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**REGIONALISM VERSUS MULTILATERALISM IN INTERNATIONAL TRADE  
LIBERALISATION WITH SPECIAL REFERENCE TO THE EU**

**Ph.D THESIS**

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## **ABBREVIATIONS**

- ACP:** African, Caribbean and Pacific Group
- AD:** Anti-Dumping
- AFTA:** ASEAN Free Trade Area
- ANZCERTA:** Australia New Zealand Closer Economic Relations Trade Agreement
- ASEAN:** Association of Southeast Asian Nations
- ATMs:** Autonomous Trade Measures
- CAP:** Common Agricultural Policy
- CCT:** Common Customs Tariff
- CEECs:** Central and Eastern European Countries
- CU:** Customs Union
- CUSFTA:** Canada-US Free Trade Agreement
- DDA:** Doha Development Agenda
- DDR:** Doha Development Round
- EC:** European Community
- EEA:** European Economic Area
- EEC:** European Economic Community
- EFTA:** European Free Trade Area
- EPG:** Eminent Persons' Group
- EU:** European Union
- FTA:** Free Trade Area
- FYROM:** Former Yugoslav Republic of Macedonia
- GATS:** General Agreement on Trade and Services
- GATT:** General Agreement on Tariffs and Trade
- GDP:** Gross Domestic Product
- GSP:** Generalised System of Preferences
- ITO:** International Trade Organisation
- MERCOSUR:** Southern Common Market
- MFA:** Multi-Fibre Arrangement
- MFN:** Most-Favoured Nation

**MTNs:** Multilateral Trade Negotiations

**NAFTA:** North American Free Trade Area

**NICs:** Newly Industrialised Countries

**NTBs:** Non-Tariff Barriers

**OECD:** Organisation for Economic Co-operation and Development

**PTAs:** Preferential Trade Agreements (or Arrangements)

**SEA:** Single European Act

**TPR:** Trade Policy Review

**TRIMs:** Trade-Related Investment Measures

**TRIPs:** Trade-Related Aspects of Intellectual Property Rights

**UR:** Uruguay Round

**US:** United States

**VERs:** Voluntary Export Restraints

**WTO:** World Trade Organisation

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## ABSTRACT

A distinctive feature of the contemporary world trading system, which experiences the development of a worldwide trend towards increased regionalism, is the co-existence of regional (preferential) trade arrangements alongside multilateral trade negotiations. While the GATT/WTO-based multilateral trading system depends on the principle of “non-discrimination”, regional trading arrangements are, by definition, discriminatory and, therefore, contradictory to the multilateral system since trade concessions are granted only to members. The relation between these two patterns of international trading system -particularly effects of regionalism on multilateralism- is the main subject of the thesis. The thesis debates whether and -more importantly- under what conditions, regional trade arrangements underpins further strengthening and liberalisation of the multilateral trading system.

Effects of regionalism on multilateralism are analysed in the thesis by distinguishing between static effects of regionalism on “non-members’ welfare” and its “dynamic time-path” effects toward worldwide non-discriminatory trade liberalisation. Besides the awareness of the thesis regarding the importance of adverse effects of regionalism on multilateralism in dynamic time-path sense, adverse static effects of regionalism (trade diversion effects) on non-members occupy a central place in the thesis with respect to finding a solution. In accordance with this focus of the thesis, its objective is to structure preferential trade arrangements so as to avoid harming non-members’ welfare in particular and the multilateral trade in general. The way, which is proposed in the thesis to reach this objective, is redesigning international laws -in this case the relevant GATT/WTO rules- with a view to containing trade diversion.

An open and strong multilateral trading system having adequate rules to contain adverse welfare effects of the regionalism on the non-members is the best guarantee against the threat of proliferation of regionalism, which is considered in this thesis as harmful both in static sense and dynamic time-path sense. Otherwise, the world trading system might get even more fragmented due to the enduring tendency towards regionalism, and the future of the multilateralism might be jeopardised. The last breakdown in the Doha Development Round negotiations poses an immediate necessity for the EU to take the control in the absence of an effective American leadership. Therefore, the thesis proposes that the EU should be *a leader* replacing the US in support of a strengthened and a more liberal multilateral trading system particularly in such a period experiencing a thorny multilateral trade round.



## ÖZET

Günümüz uluslararası ticaret sisteminde, Dünya Ticaret Örgütü (DTÖ) çerçevesinde gerçekleşen çoktarafli ticaret görüşmelerinin yanısıra bölgeselleşme hareketlerine olan eğilimde de önemli bir artış yaşanmaktadır. Çoktarafli ticaret sistemi esas olarak “ayırıcılık yapmama” ilkesine dayanırken, bölgesel (tercihli) ticaret düzenlemeleri sadece üyelerine ticaret imtiyazları sağladıkları için tanımları gereği ayırıcıdır ve dolayısıyla çoktarafli sisteme aykırıdır. Uluslararası ticaret sisteminin “bölgeselleşme” ve “çoktarafli” süreçleri arasındaki ilişki, özellikle de bölgeselleşmenin çoktarafliliğe olan etkileri tezin ana konusunu oluşturmaktadır. Tezde temel olarak, bölgesel ticaret düzenlemelerinin çoktarafli ticaret sisteminin daha fazla güçlenmesini ve liberalleşmesini destekleyip desteklemeyecekleri ve daha da önemlisi hangi şartlar altında destekleyecekleri tartışılmaktadır.

Bölgeselleşmenin çoktarafliliğe olan etkileri, “üye olmayanların” refahına olan statik etkileri ve küresel bir serbest ticaret hedefine yönelik “dinamik zaman-yolu” etkileri olarak ikiye ayrılarak incelenmektedir. Bölgeselleşmenin çoktarafliliğe dinamik zaman-yolu bağlamında olan olumsuz etkilerinin önemi farkında olunmakla beraber, üye olmayanların refahına olan zararlı etkiler (ticaret saptırma etkisi) tezde -çözüm üretmek açısından- merkezi bir yer teşkil etmektedir. Buna uygun olarak tezin amacı, tercihli ticaret düzenlemelerinin özelde üye olmayanların refahına genelde ise çoktarafli ticarete zarar vermeyecek şekilde oluşturulmalarına yönelik çözüm üretmek olmuştur. Bu amaca ulaşmak için tezde önerilen yol uluslararası kuralların -ki bu durumda ilgili GATT/DTÖ kurallarının- ticaret saptırma etkisinin önlenmesi amacıyla yeniden tasarlanmasıdır.

Bölgeselleşmenin artmasının çoktarafli ticaret sistemine zararlı bir fenomen olduğu sonucuna varılmış; ve bu tehdiye karşı en etkili yolun, bölgeselleşmenin üye olmayanlara olan zararlı refah etkilerini önlemeye yönelik kurallara sahip, açık ve güçlü bir çoktarafli ticaret sistemi olduğu saptanmıştır. Aksi takdirde, dünya ticaret sisteminin bölgeselleşmeye olan eğilim nedeniyle daha da bölünmesi ve çoktarafliğin geleceğinin tehlikeye girmesi kuvvetle muhtemeldir. Doha Ticaret Turu görüşmelerindeki son hezimet AB'nin etkili bir Amerikan liderliğinin yokluğunda kontrolü acilen ele almasını gerektirmektedir. Dolayısıyla, tezde AB'nin daha güçlü ve daha liberal bir çoktarafli ticaret sistemi lehine ABD'nin yerine liderlik etmesi gerektiği önerilmektedir. Özellikle zorluklarla dolu bir ticaret turunun yaşandığı ve derhal inisiyatif alınması gerektiği böyle bir dönemde bu öneri daha da anlam kazanmaktadır.

## INTRODUCTION

International trading system follows three alternative processes<sup>1</sup>: *Multilateralism*, which is at the centre of the system, referring to the General Agreement on Tariffs and Trade (GATT) rounds of negotiations and the World Trade Organisation (WTO); *regionalism* which broadly relates to preferential trade agreements -or arrangements- (PTAs) among a subset of nations; and *unilateralism* which pertains to the means, whereby countries individually alter their trade barriers, either directly or by inducing bilateral negotiations. The relation between the first two patterns of international trading system -particularly the effects of the latter on the former- is the main subject of the thesis.

Contemporary world trading system is simultaneously undergoing two processes, which are parallel but contradictory to each other: on the one hand, multilateral trading system under the auspices of the GATT/WTO has been servicing to liberalisation and regulation of international trade for over fifty years through multilateral trade negotiations. On the other hand, there has been a surge in the formation of new PTAs in the form of customs unions (CUs) and free trade areas (FTAs) as well as a deepening and widening of existing agreements since the second half of the 1980s after a period of failure in regional initiatives that took place from the late 1950s through the 1970s.

