16-Apr-2002	GATT Art. XXIV & GATS V	15-Feb-2002
Chile - El Salvador (Chile - Central America)	Goods & Services	FTA & EIA	29-Jan-2004(G) 05-Feb-2004(S)	GATT Art. XXIV & GATS V	01-Jun-2002
Chile - India	Goods	PTA	13-Jan-2009	Enabling Clause	17-Aug-2007
Chile - Japan	Goods & Services	FTA & EIA	24-Aug-2007	GATT Art. XXIV & GATS V	03-Sep-2007
Chile - Mexico	Goods & Services	FTA & EIA	27-Feb-2001	GATT Art. XXIV & GATS V	01-Aug-1999
China - Hong Kong, China	Goods & Services	FTA & EIA	27-Dec-2003	GATT Art. XXIV & GATS V	01-Jan-2004
China - Macao, China	Goods & Services	FTA & EIA	27-Dec-2003	GATT Art. XXIV & GATS V	01-Jan-2004
China - New Zealand	Goods & Services	FTA & EIA	21-Apr-2009	GATT Art. XXIV & GATS V	01-Oct-2008
China - Singapore	Goods & Services	FTA & EIA	02-Mar-2009	GATT Art. XXIV & GATS V	01-Jan-2009
Common Economic Zone	Goods	FTA	18-Aug-2008	GATT Art. XXIV	20-May-2004
Common Market for Eastern and Southern Africa (COMESA)	Goods	FTA	04-May-1995	Enabling Clause	08-Dec-1994
Commonwealth of Independent States (CIS)	Goods	FTA	29-Jun-1999	GATT Art. XXIV	30-Dec-1994

Appendix.D (continued)

Costa Rica - Mexico	Goods & Services	FTA & EIA	17-Jul-2006	GATT Art. XXIV & GATS V	01-Jan-1995
Dominican Republic - Central America - United States Free Trade Agreement (CAFTA-DR)	Goods & Services	FTA & EIA	17-Mar-2006	GATT Art. XXIV & GATS V	01-Mar-2006
East African Community (EAC)	Goods	CU	09-Oct-2000	Enabling Clause	07-Jul-2000
EC - Albania	Goods & Services	FTA & EIA	07-Mar-2007(G) 07-Oct-2009(S)	GATT Art. XXIV & GATS V	01-Dec-2006(G) 01-Apr-2009(S)
EC - Algeria	Goods	FTA	24-Jul-2006	GATT Art. XXIV	01-Sep-2005
EC - Andorra	Goods	CU	23-Feb-1998	GATT Art. XXIV	01-Jul-1991
EC - Bosnia and Herzegovina	Goods	FTA	11-Jul-2008	GATT Art. XXIV	01-Jul-2008
EC - Cameroon	Goods	FTA	24-Sep-2009	GATT Art. XXIV	01-Oct-2009
EC - CARIFORUM States EPA	Goods & Services	FTA & EIA	16-Oct-2008	GATT Art. XXIV & GATS V	01-Nov-2008
EC - Chile	Goods & Services	FTA & EIA	03-Feb-2004(G) 28-Oct-2005(S)	GATT Art. XXIV & GATS V	01-Feb-2003(G) 01-Mar-2005(S)
EC - Côte d'Ivoire	Goods	FTA	11-Dec-2008	GATT Art. XXIV	01-Jan-2009
EC - Croatia	Goods & Services	FTA & EIA	17-Dec-2002(G) 12-Oct-2009(S)	GATT Art. XXIV & GATS V	01-Mar-2002(G) 01-Feb-2005(S)

Appendix.D (continued)					
EC - Egypt	Goods	FTA	03-Sep-2004	GATT Art. XXIV	01-Jun-2004
EC - Faroe Islands	Goods	FTA	17-Feb-1997	GATT Art. XXIV	01-Jan-1997
EC - Former Yugoslav Republic of Macedonia	Goods & Services	FTA & EIA	23-Oct-2001(G) 02-Oct-2009(S)	GATT Art. XXIV & GATS V	01-Jun-2001(G) 01-Apr-2004(S)
EC - Iceland	Goods	FTA	24-Nov-1972	GATT Art. XXIV	01-Apr-1973
EC - Israel	Goods	FTA	20-Sep-2000	GATT Art. XXIV	01-Jun-2000
EC - Jordan	Goods	FTA	17-Dec-2002	GATT Art. XXIV	01-May-2002
EC - Lebanon	Goods	FTA	26-May-2003	GATT Art. XXIV	01-Mar-2003
EC - Mexico	Goods & Services	FTA & EIA	25-Jul-2000(G) 21-Jun-2002(S)	GATT Art. XXIV & GATS V	01-Jul-2000(G) 01-Oct-2000(S)
EC - Montenegro	Goods	FTA	16-Jan-2008	GATT Art. XXIV	01-Jan-2008
EC - Morocco	Goods	FTA	13-Oct-2000	GATT Art. XXIV	01-Mar-2000
EC - Norway	Goods	FTA	13-Jul-1973	GATT Art. XXIV	01-Jul-1973
EC – Overseas Countries and Territories (OCT)	Goods	FTA	14-Dec-1970	GATT Art. XXIV	01-Jan-1971
EC - Palestinian Authority	Goods	FTA	29-May-1997	GATT Art. XXIV	01-Jul-1997
EC - San Marino	Goods	CU	24-Feb-2010	GATT Art. XXIV	01-Apr-2002