The cornerstone of the post-World War II multilateral trading system is the Most-Favoured Nation (MFN) principle that underlies all the GATT-negotiated reductions in tariffs. In Article 1 of the GATT, contracting parties are committed to grant MFN treatment to all the other GATT signatories; that is, to extend all trade concessions to them without discrimination. Through the application of the MFN principle, purely bilateral bargains negotiated under the auspices of the GATT become available to all participating countries including smaller ones with little bargaining power. Enormous progress towards global free trade “equally for all” has been made under this non-discriminatory approach of the GATT to trade liberalisation. For many economists, the arguments supporting multilateralism and the MFN principle are unquestionably strong:

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<sup>1</sup> Ethier (1998a), for a similar classification see Bhagwati (1991).

the general assumption in favour of freer trade on most-favoured-nation basis is one of the most robust conclusions to come out of the study of economics in the past two hundred years. (Wonnacott and Lutz, 1989, p. 60)

However, the same GATT included several exceptions to MFN, most importantly with respect to PTAs through its Article 24 on the grounds that international trade liberalisation has been pursued by both multilateral trade negotiations and PTAs. By permitting contracting parties to form FTAs and CUs under certain conditions, this Article gave a legal status to such agreements, which are by definition discriminatory since trade concessions are granted only to members. The insertion of these inherently discriminatory agreements within the international trading system by the GATT itself has been a major issue of discussion over the decades and, therefore, the question of regionalism has emerged as a long-standing issue in international trading system as to whether it undermines or underpins multilateralism.

During the period from the late 1950s through the 1970s, although a number of PTAs existed among developing countries as well as in Western Europe, effective ones were confined to the European Community (EC) and the European Free Trade Area (EFTA). Additionally, trade preferences by developed to developing countries remained limited. This limited role for PTAs together with the strong United States (US) commitment to the multilateral process as a leader meant that the architects of the global trading system did not have to fear that regional arrangements might undermine the multilateral process of trade liberalisation. Indeed, trade barriers were reduced through seven rounds of multilateral trade negotiations over three decades under the auspices of the GATT.

However, winds started to change direction during the second half of the 1980s due to the fact that the US abdicated its avoidance of the Article 24-sanctioned PTAs as a result of the fear of a failure of the Uruguay Round (UR) trade negotiations. The large trade deficits along with the expected emergence of the European Union (EU) as a 'fortress' after the Single European Act (SEA) led to the search for liberalisation at regional level such as the conclusion of the Canada-US Free Trade Agreement (CUSFTA) in 1989 and the North Atlantic Free Trade Area (NAFTA) in 1992. Although the UR was concluded successfully in 1994, the apparent success of bilateral negotiations and the preferential access they

brought have changed the dynamics of the trade liberalisation process. The US has decided to follow multilateral and preferential trade objectives simultaneously. The shift of the US attitude from being a strong supporter of multilateralism to acting as an eager participant in regionalism, together with the economic, political and other motivations, has led to a proliferation of PTAs around the world. Also, the EU has contributed to this proliferation to a large extent by deepening through the SEA and by concluding, with a regionalist approach, numerous forms of association agreements (“hub-and-spoke” agreements).

In spite of the successful conclusion of the UR and the establishment of the WTO, which to some extent restore confidence of the world trading system, the appeal of regionalism shows no signs of abatement. Over the 265 PTAs that were notified to the GATT/WTO by May 2003, 138 were notified after the WTO was created in January 1995<sup>2</sup>. It is reported by the WTO that virtually all its members are signatories to one or more PTAs. By July 2003, only three WTO members, Macau China, Mongolia and Chinese Taipei, were not party to a PTA. Over 190 PTAs are currently in force, and an additional 60 are estimated to be operational although not yet notified. 43 per cent of world merchandise trade now occurs under the umbrella of those PTAs. By the end of 2005, if the PTAs reportedly planned or already under negotiation are to be concluded, the total number of PTAs in force might well approach to 300 and over 50 per cent of world merchandise trade will then occur among countries linked by preferential agreements. In such an international trade environment experiencing a contradictory symbiosis of the inherently discriminatory regionalism and non-discriminatory multilateralism, the proliferation of PTAs this time has led to legitimate fears that they may undermine the multilateral process of trade liberalisation.

Contrary to the previous period, which is called ‘first regionalism’ or ‘old regionalism’, the current rise of regionalism, which is called ‘second regionalism’ or ‘new regionalism’ and, which has been continuing since the second half of the 1980s, will likely last, even by gaining more strength, given its features and underlying reasons. PTAs are here to stay. Regionalism in the form of PTAs is a fact and a quite influential phenomenon of the international trading system, which cannot be denied and should not be underestimated given its far-reaching implications in terms of static and dynamic time-path effects. Taking

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<sup>2</sup> For the list of the PTAs notified to the GATT/WTO, please see Annex I.

into consideration their political charm and spread, and acknowledging their conflicting nature with multilateralism, it is important to contain and structure PTAs so that they become useful instead of harmful for global trade and consistent with the objectives of arriving at a multilateral free trade for all.

In the light of these findings, the concern of this thesis with increased regionalism is related to its implications for multilateralism: whether regionalism undermines or underpins multilateral trading system. Implications of regionalism for multilateral trading system are analysed in the thesis by distinguishing between static effects of regionalism on non-members' welfare and its dynamic time-path effects toward worldwide non-discriminatory trade liberalisation. The thesis is concerned with static welfare effects of regionalism in terms of how preferential trade arrangements affect welfare of *non-members*. With respect to dynamic time-path effects of regionalism it deals with, firstly, whether regionalism will lead to non-discriminatory multilateral free trade for all through continued expansion of the regional blocs until universal free trade is reached, or will fragment the world economy, and secondly whether the formation or enlargement of PTAs hinder or advance further multilateral trade liberalisation. Besides the awareness of the thesis regarding the importance of adverse effects of regionalism on multilateralism in dynamic time-path sense, adverse static effects of regionalism (trade diversion effects) on non-members occupy a central place in the thesis with respect to finding a solution.

According to the orthodox approach presented by Viner and others, static analysis of a PTA refers to its welfare implications on the world as whole and depends on the judgement whether it is "net trade creating" or "net trade diverting". If the trade creation resulting from the elimination of internal barriers outweighs the trade diversion arising from discriminatory treatment in favour of members, then the PTA is "welfare-increasing" for both its members and the world as a whole. If the latter outweighs the former, then the PTA is "welfare-decreasing" and, therefore, undesirable. In other words, in this approach, the existence of trade diversion *per se* does not lead to concerns regarding whether the PTA is a benign or harmful phenomenon for the world welfare since the aim is to ensure that trade creation exceeds trade diversion.



However, different from Viner's approach, this thesis evaluates the static effects of PTAs in terms of non-members' welfare instead of world welfare as a whole. Since welfare effects of PTAs are taken into consideration from the non-members' point of view, approach of the thesis renders the size of any trade creation irrelevant and any trade diversion detrimental and, thus, undesirable regardless whether the trade creation outweighs the trade diversion. In other words, even if a PTA is net trade creating and, thus, is welfare enhancing in terms of both members and the world as a whole, it is treated in this thesis harmful in terms of non-members due to the existence of trade diversion effect.

In accordance with the focus of the thesis -the detrimental effect of regionalism on non-members' welfare, which is trade diversion-, its objective is to structure PTAs so as to avoid harming non-members in particular and the global trade in general. The way, which is proposed in the thesis to reach this objective, is designing international laws -in this case the relevant GATT/WTO rules- with a view to containing trade diversion. The address for this proposal is firstly Article 24 and secondly GATT disciplines governing unfair capture of fair trade measures -the UR Agreement on Anti-Dumping Measures and the UR Agreement on Technical Barriers to Trade-. In other words, ensuring the aim of making PTAs more open requires relevant changes in the multilateral framework.

Article 24, which was incorporated into the GATT as the major rule on CUs and FTAs, reflects the GATT drafters' will to provide for such arrangements. However, the GATT drafters allowed such discriminatory and -therefore- contradictory arrangements through Article 24 on the conditions that the trade interests of non-members are respected and such arrangements are compatible with a rule-based world trading system. Therefore, Article 24 envisages a number of requirements for those agreements to be established. Among them, the requirement of "no raising of barriers to trade" as directly related to the interests of non-members is the subject of reference and criticism of the thesis in making a sufficient proposal so as to avoid harmful effects of PTAs on non-members.

Although Article 24 was drafted before the surge of the theoretical literature of the 1950's and 1960's on the welfare effects of PTAs, the above-mentioned requirement was designed with a view to working toward decreasing trade diversion just as the "substantially all trade" requirement was designed with the aim of increasing trade creation. However, it is

not adequate to be able to ensure trade diversion minimisation: it is evident that the Article 24's injunction "not to raise the average external tariff", that is, maintaining external tariff unchanged as it was at its pre-integration level, may not minimise trade diversion although it was designed with this aim. In other words, as argued in this thesis, Article 24 in general and this requirement in particular do not succeed in protecting outside countries' welfare interests. Even if a PTA is consistent with the requirement, it may still generate a considerable trade diversion and, thus, it is still possible for it to be harmful to the non-members as contrary to the intention of this requirement's inclusion.

Therefore, the Article 24's design is inadequate for the aim of avoiding harmful effects of PTAs on non-members; its redesign in this respect is a necessity. With a view to eliminating inadequacy of Article 24 in terms of avoiding trade diversion effect, the necessity of "not lowering prior trade volumes with the non-members" should be the basis of the way to redesign Article 24. Accordingly, the proposal of the fourth chapter of the thesis to redesign Article 24 draws on Kemp-Vanek theorem, which says that it is always possible for a PTA to be structured in such a way as to create gains for the member countries without harming any non-members by keeping trade volumes with the rest of the world at their pre-integration levels. The aim of keeping trade volumes with the rest of the world at their pre-integration levels necessitates "a considerable reduction" in previously imposed external tariffs. The lower the external barriers are, the less the scope for trade diversion is. Therefore, a satisfactory and desirable discipline for Article 24 to be imposed on PTAs would be the requirement of "simultaneous and considerable reduction of the external barriers with the progressive elimination of internal trade barriers".

However, this requirement seems contradictory with the policy of import substitution that generally depends on imposing high tariffs on imports. At first sight, it is perceived that this requirement for preventing harm to the non-members' welfare jeopardises reaching the industrialisation objective pursued by member developing countries. Actually, the developing countries can still pursue import-substitution strategy led by the development concerns while meeting the requirement. The argument of "necessarily welfare-enhancing customs unions with industrialisation constraints" by Krishna and Bhagwati is proposed to provide that any subset of countries can always form a welfare-enhancing CU without harming non-members' welfare, while ensuring that they can maintain the degree of

industrialisation that they had achieved through protective tariffs. The proposed solution involves a Kemp-Wan customs union complemented by *production tax-cum-subsidies* - instead of protective external tariffs- to achieve the non-economic objectives of member states as indicated by the theory of optimal intervention in the presence of non-economic objectives.

Just the redesigning of Article 24 -as to impose the requirement of “simultaneous and considerable reduction of the external barriers with the progressive elimination of internal trade barriers”- may not be sufficient in order to avoid harming the rest of the world. GATT disciplines governing unfair capture of fair trade measures like intensively used Anti-Dumping (AD) actions and fast raising standards relating to health and environment should also be improved. In accordance with this necessity, the solution proposed in this thesis includes redesigning not only Article 24, but also the other relevant GATT disciplines so as to avoid trade diversion effect on non-members.

This thesis examines what form of PTAs are non-trade diverting and as such unambiguously not harmful for non-members’ welfare, and reaches to the conclusion that the PTAs which keep trade volumes with the rest of the world at their pre-integration levels, do not lead to detrimental welfare effects on non-members. While it is directly concerned with non-members’ interests in static welfare sense, it indirectly addresses the interests of members too. What is good for non-members’ welfare is necessarily good for members’ but the reverse may not be true. Therefore, the thesis is inclusive rather than exclusive in terms of the solution that it proposes.

The analysis of the effects of increased regionalism on international trading system would be seriously incomplete if, having analysed the static effects, dynamic time-path questions were not analysed. The issue of PTA’s effects on international trading system does not only relate to whether a PTA is non-trade diverting, that is benign, or trade diverting, that is harmful for the rest of the world; but also relates to whether the dynamic time-path effects of the PTA are to accelerate (‘building blocks’) or decelerate (‘stumbling blocks’) the continued reduction of trade barriers toward the goal of reducing them worldwide.



Regarding its dynamic time-path effects, regionalism is more likely to be stumbling blocks toward worldwide non-discriminatory trade liberalisation. By proposing a reform of the relevant GATT rules in accordance with the direct purpose of containing detrimental welfare effects of regionalism on the rest of the world, this thesis indirectly aims at a benign regionalism (building blocks) in terms of its dynamic time-path effects too. In other words, this proposal, which focuses on the interests of non-members, is inclusive not only in terms of members' interests in static welfare sense but also in terms of multilateral trading system in dynamic time-path sense.

The EU as one of the key players in the multilateral trading system should take initiative to reform the relevant GATT/WTO disciplines so as to prevent the adverse welfare effects of PTAs on non-members. In spite of its multitude of PTAs with non-member countries and its protectionist practices, its recently rising trade liberalising outlook and its interests as a non-member of the other PTAs elsewhere in the world would help the EU to take this initiative. The new round of multilateral trade negotiations could have been an opportunity to reform the relevant disciplines, which failed to contain the formation and proliferation of PTAs and, therefore, to prevent them from harming non-members. But, this opportunity has been missed since the Doha Development Agenda (DDA) includes redefining of Article 24 so as to make its wording more precise in the light of interpretation concerns, instead of its redesigning so as to efficiently prevent harmful effects of PTAs on non-members' welfare. The EU should lead to incorporate a more radical reform of Article 24 and other relevant GATT/WTO disciplines into the agenda of the future reform and liberalisation efforts.

More urgently, the last (Cancun) Ministerial Conference of the WTO in September 2003 failed to proceed the Doha Development Round (DDR) of multilateral trade negotiations. Revival and successful conclusion of the DDR is critical to have a more liberal and strengthened multilateral trading system. An open and strong multilateral trading system with adequate rules to contain adverse welfare effects of the regionalism on the non-members is the best guarantee against the threat of proliferation of regionalism, which is considered in this thesis as harmful both in static sense (trade diversionary) and dynamic time-path sense (stumbling blocs). Otherwise, the world trading system might get even more fragmented due to the enduring tendency towards regionalism in the absence of a

credible and strong multilateralism, and the future of the multilateral trading system might be jeopardised. The future of the system heavily depends on how the key players in the WTO decide to respond to the last breakdown in the DDR negotiations. This situation poses an immediate necessity for the EU to take the control in the absence of an effective American leadership. Therefore, it is proposed in this thesis that the EU should be *a leader* replacing the US in support of a more strengthened and a more liberal multilateral trading system particularly in such a period experiencing a thorny multilateral trade round.

### **The Content of the Thesis**

The first chapter constitutes the basis of the arguments of the thesis by putting forward the fundamental facts: Firstly, multilateralism not only permits the regionalism that is inherently contradictory to its basic principle -MFN-, but also is unsuccessful in ensuring adequate mechanisms with a view to containing the adverse effects of regionalism on the other participants of multilateralism. Secondly, the current proliferation of regionalism is strong enough and invulnerable to endure as opposed to the previous wave of regionalism.

This chapter examines the contradictory co-existence of regionalism and multilateralism in the international trading system mainly in two parts: in the first part, the relation of multilateralism with regionalism is analysed by focusing on the issues that why regional and multilateral way of trade liberalisation are contradictory to each other; under which mechanism and how multilateralism allows regionalism that is -by definition- conflicting with its main principle; and whether this mechanism is adequate or not to contain adverse effects of regionalism on the rest of the multilateral trading system. In the second part, the evolution of regionalism in the post-war period from its unsuccessful experience to successful one in terms of its stamina is studied by making a comparison between the current wave of regionalism and the previous one and by studying the underlying motivations behind the increased regionalism.

The second chapter sets the theoretical framework, in which the arguments and the proposals of the thesis are built. The theory of PTAs or, in policy terms, the GATT Article 24 sanctioned FTAs and CUs have undergone two phases of evolution in two very different modes. These two phases of evolution largely reflect the contrasting policy

concerns of the time. On the one hand, the Vinerian analysis concerning PTAs in the First Regionalism dealt with the “static” questions concerning the welfare effects of unions with defined membership. On the other hand, the Second Regionalism has been preoccupied with what Bhagwati (1992) has described as the “dynamic” time-path question. In the analysis of the success of the Second Regionalism and the continuing proliferation of PTAs, the old concerns about *trade diversion* have revived.

This chapter studies three alternative theoretical approaches to the static implications of PTAs: The traditional welfare analysis of PTAs was made by Viner (1950) who divided their immediate (static) impacts on world welfare into two as ‘trade creation effect’ and ‘trade diversion effect’. The prime interest of the Vinerian analysis is in assessing the net impact of a CU compared with the pre-union situation, and it concludes that confident judgement cannot be made for CU in general and in the abstract, but must be confined to particular projects. However, the Kemp-Wan approach, by fixing the initial extra-union trade flows and letting the external tariffs adjust endogenously proposes that neither the union as a whole nor the rest of the world can lose from a PTA. While the Vinerian approach considers the welfare effects of forming arbitrarily specified PTAs, the Kemp-Wan approach envisages the sensible formation of PTAs to achieve Pareto-superior, or Pareto-better, outcome. The proposal, which is put forward in the fourth chapter, is built on this theoretical approach since the focus of the thesis is the “welfare interests of non-members”.

The third approach, which was formulated by Cooper, Massell, Johnson and Bhagwati, relates to forming a CU between the developing countries to minimise the cost of import substitution type of industrialisation by exploiting *scale economies* through preferential opening of markets with one another and therefore through enlargement of the market supplied. In this section, the argument of “necessarily welfare-enhancing customs unions with industrialisation constraints” by Krishna and Bhagwati is taken up to consolidate the third approach in accordance with the focus of the thesis. The CUs that are harmless to the non-members’ welfare can be guaranteed even if members are constrained by specific non-economic government objectives. As would be expected from the insights of both the Kemp-Wan theorem and the theory of non-economic objectives, Cooper-Massell-Johnson-Bhagwati union that are harmless to the non-members’ welfare requires both an

appropriate common tariff and an appropriate domestic *production tax-cum-subsidy* addressed to the non-economic objective desired. Therefore, the argument of Krishna and Bhagwati is a version of the Kemp-Wan theorem with an added policy instrument thrown in to reach the targeted degree of member country industrialisation.