Appendix.D (continued)					
EC - South Africa	Goods	FTA	02-Nov-2000	GATT Art. XXIV	01-Jan-2000
EC - Switzerland - Liechtenstein	Goods	FTA	27-Oct-1972	GATT Art. XXIV	01-Jan-1973
EC - Syria	Goods	FTA	15-Jul-1977	GATT Art. XXIV	01-Jul-1977
EC - Tunisia	Goods	FTA	15-Jan-1999	GATT Art. XXIV	01-Mar-1998
EC - Turkey	Goods	CU	22-Dec-1995	GATT Art. XXIV	01-Jan-1996
EC (10) Enlargement	Goods	CU	24-Oct-1979	GATT Art. XXIV	01-Jan-1981
EC (12) Enlargement	Goods	CU	11-Dec-1985	GATT Art. XXIV	01-Jan-1986
EC (15) Enlargement	Goods & Services	CU & EIA	15-Dec-1994(G) 22-Dec-1994(S)	GATT Art. XXIV & GATS V	01-Jan-1995
EC (25) Enlargement	Goods & Services	CU & EIA	26-Apr-2004	GATT Art. XXIV & GATS V	01-May-2004
EC (27) Enlargement	Goods & Services	CU & EIA	27-Sep-2006(G) 26-Jun-2007(S)	GATT Art. XXIV & GATS V	01-Jan-2007
EC (9) Enlargement	Goods	CU	07-Mar-1972	GATT Art. XXIV	01-Jan-1973
EC Treaty	Goods & Services	CU & EIA	24-Apr-1957(G) 10-Nov-1995(S)	GATT Art. XXIV & GATS V	01-Jan-1958
Economic and Monetary Community of Central Africa (CEMAC)	Goods	CU	21-Jul-1999	Enabling Clause	24-Jun-1999

Appendix.D (continued)					
Economic Community of West African States (ECOWAS)	Goods	CU	06-Jul-2005	Enabling Clause	24-Jul-1993
Economic Cooperation Organization (ECO)	Goods	PTA	10-Jul-1992	Enabling Clause	17-Feb-1992
EFTA - Chile	Goods & Services	FTA & EIA	03-Dec-2004	GATT Art. XXIV & GATS V	01-Dec-2004
EFTA - Croatia	Goods	FTA	14-Jan-2002	GATT Art. XXIV	01-Jan-2002
EFTA - Egypt	Goods	FTA	17-Jul-2007	GATT Art. XXIV	01-Aug-2007
EFTA - Former Yugoslav Republic of Macedonia	Goods	FTA	11-Dec-2000	GATT Art. XXIV	01-Jan-2001
EFTA - Israel	Goods	FTA	30-Nov-1992	GATT Art. XXIV	01-Jan-1993
EFTA - Jordan	Goods	FTA	17-Jan-2002	GATT Art. XXIV	01-Jan-2002
EFTA - Korea, Republic of	Goods & Services	FTA & EIA	23-Aug-2006	GATT Art. XXIV & GATS V	01-Sep-2006
EFTA - Lebanon	Goods	FTA	22-Dec-2006	GATT Art. XXIV	01-Jan-2007
EFTA - Mexico	Goods & Services	FTA & EIA	25-Jul-2001	GATT Art. XXIV & GATS V	01-Jul-2001
EFTA - Morocco	Goods	FTA	20-Jan-2000	GATT Art. XXIV	01-Dec-1999
EFTA - Palestinian Authority	Goods	FTA	23-Jul-1999	GATT Art. XXIV	01-Jul-1999
EFTA - SACU	Goods	FTA	29-Oct-2008	GATT Art. XXIV	01-May-2008
EFTA - Singapore	Goods & Services	FTA & EIA	14-Jan-2003	GATT Art. XXIV & GATS V	01-Jan-2003

Appendix.D (continued)					
EFTA - Tunisia	Goods	FTA	03-Jun-2005	GATT Art. XXIV	01-Jun-2005
EFTA - Turkey	Goods	FTA	06-Mar-1992	GATT Art. XXIV	01-Apr-1992
EFTA (S)	Services	EIA	15-Jul-2002	GATS Art. V	01-Jun-2002
EFTA (Stockholm Convention) (G)	Goods	FTA	14-Nov-1959	GATT Art. XXIV	03-May-1960
EFTA accession of Iceland	Goods	FTA	30-Jan-1970	GATT Art. XXIV	01-Mar-1970
Egypt - Turkey	Goods	FTA	05-Oct-2007	Enabling Clause	01-Mar-2007
Eurasian Economic Community (EAEC)	Goods	CU	21-Apr-1999	GATT Art. XXIV	08-Oct-1997
European Economic Area (EEA)	Services	EIA	13-Sep-1996	GATS Art. V	01-Jan-1994
Faroe Islands - Norway	Goods	FTA	12-Feb-1996	GATT Art. XXIV	01-Jul-1993
Faroe Islands - Switzerland	Goods	FTA	12-Feb-1996	GATT Art. XXIV	01-Mar-1995
Georgia - Armenia	Goods	FTA	08-Feb-2001	GATT Art. XXIV	11-Nov-1998
Georgia - Azerbaijan	Goods	FTA	08-Feb-2001	GATT Art. XXIV	10-Jul-1996
Georgia - Kazakhstan	Goods	FTA	08-Feb-2001	GATT Art. XXIV	16-Jul-1999
Georgia - Russian Federation	Goods	FTA	08-Feb-2001	GATT Art. XXIV	10-May-1994
Georgia - Turkmenistan	Goods	FTA	08-Feb-2001	GATT Art. XXIV	01-Jan-2000
Georgia - Ukraine	Goods	FTA	08-Feb-2001	GATT Art. XXIV	04-Jun-1996