With respect to the theoretical framework of the dynamic time-path effects of PTAs, just as the key concepts of ‘trade creation’ and ‘trade diversion’ were introduced by Viner (1950), Bhagwati (1991, p. 77) introduced the key concepts in the dynamic time-path case of PTAs acting as ‘stumbling blocks’ or ‘building blocks’ toward worldwide non-discriminatory trade liberalisation. The PTAs that, in a dynamic time-path sense, contribute to the multilateral freeing of trade either by progressively adding new members or by prompting accelerated multilateral trade negotiations are *building blocks* toward the multilateral freeing of trade. However, the PTAs that do the opposite are *stumbling blocks* to the goal of worldwide, multilateral freeing of trade.

In the third chapter, a discourse analysis is applied regarding firstly the debate on ‘trade diversion effect’ in accordance with the focus of the thesis on non-members’ welfare interests and secondly ‘building blocks versus stumbling blocks’ debate. There is considerable disagreement on these debates. Some international economists like Bhagwati (1995) have concluded that preferential trade arrangements undermine the open multilateral trading system and should be severely circumscribed, if not forbidden, under the WTO. Others argue that such arrangements are a step towards multilateral liberalisation (non-discriminatory multilateral free trade for all) and inherently underpin the WTO and international trading system. The aim of the third chapter is to have a clear answer as to the question “whether the proliferation of PTAs is benign or harmful for multilateral trading system in terms of its static and dynamic time-path effects”. The negative conclusion of this discourse analysis leads the thesis to propose an alternative solution with the purpose of containing the negative effects of the increased regionalism on non-members.

The fourth chapter elaborates a proposal to avoid the detrimental effects of regionalism on non-members’ welfare after evaluating some alternative suggestions. Since, welfare interests of non-members are its primary concern, aiming at avoiding trade diversion effect

has priority over the other issues for the thesis to make regionalism a benign phenomenon for the other participants of the multilateral trading system in particular and for the system in general. The argument, which this proposal depends on, is Kemp-Vanek admissibility. It says that external tariff of the newly formed or the enlarged PTAs should be determined so that import demands and export supplies will be exactly at their pre-integration levels. In other words, an arrangement would be admissible and, therefore, harmful effects to the rest of the world can be avoided only if the external tariffs on the potentially trade-diverted goods were considerably reduced simultaneously with the internal tariff reduction.

However, the Kemp-Vanek model as a theoretical approach may not have any relevance for real world. In order to make Kemp-Vanek model a good description of how harmless integration occurs in practice, it is essential to redesign the inadequate GATT disciplines so as to ensure avoiding of harmful effects of the PTAs for the international trade. A satisfactory and desirable discipline for Article 24 to be imposed on PTAs would be the requirement of reducing the external tariffs -simultaneously with the progressive elimination of internal tariffs- to the extent that it secures the same level of external trade volumes as the pre-integration level. In addition to Article 24, which is directly governing the issue of PTA, redesigning of the indirect but equally relevant disciplines governing unfair capture of fair trade measures like AD actions and standards in accordance with the argument is necessary for a sufficient avoidance of injury to the rest of the world.

A case study, which addresses the EU as the most developed and the most influential regional arrangement with its far-reaching implications for the rest of the world and multilateral trade liberalisation, takes place in the last chapter. In accordance with the context of the thesis, the effects of the EU on the multilateral trading system are examined in this chapter in static and dynamic time-path senses. In the static sense, since the thesis focused on the effects of the PTAs on non-members' welfare, the EU is analysed from the perspective of its effects on non-EU countries. When it comes to the third countries, the main subjects to be addressed are tariffs, some other frequently used trade policy measures which can easily be used as effective protective tools at the expense of the non-members, and of course the Common Agricultural Policy. Besides these matters, trade agreements with the third countries (including accession treaties as the highest level of preferential



trade patterns) are also matters of concern in terms of non-members' welfare in static sense.

This chapter acknowledges as given the notion of the thesis that the simplest ground for fearing that PTA will have a protectionist effect is the analysis of trade diversion, which implies an automatically negative effect on the rest of the world from the formation of a bloc, even if the bloc does not have higher external trade barriers on average than did its constituent members. That is why the protectionist practices of the EU against non-EU countries are analysed in this chapter.

With respect to dynamic time-path effects of the EU, firstly its enlargements are under consideration. Whether the EU as an expanding regional bloc can lead to global free trade through its enlargements, or in other words, whether the EU will continue to enlarge until leading to global free trade is discussed in this chapter. Secondly, the effects of the EU on the multilateral trade liberalisation as an important participant since the beginning of the integration process are examined.

In the concluding part of the chapter, the EU is proposed as an *emerging leader* in support of the multilateral trading system in the absence of an influential American leadership. The immediate necessity -for an effective leadership- posed by the failure of the last (Cancun) Ministerial Conference of the WTO in September 2003 to proceed the Doha Round of multilateral trade negotiations has led to searching, in this chapter, whether the EU can be an appropriate alternative to the strong need of leadership for the successful conclusion of the Multilateral Trade Negotiations (MTNs).

Firstly, the facts necessitate that the EU should lead the MTNs are put forward and whether the EU has the capacity and the willingness necessary to provide effective exercise of WTO leadership is examined. Secondly, obstacles before the EU to take on the WTO leadership are taken up. These obstacles mainly are diversion of its concentration in favour of its intensive internal agenda and its enlargement process; the difficulty regarding reaching and maintaining common position in MTNs as well as its discriminatory trade policies arising from its simultaneous pursuing of preferential trade policy. Lastly, it is concluded that the EU is a feasible alternative having the capacity and the willingness to

provide effective exercise of WTO leadership in view of the switch to a more liberal trade understanding and an increase in European commitment to multilateralism. This conclusion is supported by the EU's increased absolute economic size through several enlargements and its relative economic size vis-à-vis all partners individually and, even vis-à-vis groups of them.

## **Definitions**

Three key terms are used frequently in the thesis: 'Preferential Trade Agreement or Arrangement (PTA)', 'Free Trade Area (FTA)', and 'Customs Union (CU)'. A *PTA* refers to a union between two or more countries, in which lower tariffs are imposed on goods produced in the member countries than on goods produced in the non-members. An *FTA* is a *PTA*, in which member countries do not impose any trade barriers on goods produced within the union but do so on those produced outside the union. A *CU* is an *FTA*, in which all members apply a common external tariff (CET) on a good imported from outside countries. The CET can differ across goods but not across union partners. The term *PTA* being wider, it is used to include the arrangements with limited tariff preferences, that is, *FTAs* and *CUs*.

The thesis does not distinguish between *CUs* and *FTAs* in spite of keeping in mind the difference between them. They are, with an integrated approach, referred as the Article 24-sanctioned *PTAs* or just *PTAs* or regional arrangements. However, in the fourth chapter, *CUs* -as different from *FTAs*- are proposed as preferable to the latter to have benign *PTAs* for specifically non-members and generally international trading system.

*Regionalism* or *Regional Trading Agreements (Arrangements)* refers to *PTAs* defined by a geographic region when strictly speaking. Since it is evident that most of the *PTAs* around the world have a regional character, the term 'regionalism' is used in this thesis in its broad definition: It broadly refers to *PTAs* among a subset of nations.

The concern of the thesis is only with the literature on preferential liberalisation of trade barriers on *goods*. Thus, the issues such as preferential trade in services, the role of investment in regional arrangements, or harmonisation of domestic policies are excluded.

Although these issues do take part in shaping the current policy debate, they have not been seriously addressed in the theoretical literature.





## **CHAPTER 1. MULTILATERALISM AND REGIONALISM**

The most prominent and controversial feature of the international trading system is the co-existence of multilateralism and regionalism that are, by their nature, in contention with each other. This chapter examines this contradictory co-existence mainly in two parts: in the first part, the relation of multilateralism with regionalism is analysed. In the second part, the evolution of regionalism in the post-war period from its unsuccessful experience to successful one in terms of its stamina is studied.

While the GATT/WTO-based multilateral trading system depends on the principle of non-discrimination, regional trading arrangements are, by definition, discriminatory and, therefore, contradictory to the multilateral system. However, GATT as a regulatory agency of the multilateral trading system permits the formation of those conflicting arrangements under certain conditions through its own mechanisms and, thus, itself leads to this contradictory co-existence. It not only tolerates regionalism that is inherently contradictory to its basic principle -MFN-, but also is unsuccessful in ensuring adequate mechanisms with a view to containing the adverse effects of regionalism on the rest of the multilateral trading system.

The direct GATT mechanism, which exempts regional trading agreements from the MFN principle under certain conditions, is Article 24. Due to its loose requirement regarding “no raising of barriers to trade with non-members”, regional trading arrangements that are detrimental for non-members’ welfare could not be controlled. In view of the poor design of Article 24, the chapter, in the first part, concludes that redesign of the article is a need in order to avoid adverse welfare effects of regionalism on the other participants of multilateralism.

Taking into consideration the features and the underlying motivations of the current wave of regionalism as studied in the second part, this chapter also concludes that the new regionalism seems strong and invulnerable to endure as opposed to the previous wave of regionalism. The current regionalism is most likely to continue to proliferate -probably by leading to detrimental effects on the rest of the world and on the multilateral trading system- under the facilitating, rather than containing multilateral rules unless a sufficient

redesign of these rules becomes a priority agenda item for the multilateral trade negotiations.