Appendix.D (continued)					
Global System of Trade Preferences among Developing Countries (GSTP)	Goods	PTA	25-Sep-1989	Enabling Clause	19-Apr-1989
Gulf Cooperation Council (GCC)	Goods	CU	06-Oct-2009	GATT Art. XXIV	01-Jan-2003
Iceland - Faroe Islands	Goods & Services	FTA & EIA	10-Jul-2008	GATT Art. XXIV & GATS V	01-Nov-2006
India - Afghanistan	Goods	PTA	08-Mar-2010	Enabling Clause	13-May-2003
India - Bhutan	Goods	FTA	30-Jun-2008	Enabling Clause	29-Jul-2006
India - Singapore	Goods & Services	FTA & EIA	03-May-2007	GATT Art. XXIV & GATS V	01-Aug-2005
India - Sri Lanka	Goods	FTA	17-Jun-2002	Enabling Clause	15-Dec-2001
Israel - Mexico	Goods	FTA	22-Feb-2001	GATT Art. XXIV	01-Jul-2000
Japan - Indonesia	Goods & Services	FTA & EIA	27-Jun-2008	GATT Art. XXIV & GATS V	01-Jul-2008
Japan - Malaysia	Goods & Services	FTA & EIA	12-Jul-2006	GATT Art. XXIV & GATS V	13-Jul-2006
Japan - Mexico	Goods & Services	FTA & EIA	31-Mar-2005	GATT Art. XXIV & GATS V	01-Apr-2005
Japan - Philippines	Goods & Services	FTA & EIA	11-Dec-2008	GATT Art. XXIV & GATS V	11-Dec-2008
Japan - Singapore	Goods & Services	FTA & EIA	08-Nov-2002	GATT Art. XXIV & GATS V	30-Nov-2002
Japan - Switzerland	Goods & Services	FTA & EIA	01-Sep-2009	GATT Art. XXIV & GATS V	01-Sep-2009
Japan - Thailand	Goods & Services	FTA & EIA	25-Oct-2007	GATT Art. XXIV & GATS V	01-Nov-2007

Appendix.D (continued)					
Japan - Viet Nam	Goods & Services	FTA & EIA	01-Oct-2009	GATT Art. XXIV & GATS V	01-Oct-2009
Jordan - Singapore	Goods & Services	FTA & EIA	07-Jul-2006	GATT Art. XXIV & GATS V	22-Aug-2005
Korea, Republic of - Chile	Goods & Services	FTA & EIA	08-Apr-2004	GATT Art. XXIV & GATS V	01-Apr-2004
Korea, Republic of - Singapore	Goods & Services	FTA & EIA	21-Feb-2006	GATT Art. XXIV & GATS V	02-Mar-2006
Kyrgyz Republic - Armenia	Goods	FTA	12-Dec-2000	GATT Art. XXIV	27-Oct-1995
Kyrgyz Republic - Kazakhstan	Goods	FTA	29-Jun-1999	GATT Art. XXIV	11-Nov-1995
Kyrgyz Republic - Moldova	Goods	FTA	15-Jun-1999	GATT Art. XXIV	21-Nov-1996
Kyrgyz Republic - Russian Federation	Goods	FTA	15-Jun-1999	GATT Art. XXIV	24-Apr-1993
Kyrgyz Republic - Ukraine	Goods	FTA	15-Jun-1999	GATT Art. XXIV	19-Jan-1998
Kyrgyz Republic - Uzbekistan	Goods	FTA	15-Jun-1999	GATT Art. XXIV	20-Mar-1998
Lao People's Democratic Republic - Thailand	Goods	PTA	26-Nov-1991	Enabling Clause	20-Jun-1991
Latin American Integration Association (LAIA)	Goods	PTA	01-Jul-1982	Enabling Clause	18-Mar-1981
Melanesian Spearhead Group (MSG)	Goods	PTA	03-Aug-1999	Enabling Clause	01-Jan-1994
MERCOSUR - India	Goods	PTA	23-Feb-2010	Enabling Clause	01-Jun-2009
MERCOSUR (G)	Goods	CU	17-Feb-1991	Enabling Clause	29-Nov-1991

Appendix.D (continued)					
MERCOSUR (S)	Services	EIA	05-Dec-2006	GATS Art. V	07-Dec-2005
Mexico - El Salvador (Mexico - Northern Triangle)	Goods & Services	FTA & EIA	23-May-2006	GATT Art. XXIV & GATS V	15-Mar-2001
Mexico - Guatemala (Mexico - Northern Triangle)	Goods & Services	FTA & EIA	03-Jul-2006	GATT Art. XXIV & GATS V	15-Mar-2001
Mexico - Honduras (Mexico - Northern Triangle)	Goods & Services	FTA & EIA	10-Jul-2006(G) 20-Jun-2006(S)	GATT Art. XXIV & GATS V	01-Jun-2001
Mexico - Nicaragua	Goods & Services	FTA & EIA	17-Oct-2005	GATT Art. XXIV & GATS V	01-Jul-1998
New Zealand - Singapore	Goods & Services	FTA & EIA	04-Sep-2001	GATT Art. XXIV & GATS V	01-Jan-2001
Nicaragua and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu	Goods & Services	FTA & EIA	09-Jul-2009	GATT Art. XXIV & GATS V	01-Jan-2008
North American Free Trade Agreement (NAFTA)	Goods & Services	FTA & EIA	29-Jan-1993(G) 01-Mar-1995(S)	GATT Art. XXIV & GATS V	01-Jan-1994
Pacific Island Countries Trade Agreement (PICTA)	Goods	FTA	28-Aug-2008	Enabling Clause	13-Apr-2003
Pakistan - China	Goods	FTA	18-Jan-2008	GATT Art. XXIV	01-Jul-2007
Pakistan - Malaysia	Goods & Services	FTA & EIA	19-Feb-2008	Enabling Clause & GATS Art. V	01-Jan-2008
Pakistan - Sri Lanka	Goods	FTA	11-Jun-2008	Enabling Clause	12-Jun-2005
Panama - Chile	Goods & Services	FTA & EIA	17-Apr-2008	GATT Art. XXIV & GATS V	07-Mar-2008

Appendix.D (continued)					
Panama - Costa Rica (Panama - Central America)	Goods & Services	FTA & EIA	07-Apr-2009	GATT Art. XXIV & GATS V	11-Apr-2003
Panama - El Salvador (Panama - Central America)	Goods & Services	FTA & EIA	24-Feb-2005	GATT Art. XXIV & GATS V	11-Apr-2003
Panama - Honduras (Panama - Central America)	Goods & Services	FTA & EIA	16-Dec-2009	GATT Art. XXIV & GATS V	09-Jan-2009
Panama - Singapore	Goods & Services	FTA & EIA	04-Apr-2007	GATT Art. XXIV & GATS V	24-Jul-2006
Panama and the Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu	Goods & Services	FTA & EIA	28-Jul-2009	GATT Art. XXIV & GATS V	01-Jan-2004
Pan-Arab Free Trade Area (PAFTA)	Goods	FTA	03-Oct-2006	GATT Art. XXIV	01-Jan-1998
Peru - China	Goods & Services	FTA & EIA	03-Mar-2010	GATT Art. XXIV & GATS V	01-Mar-2010
Peru - Singapore	Goods & Services	FTA & EIA	30-Jul-2009	GATT Art. XXIV & GATS V	01-Aug-2009
Protocol on Trade Negotiations (PTN)	Goods	PTA	09-Nov-1971	Enabling Clause	11-Feb-1973
Singapore - Australia	Goods & Services	FTA & EIA	25-Sep-2003	GATT Art. XXIV & GATS V	28-Jul-2003
South Asian Free Trade Agreement (SAFTA)	Goods	FTA	21-Apr-2008	Enabling Clause	01-Jan-2006
South Asian Preferential Trade Arrangement (SAPTA)	Goods	PTA	21-Apr-1997	Enabling Clause	07-Dec-1995
South Pacific Regional Trade and Economic Cooperation Agreement (SPARTECA)	Goods	PTA	07-Jan-1981	Enabling Clause	01-Jan-1981

Appendix.D (continued)					
Southern African Customs Union (SACU)	Goods	CU	25-Jun-2007	GATT Art. XXIV	15-Jul-2004
Southern African Development Community (SADC)	Goods	FTA	02-Aug-2004	GATT Art. XXIV	01-Sep-2000
Thailand - Australia	Goods & Services	FTA & EIA	27-Dec-2004	GATT Art. XXIV & GATS V	01-Jan-2005
Thailand - New Zealand	Goods & Services	FTA & EIA	01-Dec-2005	GATT Art. XXIV & GATS V	01-Jul-2005
Trans-Pacific Strategic Economic Partnership	Goods & Services	FTA & EIA	18-May-2007	GATT Art. XXIV & GATS V	28-May-2006
Turkey - Albania	Goods	FTA	09-May-2008	GATT Art. XXIV	01-May-2008
Turkey - Bosnia and Herzegovina	Goods	FTA	29-Aug-2003	GATT Art. XXIV	01-Jul-2003
Turkey - Croatia	Goods	FTA	02-Sep-2003	GATT Art. XXIV	01-Jul-2003
Turkey - Former Yugoslav Republic of Macedonia	Goods	FTA	05-Jan-2001	GATT Art. XXIV	01-Sep-2000
Turkey - Georgia	Goods	FTA	18-Feb-2009	GATT Art. XXIV	01-Nov-2008
Turkey - Israel	Goods	FTA	16-Apr-1998	GATT Art. XXIV	01-May-1997
Turkey - Montenegro	Goods	FTA	12-Mar-2010	GATT Art. XXIV	01-Mar-2010
Turkey - Morocco	Goods	FTA	10-Feb-2006	GATT Art. XXIV	01-Jan-2006
Turkey - Palestinian Authority	Goods	FTA	01-Sep-2005	GATT Art. XXIV	01-Jun-2005
Turkey - Syria	Goods	FTA	15-Feb-2007	GATT Art. XXIV	01-Jan-2007