## **1. 1. MULTILATERAL TRADING SYSTEM AND ITS RELATION WITH REGIONAL TRADING ARRANGEMENTS**

### **1. 1. 1. Multilateral Trading System from the GATT to the WTO**

Although international trading system does not only mean the GATT/WTO regime, in the centre of the system “multilateralism”, which refers to the GATT rounds of negotiations and the WTO, takes place. The severity of the Great Depression and the disastrous results of discriminatory bilateralism to undo unilateral protectionism during the inter-war period strengthened the determination of policy makers to limit the extent of governmental intervention in international trade. Therefore, such arbitrary history and structure of trade policy formed by both unilateral protectionism and discriminatory bilateralism prior to World War II led to the formation of the GATT after the war.

None of the countries participating in the drafting of the GATT had anticipated that it would emerge as the central international trade institution of the post-war period. Actually, a much greater and institutionalised world trading organisation, which was to be called the International Trade Organisation (ITO), had been planned<sup>3</sup>. The GATT emerged from the negotiations to create ITO. It was signed in Geneva on October 30, 1947 by representatives from 23 countries to implement some mutual tariff reductions before the ITO negotiations concluded<sup>4</sup>. The Agreement, which would have been terminated as a provisional agency if the ITO had been established, was the only concrete result of the negotiations on the post-World War II trading system because the ITO never came into being. When the ITO

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<sup>3</sup> During the Second World War Anglo-American co-operation and deliberations concerning the post-war economic order led to the 1944 Bretton Woods Conference that established the institutional framework for that order. Bretton Woods designed an institutional infrastructure formulated on three international organisations to establish a stable international system: the International Monetary Fund (IMF) for macro-economic stability, the World Bank for the developing countries and the International Trade Organisation (ITO) for trade.

<sup>4</sup> Since the contracting countries were anxious that the implementation of mutual tariff reductions not be conditional upon the conclusion of the ITO talks, the GATT was created as an interim trade agreement. In order to assure that the agreed trade reductions would not be weakened by other trade measures and to provide a multilateral framework for bilaterally negotiated trade agreements, commercial policy provisions of the Draft ITO agreement were incorporated in the GATT. But it still lacked an institutional structure.

Charter was not ratified by the US Congress in 1950, the ITO was effectively dead and the GATT became the founding document for an international institution and the principal institution for commercial policy and international trade regulation. It assumed the commercial-policy role that had been assigned to the ITO and its articles became the basis for the international trading system. The original goal was not achieved, but by historical accident the GATT with a more flexible structure survived to provide the basis for post-war international trade law.

The GATT meant the beginning of a period of increasing multilateralism in international trade, and the US adherence to an open multilateral trading system became a key underpinning for the post-war international economic architecture. A global rule-based trading system was formulated on the basis of the Agreement and it can be said that the GATT has had a profound and beneficial influence on the more liberal global trading system. It aims to promote a non-discriminatory, open and undistorted market in which only prices and tariffs determine comparative advantage. As the preamble to the Agreement makes explicitly clear, its main objective is to liberalise trade and open up markets through an overall reduction of trade barriers (GATT, 1992a, p. 1).

The GATT significantly contributed to the liberalisation of international trade through a series of major negotiations called “Rounds” which are instrumental to the GATT process of reducing tariffs. Since the inception of the GATT trading system, there have been eight rounds of trade negotiations. These are successively Establishment (Geneva) Round (1947), Annecy Round (1949), Torquay Round (1950-51), Geneva Round (1956), Dillon Round (1960-62), Kennedy Round (1963-67), Tokyo Round (1973-79) and lastly the Uruguay Round (1986-1994). As a result of the first seven multilateral trade rounds, tariff levels fell from approximately 40% in 1948 to 5% in the 80s. This big reduction in tariffs was accompanied by a substantial growth of free trade and income for not only but mainly the developed countries. Additionally, the volume of world trade multiplied nine times between 1946 and 1985. Trade grew more rapidly than world output and income in the post-war period. (Gibb, 1994, p. 13)

Owing to the last GATT round, which was the most ambitious round of all multilateral trade negotiations ever agreed under the auspices of the GATT, tariffs on manufactures are

on average 40% lower than the previous GATT Round. That is, tariff levels have fallen to approximately 3%. The UR has been appreciated because of its achievements in market liberalisation, strengthening of rules and institutions and extension of multilateral disciplines to new areas like government procurement, Trade Related Aspects of Intellectual Property rights (TRIPs), and Trade Related Investment Measures (TRIMs). Negotiations went beyond the issue of tariffs, which had preoccupied previous ones. In other words, non-tariff barriers like technical standards, and sectors other than manufacturing as agriculture and services were on the agenda. (Van Dijk, 1996, p. 3)

Among the others, reaching a formal agreement to inaugurate the WTO on 1 January 1995 was the most substantial institutional development provided by the UR. As a single institutional framework, the WTO covers all of GATT with agreements and arrangements concluded under its auspices and the complete results of the UR. It is an international organisation that administers multilateral agreements pertaining to trade in goods (GATT), trade in services (GATS), TRIPs and TRIMs. Thus, the world trading system has had a stronger institutional structure through the WTO. The GATT was formally an intergovernmental agreement that had provisions concerning the regulation and liberalisation of international trade. Since, it was not an international organisation which is a legal entity in its own right, it lacked an institutional structure for example to settle the disputes between the contracting parties and its sphere of influence was narrower than its successor.

The world trading system has been developing in the framework of the merits and principles of the GATT since 1947. The GATT has provided a consensual framework of rules and procedures for the efficient conduct of international trade. That is, it has served as a regime of international trading system for its regulation and liberalisation and gained organisational structure gradually. Over more than four decades of its existence, the GATT regime evolved into a *de facto* world trade organisation. The WTO has just institutionalised this regime and enhanced its sphere of influence. Therefore, it has provided a *de jure* and institutionally strengthened international organisation for the international trading regime. The GATT and its spirit still exist and the world trading system depends on its principles and rules. By the world trading regime if we mean institutional structure and international organisation then we refer to the “WTO”, but if we

mean the principles and the rules of the regime then we refer to the “GATT”. Thus, the most suitable concept to call current multilateral trading regime as a whole might be “the GATT/WTO regime”.

Currently, the WTO has 147 members and it is open to new memberships provided that its membership criteria are met<sup>5</sup>. However, as Bhagwati (1992, p. 536 in footnotes) underlined, it still falls short of total universalism since it does not include all the countries in the world. Therefore, GATT’s MFN is universal only for its members and there are still non-members that might be affected negatively from being non-member. But it should be noted that since it is open to membership to all countries who meet the admission criteria, it has generally been inclusive rather than exclusive.

The GATT has two main indispensable principles which were identified in its preamble: The first one is the principle of “non-discrimination”, which implies the extension of Most Favoured Nation treatment to all GATT contracting parties and national treatment of all foreign goods coming from the GATT signatories once they have passed through customs; and the second one is the principle of “reciprocity”, which means balanced and mutual concessions and acceptance of new disciplines<sup>6</sup>. These guiding principles, being the method for achieving progressive movement toward free trade, were adopted as the *modus operandi* of the GATT. In other words, the GATT regime has depended on these main pillars for the regulation and liberalisation of the international trading system. This would prevent the aggressive use of power to gain either unrequited trade concessions or acceptance of new disciplines, hence protecting the weak against the strong.

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<sup>5</sup> For the list of 147 WTO members and observers, please see Annex II.

<sup>6</sup> In addition to these main pillars, a “fix rule” trading regime is accepted under the GATT. The GATT’s objectives of the regulation and liberalisation of world trade can be achieved most effectively through what Bhagwati (1990b, p. 150) has called a “fix rule” trading regime. Deardorff and Stern (1994, p. 31) defined it as a regime where trade is guided by a set of rules administering access to markets. In other words, a fix rule trading regime depends on the rules that permit markets to function in such a way that the actions of private transactions will serve to expand economic efficiency and welfare. This regime is different from a “fix quantity” trading regime in which trade is managed more directly by government authority establishing quantitative targets for trade without necessarily regard to the effects that managed trade may have on efficiency and welfare. Bhagwati pointed out that a “fix rule” trading regime is to be preferred to a “fix quantity” one. The latter, that is “managed trade” or “results-oriented” trade which seeks quantitative targets of outcomes in trade instead of settling on rules, is to be rejected.



As a principle of non-discrimination, the MFN treatment is the main explanation of the contradictory relation between regional trading arrangements and multilateral trading system that this thesis depends on. Therefore, it is crucial to understand the MFN principle as the cornerstone of the GATT/WTO system and its conflicting relevance with regional trading arrangements before examining Article 24 regulating exemption for PTAs from this principle.

### **1. 1. 2. Most-Favoured-Nation Principle of the GATT<sup>7</sup> and Regional Trading Arrangements**

As Pomfret (1997, p. 71) underlined, the negotiations that led to the GATT were heavily influenced and guided by the inter-war experience. Restrictive commercial policies and discriminatory bilateralism were seen as the contributors to the economic depression of the 1930s and to the outbreak of the war. All these perceptions led to a strong tendency by the major powers to form a post-war international economic order based on a “liberal non-discriminatory” trading system. Therefore, the MFN principle is adopted as the cornerstone of the GATT and stipulated by the very first Article of the Agreement which explains the meaning behind the principle and requires that:

... any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.  
(GATT, 1986, p. 2)

Therefore, Article 1 states that no country shall confer any special privilege, concession, advantage, favour or immunity to another country at the expense of the others or discriminate against it in favour of the others. In other words, The MFN clause stipulated by Article 1 requires that any contracting party cannot treat the trade of any other country - whether it is a contracting party to the GATT or not- more favourably than any other

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<sup>7</sup> As Gibb (1994, p. 15) stated, the MFN principle is consolidated by Article 3 of the GATT, which stipulates the “national treatment” clause. This clause requires national treatment of all foreign goods once they have passed through customs. Therefore, the importing country has to apply the same internal tax rules as it applies to its domestic goods to imported goods that are exported from a contracting country to another. In other words, foreign goods from contracting parties must not be liable to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic goods. National Treatment rule together with the MFN status constitute the constituent parts of the non-discrimination principle of the GATT/WTO system.

contracting party. All of the contracting parties are treated on an equal basis and share the benefits and costs of any change in trade barriers. Therefore, international trade must be conducted on the basis of non-discrimination.

The MFN clause neither is peculiar to nor came into being with the GATT system. In fact, as stated by J. H. Jackson (cited in Snape, 1993, p. 274), MFN clauses have at least a seven-hundred-year history in trade agreements. However, they have been particularly important in the last two centuries with a view to preventing retaliatory trade policies<sup>8</sup>. The extension of the MFN treatment “unconditionally” to all of the signatories is the backbone to the GATT<sup>9</sup>. While in the GATT system contracting parties are committed to the principle on multilateral basis, before the GATT, MFN clauses took place in bilateral (or plurilateral) agreements. Thus, incorporating unconditional MFN into a multilateral framework was the major innovation and contribution of the GATT.

As mentioned earlier, one of the main post-World War II objectives of the US was the removal of trade preferences, especially the Commonwealth system and therefore to establish an unconditionally non-discriminatory trading system without any exception. But unfortunately throughout the meetings it was understood that existing preferences would be exempted from MFN. Despite Anglo-American agreement on the principle of non-discrimination, British Imperial Preferences were the main disputed area and a stumbling block during the negotiations. As a result of British insistence, a “grandfather” clause permitting continuation of existing preferential arrangements was included into the GATT. Although the US was against continuation of the existing preferential arrangements due to potential economic costs to itself from Imperial Preferences in the form of ‘trade diversion’, it was convinced about the incorporation of a grandfather clause in the GATT in return for British agreement not to increase preference margins<sup>10</sup>.

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<sup>8</sup> Jackson (1969, p. 250) pointed out that the MFN clause was culminated in 1860 when it became the common commercial law of the great European Powers. However, the extent of MFN application changed from the narrow confines of tariffs alone to a broader application to other types of barriers. Discriminations and various restrictions existed in spite of MFN. Additionally, one of Wilson’s Fourteen Points in 1918 and the League of Nations Covenant urged the establishment of an equality of trade conditions among all the nations consenting to the Peace in the case of Wilson’s Fourteen Points and among all the members in the case of League of Nations.

<sup>9</sup> In the 19<sup>th</sup> and early 20<sup>th</sup> centuries MFN clauses that extended trade benefits unconditionally were also applied by the European Powers, especially the Great Britain. However, the US attempted to apply the MFN clause conditionally until 1922.

<sup>10</sup> Ironically, this hot issue that had been so emotional during the negotiations for the post-World War II trading system (in the late 1940s), lost its practical significance since British policy became oriented towards Europe, and Commonwealth preferences formally terminated when Britain joined the EC in 1973. Although

MFN treatment provides that the principles of the GATT and the commitments made in the context of rounds are uniformly applied by each country to its trading partners. This contributes to securing and realising the economic benefits of international trade both for importers and exporters. Equal treatment of imports from different origins helps ensure that these are bought from the lowest-cost foreign suppliers. In other words, it reinforces comparative advantage in the world market and minimises the cost of protection at home. MFN requirement to treat all contracting parties equally and therefore to depoliticise trade is a restraint on the attraction to discriminate against imports from particular sources, especially small or politically weak countries. Hence, non-discrimination contributes greatly to the regularity, orderliness and predictability that form the essence of a rule-based international trading order. Resulting multilateral trading system depending on MFN principle has permitted world trade to flourish through increased reliance on comparative rather than political advantage. These merits of the MFN principle in practice constitute a strong case for it. (WTO, 1995a, p. 5)

Since trade concessions granted to one GATT signatory are also to be applied to the trade of all other signatories, regional trading arrangements (bilateral or plurilateral) are, by definition, discriminatory and therefore contradictory to the MFN principle: trade concessions are granted only to partner countries whose preferential access to other members' markets may enable them to displace exporters from non-member countries. In the case of preferential trading arrangement, the MFN principle is not applied and prior concessions granted to third countries may be impaired by the preferences made to the regional trading agreement partners.

Although discrimination in regional arrangements runs counter to the principle of non-discrimination to which commitment is the cornerstone of the multilateral trading system, the GATT permits regional trading arrangements (CUs and FTAs) under certain conditions through Article 24<sup>11</sup>. That is, the General Agreement allows CUs and FTAs as an exception to the general rule of MFN treatment on the condition that certain criteria are met. Therefore, regional trading arrangements are GATT-consistent although they are not

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the grandfather clause had become a dead letter with respect to British Imperial Preferences, it was to provide wedges for undermining the non-discrimination principle during the post-war period. (Pomfret, 1997, pp. 71-73)

<sup>11</sup> For the information about the other GATT/WTO provisions on PTAs, please see Annex IV.



MFN-consistent at all. In other words, they are “GATTable” as Patterson (cited in Gibb, 1994, p. 15) observed.

With the strong case for the MFN principle mentioned above and the resulting commitment to it, the question naturally arises as to why the founders of GATT included provisions permitting CUs and FTAs that are discriminatory by their definition. Dam (1970, p. 274) argued that even the US, which vigorously opposed to preferences, simply because of political (security) considerations accepted the case for CU, in which members would remove their mutual trade barriers and adopt a common trade policy including a common external tariff vis-à-vis non-members. Actually, this was a result of the compromise during the ITO negotiations between the US and the major European countries, which wanted to reconstruct their war-torn economies through a Western European Customs Union. A French proposal, supported by the other European countries like Netherlands and Belgium, was finally included in GATT<sup>12</sup>. This proposal suggested that the formation of regional unions was a positive step that was to be encouraged. In other words, it was adopted to increase freedom of trade by encouraging the development of greater economic unity throughout areas more extensive than those defined by political frontiers. (Curzon, 1965, p. 260)

In addition to the reason of political considerations, a second answer to the question above has been expressed by many like Bhagwati (1990a, p. 1308), de la Torre and Kelly (1992, p. 43) as follows: As distinct from the various forms of *ad hoc* and partial discrimination that were predominant in the inter-war period, *genuine* CUs and FTAs were viewed as compatible with the MFN principle. Removing restrictions on all or most trade means an important step in the direction of performing economic activity with one or more partners on the same basis as between different states of a federal state (like the US) or provinces of a unitary state (like Turkey). In other words, the architects of the GATT recognised that economic integration between a subset of countries has or can have an economic rationale similar to the process of integration within a single sovereign state. Therefore, regional trading agreements do not pose an inherent threat to efforts to promote continued

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<sup>12</sup> This proposal was expanded to also have provisions on free trade areas at the will of certain developing countries. Since in the case of free trade area there is no requirement to adopt common external trade policy that requires more than an agreement on the harmonisation of trade policies, the free trade area model is better suited to the needs of integration among developing countries.

integration on a worldwide basis. That is, the resulting quasi-national status following from such integration in trade would legitimise the exception to the MFN obligation.

Therefore, as long as a regional arrangement brought about the complete elimination of trade barriers within a multination area, it was viewed as a step toward free trade. As a result, the founders of the GATT recognised that such agreements could provide a complementary, practical route to universal free trade where a faster and deeper degree of liberalisation between a subset of countries was reached. This recognition was embodied in Article 24 (4) which states the desirability of promoting trade liberalisation through the closer integration between the economies of the contracting parties to such agreements. Therefore, Article 24 of the GATT allows derogations from the MFN obligation of Article 1 for preferential trading arrangements (free trade areas, customs unions, or interim arrangements leading to either of the formers) under certain conditions.

### **1. 1. 3. The GATT Discipline Regulating Exemption for PTAs from the MFN Principle: Article 24**

Customs unions and free trade areas are permitted exceptions to the main principle of non-discrimination via Article 24<sup>13</sup> since the GATT contracting parties recognised that such agreements have the potential for further economic integration without necessarily adversely affecting the economic interests of non-members countries. Paragraph 4 of Article 24 stipulates the parameters of trade liberalisation:

“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”

Mainly, Article 24, which is the major GATT rule on CUs and FTAs, reflects the GATT drafters’ will to provide for such arrangements. However, it aims that the trading interests of non-member countries are respected and, that such arrangements are compatible with a rules-based world trading system. For that reason, Article 24, while constituting exception to the MFN principle for the formation of CUs and FTAs, envisages a number of

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<sup>13</sup> For the full text of Article, please see Annex III.

conditions which those agreements must meet to be able to be established. Article 24 of the GATT allows CUs and FTAs to exist as long as:

1. such agreements eliminate all tariffs and other trade restrictions on “substantially all” intra-regional exchanges of goods, (in other words, they must cover “substantially all trade” between the members)
2. trade barriers after integration do not rise on the whole against other contracting parties of the GATT
3. any interim agreement leading to a FTA or a CU includes a plan for the formation of such an arrangement “within a reasonable length of time” and
4. they are notified to the GATT that may decide to establish a Working Party to determine if these conditions are satisfied.