Appendix.D (continued)					
Turkey - Tunisia	Goods	FTA	01-Sep-2005	GATT Art. XXIV	01-Jul-2005
Ukraine - Azerbaijan	Goods	FTA	18-Aug-2008	GATT Art. XXIV	02-Sep-1996
Ukraine - Belarus	Goods	FTA	18-Aug-2008	GATT Art. XXIV	11-Nov-2006
Ukraine - Former Yugoslav Republic of Macedonia	Goods	FTA	18-Aug-2008	GATT Art. XXIV	05-Jul-2001
Ukraine - Kazakhstan	Goods	FTA	18-Aug-2008	GATT Art. XXIV	19-Oct-1998
Ukraine - Moldova	Goods	FTA	18-Aug-2008	GATT Art. XXIV	19-May-2005
Ukraine - Russian Federation	Goods	FTA	18-Aug-2008	GATT Art. XXIV	21-Feb-1994
Ukraine - Tajikistan	Goods	FTA	18-Aug-2008	GATT Art. XXIV	11-Jul-2002
Ukraine - Uzbekistan	Goods	FTA	18-Aug-2008	GATT Art. XXIV	01-Jan-1996
Ukraine -Turkmenistan	Goods	FTA	18-Aug-2008	GATT Art. XXIV	04-Nov-1995
US - Australia	Goods & Services	FTA & EIA	22-Dec-2004	GATT Art. XXIV & GATS V	01-Jan-2005
US - Bahrain	Goods & Services	FTA & EIA	08-Sep-2006	GATT Art. XXIV & GATS V	01-Aug-2006
US - Chile	Goods & Services	FTA & EIA	16-Dec-2003	GATT Art. XXIV & GATS V	01-Jan-2004
US - Israel	Goods	FTA	13-Sep-1985	GATT Art. XXIV	19-Aug-1985
US - Jordan	Goods & Services	FTA & EIA	15-Jan-2002	GATT Art. XXIV & GATS V	17-Dec-2001
US - Morocco	Goods & Services	FTA & EIA	30-Dec-2005	GATT Art. XXIV & GATS V	01-Jan-2006

Appendix.D (continued)					
US - Oman	Goods & Services	FTA & EIA	30-Jan-2009	GATT Art. XXIV & GATS V	01-Jan-2009
US - Peru	Goods & Services	FTA & EIA	03-Feb-2009	GATT Art. XXIV & GATS V	01-Feb-2009
US - Singapore	Goods & Services	FTA & EIA	17-Dec-2003	GATT Art. XXIV & GATS V	01-Jan-2004
West African Economic and Monetary Union (WAEMU)	Goods	CU	27-Oct-1999	Enabling Clause	01-Jan-2000

APPENDIX E: ESTIMATION OUTPUTS OF EVIEWS 7.0

E.1 Panel Unit Root Tests

Panel unit root test: Summary				
Series: RX				
Date: 04/11/10 Time: 16:30				
Sample: 1980 2008				
Exogenous variables: Individual effects				
Automatic selection of maximum lags				
Automatic lag length selection based on AIC: 0 to 6				
Newey-West automatic bandwidth selection and Bartlett kernel				
Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-2.2891	0.011	1259	33694
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	4.70081	1	1259	33694
ADF - Fisher Chi-square	3569.25	0	1259	33694
PP - Fisher Chi-square	3173.29	0	1259	35252
** Probabilities for Fisher tests are computed using an asymptotic Chi				
-square distribution. All other tests assume asymptotic normality.				

Null Hypothesis: Stationarity		
Series: RX		
Date: 04/11/10 Time: 16:32		
Sample: 1980 2008		
Exogenous variables: Individual effects		
Newey-West automatic bandwidth selection and Bartlett kernel		
Total (balanced) observations: 36540		
Cross-sections included: 1260		
Method	Statistic	Prob.**
Hadri Z-stat	80.8674	0
Heteroscedastic Consistent Z-stat	83.129	0
* Note: High autocorrelation leads to severe size distortion in Hadri test, leading to over-rejection of the null.		
** Probabilities are computed assuming asympotic normality		

Panel unit root test: Summary				
Series: IRGDP [JRGDP]				
Date: 04/11/10 Time: 16:39				
Sample: 1980 2008				
Exogenous variables: Individual effects				
Automatic selection of maximum lags				
Automatic lag length selection based on AIC: 0 to 6				
Newey-West automatic bandwidth selection and Bartlett kernel				
Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-2.7426	0.003	1260	33285
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	46.6052	1	1260	33285
ADF - Fisher Chi-square	1011.51	1	1260	33285
PP - Fisher Chi-square	915.068	1	1260	35280
** Probabilities for Fisher tests are computed using an asymptotic Chi				
-square distribution. All other tests assume asymptotic normality.				