Although Article 24 was drafted before the surge of theoretical literature of the 1950’s and 1960’s on preferential trading arrangements, its was designed with the aim of working toward increasing the benefits of trade creation through the requirement of “substantially all trade” and of reducing the disadvantages of trade diversion through “no raising of barriers to trade” requirement:

“Substantially-all-trade” requirement is stipulated in paragraph 8 of Article 24 that defines the characteristics of CUs and FTAs. This paragraph states that members of these kinds of arrangements eliminate tariffs and other restrictive regulations of commerce with respect to substantially all the trade between their constituent customs territories. This condition appears somewhat paradoxical since, *ceteris paribus*, a movement in the direction of 100 percent tariff cuts within a preferential arrangement would be associated with an increase in the probability of losses from trade diversion. Although this requirement enhances the trade creating effect of such arrangement since it supports governments to resist the political pressures to avoid or minimise tariff reductions in inefficient import-competing sectors, its potential trade-diverting feature may offset -or surpass- created trade. Even its trade-diverting feature does not offset created trade and trade creation effect dominates over trade diversion effect, it is still considerably harmful for non-members due to the existence of potentially high level of trade diversion. In this situation, the question rationally arises as to why this requirement was incorporated into Article 24.

This criterion was central in the view of the GATT founders mainly because it ensures the limiting the number of preferential arrangements to those, which have sufficient political support in member countries to cope with protectionist opposition to complete free trade among the partners. It allows regional arrangements only when the parties are really serious about free trade among each other for most products. Therefore, this high political cost of establishing CUs and FTAs functions as a deterrent to their formation. In other words, this criterion aimed to limit the number of preferential arrangements. The intent behind that was to minimise the risk of the world trading system fragmenting into the discriminatory and sectoral bilateral arrangements like in 1930s.

Paragraph 5 of Article 24 stipulates another major requirement, which concerns the duties and other trade regulations applied to non-member countries, to be satisfied by CUs and FTAs for their formation and acceptability with a view to reducing “trade diversion” on the trade of non-member countries. In the case of CUs, the common external tariff and other restrictive regulations applicable to non-members and imposed at the time of the formation of the union must not on the whole be higher or more restrictive than those imposed by the constituent territories prior to its formation. Although members of FTAs do not adopt a common external tariff or common trade policy, they are subject to similar obligation: They can not increase their individual duties and other trade regulations applied to third countries at the time of the formation of FTAs.

In the case of FTAs, this condition does not raise the problem of the method of calculation of *ex post* duties and other restrictive measures. However, as it was noted by the WTO (1995a) and Devos (1997), it led to the problem of the method of calculation of the common external tariff like simple averaging, weighted averaging or alignment at the lowest tariff as well as the problem of the choice of duties used in the calculation like bound, unbounded or actually applied. This paragraph does not say anything on that. Yet, the method in which the common external tariff of a CU is elaborated from individual member tariffs has important effects on the *ex post* market access opportunities of non-member countries suppliers. This means that the effects on non-member countries may be significantly different depending on the choices. In the case of European Economic Community (EEC) common external tariff, the member countries had used the arithmetical average of applied duties.

The debate on this criterion concentrated on the meaning of the concept of “on the whole”. There are two opposite views on that: One is that this requirement is applied aggregatively to non-member countries as a group and to total trade with the possible increasing of barriers in certain sectors or for certain products compensated by a reduction in others. The other is that consideration had to be given to the effects on countries taken, less aggregatively, individually and on sector-by-sector cases. For example, in the examination of the Rome Treaty, non-member countries argued that members of a CU or FTA should not increase barriers to the trade of *any* individual non-member country. However, the EEC members interpreted this requirement that it should be applied to non-member countries as a group rather than individually and it can be possible to increase barriers to trade in a sector if barriers are reduced in other sectors. The same concerns regarding the operation of this provision were repeatedly raised by non-member countries in the working parties, which were established to examine subsequent enlargements of the EC. (WTO, 1995a, pp. 14, 15) This problem was not solved in the UR negotiations although the issue of aggregation was the subject of dispute regarding “the issue of compensation” with non-EC countries arguing for examination of the effects of PTAs on specific countries and products, and the EC arguing that integration-induced increases in protection be permissible if there are decreases in protection elsewhere (Devuyst, 1992).

Which approach is accepted is important in order to make judgement whether the formation or enlargement of the concerned PTA has detrimental effects on non-members in terms of their market access opportunities. For example, it might be reached such a conclusion that the original formation and the successive enlargements of the EC are harmful to non-members because of the huge amount of lowering of agricultural imports if the latter approach is accepted. However, the opposing result might be reached, if the former approach is accepted. This thesis accepts the latter approach especially for its proposal formed in the fourth chapter so as to prevent harmful trade diversion effect on non-members. Through this approach a satisfactory but still implementable solution to the main concern of the thesis might be possible.



#### 1. 1. 4. Need to Reform Article 24 of the GATT

As a main exception to the central MFN principle justifying an inherently contradictory phenomenon, regionalism, Article 24 has always been targeted by serious criticisms regarding its immediate reform need. Its unsatisfactory nature for PTAs to be harmless to non-members and the need for its improvement have long been recognised. However, it remained essentially unchanged since its creation. There are two approaches to the criticisms for reform of Article 24: Many prominent scholars and others have advocated redefining its provisions to avoid ambiguity and applying them more strictly<sup>14</sup>. Others, like Bhagwati, consider the redesign of the treatment of PTAs to be a priority agenda item for multilateral negotiations. The criticism of this thesis depends on the latter approach and makes proposal in this respect.

In the former case, some, like Sampson (1996a, pp. 90-91), argue that its provisions and rules suffer from serious ambiguities in terms of their interpretation and resulting implementation problems and it could have considerable value if there was a clear understanding as to how its key provisions are to be interpreted and implemented. For example, the method of calculation of *ex post* trade barriers and the meaning of the concept of “on the whole”, as taken up above, represents two of Article 24’s interpretation problems arising from its vagueness. Therefore, many argue that with a view to making them stricter and more certain its provisions need a revision and improvement in terms of redefining. Some efforts took place during the UR Understanding on the Interpretation of Article 24<sup>15</sup> in order to eliminate the criticisms regarding ambiguous and imprecise feature of Article 24 provisions. However, as Devos (1997, pp. 725-749) stated, overall the UR Understanding does not add very much precision to the terms of Article 24. Although it clarified certain provisions of Article 24, most ambiguities still remain. Due to the continuing concerns and criticisms regarding interpretation and, therefore, implementation

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<sup>14</sup> Criticism in this respect is not a new phenomenon. According to an eminent GATT study group appointed by the Director-General to decades ago, many existing PTAs “fall far short of the requirements (of Article 24)... The exceptions and ambiguities which have thus been permitted have seriously weakened the trade rules, and make it very difficult to resolve disputes to which Article 24 is relevant. They have set a dangerous precedent for further special deals, fragmentation of the trading system, and damage to the trade interests of non-participants... GATT rules on CUs and free trade areas should be examined, redefined as to avoid ambiguity, and more strictly applied.” (Leutwiler *et al.* quoted by Sampson, 1997, p. 87 in endnotes).

<sup>15</sup> The UR Understanding on the Interpretation of Article 24 of the GATT 1994 was adopted as a part of the Final Act of the Uruguay Round

problems, redefining provisions of Article 24 to avoid ambiguity and applying them more strictly has incorporated into the agenda of the ongoing round of multilateral trade negotiations.

More importantly than interpretation and thus implementation problems arising from ambiguous wording of Article 24, its “no raising of barriers to trade” requirement is inadequate to be able to ensure trade diversion minimisation as intended by the GATT founders. The poor design of Article 24 in this respect constitutes major criticism of the thesis: Even if a PTA is consistent with Article 24 since not raising average external tariffs, it is still possible for it to lead to considerable harm to the non-members’ welfare. Therefore, as claimed in this thesis, inadequacy of the requirement of “no raising of barriers to trade with non-members” in avoiding trade diversion effects on non-members should be eliminated.

Redefining Article 24 as to make its wording more precise and unambiguous is of course a necessity for being strictly applied particularly considering the fact that its ambiguity and lack of precision constitute major loopholes by which doubtful arrangements have not been disapproved and Article 24 has been weakly enforced through the years<sup>16</sup>. However, such a revision just addresses the criticism of being imprecise and, therefore, provides a clearer judgement about whether PTAs are compatible with GATT/WTO rules in legal sense. But, it does not overcome more important criticism and focus of this thesis: it does not succeed in protecting outside countries from harmful effects of PTAs. Even if a preferential agreement is conformed to the redefined requirements, it may still generate considerable trade diversion unless the inadequacy of the relevant requirement -no raising of trade barriers- is eliminated. Thus, an improvement regarding interpretation problems might be necessary but far from being sufficient.