Null Hypothesis: Stationarity		
Series: IRGDP [JRGDP]		
Date: 04/11/10 Time: 16:53		
Sample: 1980 2008		
Exogenous variables: Individual effects		
Newey-West automatic bandwidth selection and Bartlett kernel		
Total (balanced) observations: 36540		
Cross-sections included: 1260		
Method	Statistic	Prob.**
Hadri Z-stat	122.518	0
Heteroscedastic Consistent Z-stat	120.842	0
* Note: High autocorrelation leads to severe size distortion in Hadri test, leading to over-rejection of the null.		
** Probabilities are computed assuming asympotic normality		

Panel unit root test: Summary				
Series: IPOP [JPOP]				
Date: 04/11/10 Time: 16:56				
Sample: 1980 2008				
Exogenous variables: Individual effects				
Automatic selection of maximum lags				
Automatic lag length selection based on AIC: 0 to 6				
Newey-West automatic bandwidth selection and Bartlett kernel				
Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-46.231	0	1190	30205
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	11.5488	1	1190	30205
ADF - Fisher Chi-square	3510.8	0	1190	30205
PP - Fisher Chi-square	12908.9	0	1190	33320
** Probabilities for Fisher tests are computed using an asymptotic Chi				
-square distribution. All other tests assume asymptotic normality.				

Null Hypothesis: Stationarity		
Series: IPOP [JPOP]		
Date: 04/11/10 Time: 16:56		
Sample: 1980 2008		
Exogenous variables: Individual effects		
Newey-West automatic bandwidth selection and Bartlett kernel		
Total (balanced) observations: 36540		
Cross-sections included: 1260		
Method	Statistic	Prob.**
Hadri Z-stat	124.456	0
Heteroscedastic Consistent Z-stat	120.878	0
* Note: High autocorrelation leads to severe size distortion in Hadri test, leading to over-rejection of the null.		
** Probabilities are computed assuming asympotic normality		

Panel unit root test: Summary				
Series: RER				
Date: 04/11/10 Time: 16:37				
Sample: 1980 2008				
Exogenous variables: Individual effects				
Automatic selection of maximum lags				
Automatic lag length selection based on AIC: 0 to 6				
Newey-West automatic bandwidth selection and Bartlett kernel				
Method	Statistic	Prob.**	Cross-sections	Obs
Null: Unit root (assumes common unit root process)				
Levin, Lin & Chu t*	-8.6669	0	1260	34409
Null: Unit root (assumes individual unit root process)				
Im, Pesaran and Shin W-stat	0.07717	0.5308	1260	34409
ADF - Fisher Chi-square	2822.32	0	1260	34409
PP - Fisher Chi-square	1836.88	1	1260	35280
** Probabilities for Fisher tests are computed using an asymptotic Chi				
-square distribution. All other tests assume asymptotic normality.				

Null Hypothesis: Stationarity		
Series: RER		
Date: 04/11/10 Time: 16:38		
Sample: 1980 2008		
Exogenous variables: Individual effects		
Newey-West automatic bandwidth selection and Bartlett kernel		
Total (balanced) observations: 36540		
Cross-sections included: 1260		
Method	Statistic	Prob.**
Hadri Z-stat	91.0746	0
Heteroscedastic Consistent Z-stat	65.1329	0
* Note: High autocorrelation leads to severe size distortion in Hadri test, leading to over-rejection of the null.		
** Probabilities are computed assuming asympotic normality		

Panel unit root test: Im, Pesaran and Shin (1997) unit root test				
Date: 04/29/10 Time: 09:12				
Sample: 1980 2008				
Exogenous variables: Individual effects				
Automatic selection of maximum lags				
Automatic lag length selection based on AIC: 0 to 5				
Newey-West automatic bandwidth selection and Bartlett kernel				
Null: Unit root (assumes individual unit root process)				
Series	Statistic	Prob.	Cross-sections	Observations
D(RX)	-134.541	0	1259	32726
D(IRGDP) [D(JRGDP)]	-82.2171	0	1260	33285
D(IPOP)[D(JPOP)]	-1.99213	0.0232	1260	32095
D(RER)	-127.014	0	1260	33490

E.2 Panel Cointegration Tests

Pedroni Residual Cointegration Test				
Series: RX RER IRGDP JRGDP IPOP JPOP				
Date: 04/11/10 Time: 16:59				
Sample: 1980 2008				
Included observations: 36540				
Cross-sections included: 1260				
Null Hypothesis: No cointegration				
Trend assumption: No deterministic trend				
Automatic lag length selection based on AIC with a max lag of 5				
Newey-West automatic bandwidth selection and Bartlett kernel				
Alternative hypothesis: common AR coefs. (within-dimension)				
			Weighted	
	Statistic	Prob.	Statistic	Prob.
Panel v-Statistic	-18.823	1	-25.293	1
Panel rho-Statistic	3.62806	0.9999	9.26394	1
Panel PP-Statistic	-79.707	0	-68.404	0
Panel ADF-Statistic	-63.384	0	-58.855	0
Alternative hypothesis: individual AR coefs. (between-dimension)				
	Statistic	Prob.		
Group rho-Statistic	23.5295	1		
Group PP-Statistic	-78.784	0		
Group ADF-Statistic	-53.302	0		

Kao Residual Cointegration Test				
Series: RX RER IRGDP JRGDP IPOP JPOP				
Date: 04/11/10 Time: 17:02				
Sample: 1980 2008				
Included observations: 36540				
Null Hypothesis: No cointegration				
Trend assumption: No deterministic trend				
Automatic lag length selection based on AIC with a max lag of 7				
Newey-West automatic bandwidth selection and Bartlett kernel				
			t-Statistic	Prob.
ADF			16.0573	0
Residual variance			3.09294	
HAC variance			0.85343	
Augmented Dickey-Fuller Test Equation				
Dependent Variable: D(RESID)				
Method: Least Squares				
Date: 04/11/10 Time: 17:02				
Sample (adjusted): 1988 2008				
Included observations: 26460 after adjustments				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
RESID(-1)	-0.485	0.00786	-61.726	0
D(RESID(-1))	-0.0545	0.00793	-6.8731	0
D(RESID(-2))	-0.0111	0.00757	-1.4601	0.1443
D(RESID(-3))	0.04124	0.00722	5.71628	0
D(RESID(-4))	0.08686	0.00691	12.5774	0
D(RESID(-5))	0.07653	0.00647	11.8354	0
D(RESID(-6))	0.06718	0.00586	11.4689	0
D(RESID(-7))	0.05239	0.00502	10.4311	0
R-squared	0.27349	Mean dependent var		0.00689
Adjusted R-squared	0.2733	S.D. dependent var		1.64484
S.E. of regression	1.40217	Akaike info criterion		3.51423
Sum squared resid	52007	Schwarz criterion		3.5167
Log likelihood	-46485	Hannan-Quinn criter.		3.51502
Durbin-Watson stat	1.94993			

E.3 OLS Estimations (Without Fixed Effects)

Dependent Variable: RX				
Method: Panel Least Squares				
Date: 04/11/10 Time: 16:22				
Sample: 1980 2008				
Periods included: 29				
Cross-sections included: 1258				
Total panel (balanced) observations: 36482				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-29.033	0.41945	-69.217	0
RER	-0.026	0.00409	-6.3686	0
IRGDP	1.46123	0.01458	100.204	0
JRGDP	1.16284	0.01463	79.5105	0
IPOP	-0.3774	0.01347	-28.007	0
JPOP	-0.2345	0.01348	-17.397	0
DIS	-1.1308	0.02012	-56.214	0
EU	-0.7233	0.06205	-11.657	0
XEU	-0.2709	0.03951	-6.8564	0
MEU	-0.045	0.03955	-1.1387	0.2548
NF	-0.566	0.27225	-2.0788	0.0376
XNF	-1.1599	0.07313	-15.86	0
MNF	-0.2034	0.07326	-2.7763	0.0055
MR	1.53586	0.17921	8.57007	0
XMR	-0.2969	0.05833	-5.09	0
MMR	0.03258	0.05831	0.55869	0.5764
AF	1.46208	0.14769	9.89999	0
XAF	1.53508	0.05494	27.9412	0
MAF	0.94992	0.05491	17.2987	0
R-squared	0.51105	Mean dependent var		19.0456
Adjusted R-squared	0.51081	S.D. dependent var		3.63373
S.E. of regression	2.54152	Akaike info criterion		4.70392
Sum squared resid	235525	Schwarz criterion		4.70835
Log likelihood	-85785	Hannan-Quinn criter.		4.70533
F-statistic	2117.27	Durbin-Watson stat		0.4848
Prob(F-statistic)	0			

E.4 Hausman Test (Fixed versus Random Effects Specification)

Correlated Random Effects - Hausman Test				
Equation: Untitled				
Test cross-section and period random effects				
Test Summary		Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random		477.969	5	0
Period random		0	5	1
Cross-section and period random		710.103	5	0
* Period test variance is invalid. Hausman statistic set to zero.				
Cross-section random effects test comparisons:				
Variable	Fixed	Random	Var(Diff.)	Prob.
RER	0.01001	0.00309	1.7E-05	0.0911
IRGDP	1.43422	1.61352	0.00238	0.0002
JRGDP	1.22902	1.37394	0.00239	0.003
IPOP	1.72948	-0.3591	0.02869	0
JPOP	2.01533	-0.2431	0.02862	0

E.5 OLS with Fixed Effects Estimations

Dependent Variable: RX				
Method: Panel Least Squares				
Date: 04/11/10 Time: 16:16				
Sample: 1980 2008				
Periods included: 29				
Cross-sections included: 1259				
Total panel (balanced) observations: 36511				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-170.16	4.93283	-34.495	0
RER	0.01694	0.00782	2.16647	0.0303
IRGDP	1.84862	0.07148	25.8638	0
JRGDP	1.79917	0.07156	25.1416	0
IPOP	3.09299	0.20378	15.1782	0
JPOP	2.35681	0.20335	11.5902	0
EU	1.06573	0.08747	12.1837	0
XEU	0.22137	0.0639	3.46411	0.0005
MEU	0.36459	0.06285	5.80089	0
NF	0.2108	0.2879	0.7322	0.4641
XNF	-0.6641	0.07668	-8.6608	0
MNF	0.16093	0.07669	2.09844	0.0359
MR	0.12448	0.21299	0.58445	0.5589
XMR	0.17143	0.07337	2.33641	0.0195
MMR	0.84592	0.07335	11.5324	0
AF	-0.6983	0.17268	-4.0435	0.0001
XAF	-0.2456	0.07124	-3.4477	0.0006
MAF	0.31444	0.07121	4.41574	0
	Effects Specification			
Cross-section fixed (dummy variables)				
Period fixed (dummy variables)				
R-squared	0.74129	Mean dependent var	19.0485	
Adjusted R-squared	0.73171	S.D. dependent var	3.63375	
S.E. of regression	1.88215	Akaike info criterion	4.13777	
Sum squared resid	124721	Schwarz criterion	4.44154	
Log likelihood	-74233	Hannan-Quinn criter.	4.23434	
F-statistic	77.4199	Durbin-Watson stat	0.90431	
Prob(F-statistic)	0			

E.6 Dynamic OLS (DOLS) Estimations

Dependent Variable: RX				
Method: Panel Least Squares				
Date: 04/27/10 Time: 15:23				
Sample (adjusted): 1984 2007				
Periods included: 24				
Cross-sections included: 1259				
Total panel (balanced) observations: 30216				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-154.06	6.62548	-23.253	0
RER	0.00367	0.01028	0.35698	0.7211
IRGDP	1.81289	0.09365	19.3577	0
JRGDP	1.65761	0.09379	17.674	0
IPOP	2.77823	0.27776	10.0022	0
JPOP	2.01515	0.27718	7.27012	0
EU	0.81372	0.09666	8.41818	0
XEU	0.18699	0.07143	2.61792	0.0089
MEU	0.1521	0.07074	2.1502	0.0315
NF	0.25916	0.30213	0.8578	0.391
XNF	-0.4913	0.08048	-6.104	0
MNF	0.11829	0.08049	1.46966	0.1417
MR	0.15787	0.23546	0.67047	0.5026
XMR	0.07629	0.08107	0.94107	0.3467
MMR	0.85351	0.08106	10.5297	0
AF	-0.3559	0.18659	-1.9074	0.0565
XAF	-0.1867	0.07686	-2.4288	0.0152
MAF	0.35953	0.07683	4.67976	0
D(RER)	-0.0553	0.01942	-2.85	0.0044
D(IRGDP)	-1.1899	0.39507	-3.0118	0.0026
D(JRGDP)	0.73962	0.39462	1.87425	0.0609
D(IPOP)	-5.3161	4.35236	-1.2214	0.2219
D(JPOP)	-1.9508	4.3542	-0.448	0.6541
D(RER(1))	-0.1039	0.01833	-5.6664	0
D(IRGDP(1))	0.08277	0.3802	0.21769	0.8277
D(JRGDP(1))	-0.808	0.37999	-2.1265	0.0335
D(IPOP(1))	-4.5106	3.68167	-1.2252	0.2205
D(JPOP(1))	0.36118	3.68441	0.09803	0.9219
D(RER(-1))	-0.0341	0.01939	-1.7588	0.0786

DOLS estimations (continued)				
D(IRGDP(-1))	-0.802	0.38187	-2.1003	0.0357
D(JRGDP(-1))	1.11771	0.38145	2.93018	0.0034
D(IPOP(-1))	-7.6817	4.26765	-1.8	0.0719
D(JPOP(-1))	1.1275	4.26943	0.26409	0.7917
D(RER(-2))	-0.0175	0.01931	-0.9078	0.364
D(IRGDP(-2))	-0.6068	0.36941	-1.6425	0.1005
D(JRGDP(-2))	0.87416	0.36904	2.36876	0.0179
D(IPOP(-2))	-1.2585	4.14369	-0.3037	0.7613
D(JPOP(-2))	-0.5024	4.14542	-0.1212	0.9035
D(RER(-3))	-0.0272	0.01923	-1.4155	0.1569
D(IRGDP(-3))	0.86192	0.34808	2.47618	0.0133
D(JRGDP(-3))	0.20687	0.34787	0.59468	0.5521
D(IPOP(-3))	0.51285	3.58012	0.14325	0.8861
D(JPOP(-3))	-5.7841	3.58273	-1.6144	0.1064
Effects Specification				
Cross-section fixed (dummy variables)				
Period fixed (dummy variables)				
R-squared	0.74892	Mean dependent var		19.1805
Adjusted R-squared	0.73742	S.D. dependent var		3.45952
S.E. of regression	1.77275	Akaike info criterion		4.02577
Sum squared resid	90797.5	Schwarz criterion		4.39017
Log likelihood	-59497	Hannan-Quinn criter.		4.14265
F-statistic	65.1377	Durbin-Watson stat		0.98332
Prob(F-statistic)	0			

E.7 Predictive Accuracy of Models

OLS	
Forecast: RXF	
Actual: RX	
Forecast sample: 1980 2008	
Adjusted sample: 1980 2008	
Included observations: 36482	
Root Mean Squared Error	2.540853
Mean Absolute Error	1.340727
Mean Absolute Percentage Error	5.861838
Theil Inequality Coefficient	0.065806
Bias Proportion	0
Variance Proportion	0.166265
Covariance Proportion	0.833735
OLS_{FE}	
Forecast: RXF	
Actual: RX	
Forecast sample: 1980 2008	
Adjusted sample: 1980 2008	
Included observations: 36511	
Root Mean Squared Error	1.848238
Mean Absolute Error	0.80915
Mean Absolute Percentage Error	3.489508
Theil Inequality Coefficient	0.047763
Bias Proportion	0
Variance Proportion	0.074702
Covariance Proportion	0.925298
DOLS	
Forecast: RXF	
Actual: RX	
Forecast sample: 1980 2008	
Adjusted sample: 1984 2007	
Included observations: 30216	
Root Mean Squared Error	1.733478
Mean Absolute Error	0.711067
Mean Absolute Percentage Error	3.074681
Theil Inequality Coefficient	0.044559
Bias Proportion	0
Variance Proportion	0.072156
Covariance Proportion	0.927844

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