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<sup>16</sup> Between 1948 and 1994 a total of 69 CUs and free trade areas were notified to the GATT and examined by it under the provisions of Article 24. WTO (1995a) reports that of 69 working parties reporting on each of these arrangements, only 6 were able to agree that the arrangement satisfied the requirements of Article 24. Of them only Caribbean Community and Common Market (CARICOM) and Czech-Slovak Customs Union are still operative. However, the remaining working parties did not conclude that they were not compatible with Article 24. That is, they did not disapprove any such arrangements. Therefore, the matter in each case was left inconclusive and undetermined.



The solution should aim at avoiding trade diversion effects on non-members in a precise and unambiguous manner in order to both protect non-members from negative impacts of regionalism and inhibit new interpretation problems. Therefore, a proposal involving “redesigning” of Article 24 in accordance with this finding would be the best way to solve the problem of making PTAs more open. Such a proposal taking into consideration all these concerns is formulated in the fourth chapter. In the same vein, the “redesigning” of the treatment of PTAs without leading to any new ambiguities, not “redefining” of the existing rules governing PTAs, must have been a priority agenda item for ongoing round of multilateral trade negotiations.

## **1. 2. REGIONALISM IN PRACTICE AND ITS MOTIVATIONS**

With changing features and degree of success from period to period, regionalism in the form of (bilateral or plurilateral) preferential trade arrangements has been a prominent phenomenon in international trading system as to its effects since the second half of the 19<sup>th</sup> century. Currently, international trading system is undergoing the third revival of regionalism in its history and enormous proliferation of regional trade arrangements everywhere in the world besides existing multilateralism in the framework of the GATT/WTO system. This part of the chapter, after making a comparison between the current wave of regionalism and the previous one and studying the motivations behind the increased regionalism, concludes that new regionalism seems strong and invulnerable to endure as opposed to the previous wave of regionalism when taking into consideration its features and underlying reasons. History is unlikely to repeat itself. Current regionalism is likely to continue to proliferate in any manner, maybe detrimental, under the facilitating, rather than obstructing multilateral rules analysed above.

### **1. 2. 1. Different Waves of Regionalism**

Regionalism is not a recent phenomenon. As Mansfield and Milner (1999, pp. 596-601) explained, there are four waves of regionalism that have arisen over the past two centuries. The first two waves were experienced before World War II and the last two waves have taken place since World War II. The political settings in which the first three waves arose are quite different from the current setting.

## 1. 2. 1. 1. Regionalism Before the World War II

The initial wave of regionalism occurred during the second half of the 19<sup>th</sup> century and was largely European phenomenon (German Zollverein<sup>17</sup>, CUs between Austrian, Swiss, Danish, Italian states and CUs between various groups of nation-states). Intra-European trade rose dramatically and constituted a vast portion of global commerce during this period. Economic integration became so extensive that in many respects Europe had begun to function as a single market at the end of the 19<sup>th</sup> century. In addition to the CUs, the development of a broad network of bilateral commercial agreements triggered off by the Anglo-French commercial treaty of 1860 also contributed heavily to the growth of regionalism in Europe. Those agreements were linked by unconditional MFN clauses and contributed to the relatively open international trade system that characterised the second half of the 19<sup>th</sup> century<sup>18</sup> by creating the main principles of the system until the depression at the end of the century.

However, the growth of regionalism was disrupted by World War I and after the war ended a second wave of regionalism that had a totally different nature than its predecessor began. The regional arrangements formed between World Wars I and II tended to be highly preferential and discriminatory. Some of those arrangements were formed to consolidate the empires of major powers like the Commonwealth system of preferences established by Great Britain in 1932. But, most of them were formed among sovereign states.

Whether regionalism deepened the economic depression of the inter-war period and contributed to political tensions culminating in World War II is a longstanding and unresolved debate among many scholars. For example, Irwin (1993, p. 91) draws one's attention to the contrast between these two era: In the period of first wave of regionalism a network of bilateral commercial agreements containing MFN clause led to more liberal trade system in Europe and the world. However, in the inter-war period discriminatory trade blocs and protectionist bilateral arrangements contributed to the severe contraction of world trade that accompanied the Great Depression.

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<sup>17</sup> Nation-building in Germany began with, or at least was brought forward by, the establishment of a *Deutscher Zollverein* or German Customs Union in 1834.

<sup>18</sup> Douglas A. Irwin (1993) refers to that period as an era of "progressive bilateralism".

Irwin's those interpretations represent the conventional view. Accordingly, second wave of regionalism is often associated with the pursuit of *beggar-thy-neighbour* policies and substantial trade diversion as well as heightened political conflict. Because of the political rivalries among the major powers and the use of regional trade strategies by these countries for mercantilist purposes, the rise of regionalism during inter-war period was attributed by scholars to states' inability to arrive at multilateral solutions for economic problems and their resort to the alternative possibility of trade liberalising agreements on a regional basis. Therefore, although regionalism was not a new phenomenon, both the political context in which it arose and its consequences were fundamentally different than the first wave of regionalism.

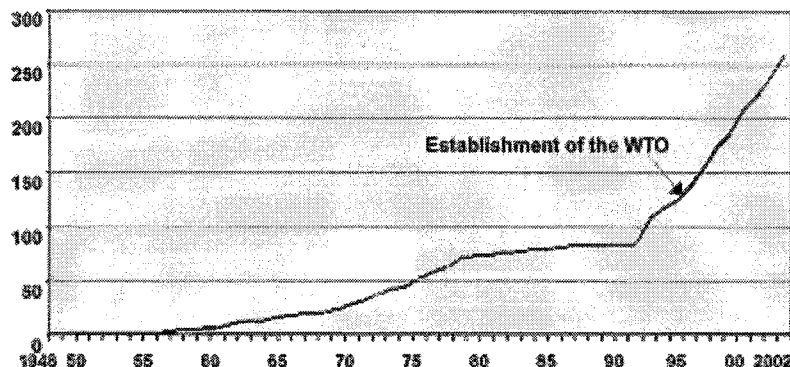
### **1. 2. 1. 2. Regionalism After the World War II**

Regionalism continued to spread widely in terms of both the number of preferential trading arrangements formed and of states joined them throughout the post-World War II period, notwithstanding the emergence of a multilateral trading system based on the principles of non-discrimination and reciprocity embodied in the GATT. However, the frequency of preferential trading formation has fluctuated. While few PTAs were formed during the second half of the 1940s and the 1950s, a surge in PTAs occurred in the 1960s and the 1970s. With respect to the 1980s, the formation of PTAs again decreased, however, there has been a significant rise in such arrangements during the 1990s and more than 50 percent of all world commerce is currently conducted within PTAs. They have become so pervasive that today almost all of the 147 contracting parties of the WTO are members of at least one PTA. (WTO, 1996a, p. 38 and WTO, 1995a)

Regionalism seems to have occurred in two waves during the post-World War II period: The first wave of regionalism, which Bhagwati (1992, p. 538) called the *first regionalism* or many scholars named *old regionalism*, heavily took place from the late 1950s through the 1970s. With respect to the Bhagwati's concept of *second regionalism* or, in other words, *new regionalism*, it revived in the mid-1980s, proliferated during the 1990s and has been continuing to proliferate recently with a strong prospect that it will continue to proliferate in the near future too.

**Figure 1. 1. Evolution of Regional Trade Agreements in the world, 1948-2002**

**Number of PTAs**



*Source: WTO Secretariat*

### **1. 2. 1. 2. 1. First (Old) Regionalism**

The first regionalism after the Second World War II was marked by the establishment of the EEC in 1957 among six Western European countries, EFTA in 1960 among another group of Western European countries and a plethora of regional trade arrangements formed by developing countries in Latin America, the Middle East and Africa<sup>19</sup>. Since Asia was not affected by these influences, Asian countries did not tend to form any regional integration among themselves in these years. They either preferred to remain inward-oriented and quite closed to outside like India and China, or pursued growth strategies based on exports and sought to expand their access to foreign markets like the East Asian countries. (Grilli, 1997, pp. 194, 195) In North America, regionalism remained virtually non-existent as a policy tendency too. The key economic power, the US, continued to show a strong preference for multilateral trade relations. Since it was suspicious of discriminatory trade arrangements, restrained itself from resorting to Article 24 although supported the formation of the EEC in 1958 for political reasons.

<sup>19</sup> Latin American Free Trade Area (LAFTA) established in 1960, Central American Common Market (CACM) in 1961, Arab Common Market (ACM) agreed upon in 1964, the Union Douaniere et Economique de l' Afrique Centrale (UDEAC) initiated in 1964, the Southern African Customs Union (SACU) in 1969, the Communauté Economique de l' Afrique de l'Ouest (CEAO) in 1972, and the Economic Community of West African States (ECOWAS) in 1975.

These initiatives gave real dimensions to Jacob Viner's analysis of "CUs" which dealt with the static analysis of the welfare effects of CUs. In other words, in the first regionalism economists were more occupied with the "trade diverting" and "trade creating" effects of CUs. The old regionalism was formed by the preferential trade arrangements which depends on either North-North or South-South trade relations: While the regional trade arrangements in Western Europe were established among only industrialised countries, those in Latin America, the Middle East and Africa were formed among developing countries except the Southern African Customs Union (SACU) which had South Africa among its members.

As Grilli argued, the first regionalism heavily concentrated on trade objectives. Since tariffs were high between the countries, the pursuit of trade preferences from partners was the main goal of especially developing countries. However, the first regionalism was not only geographically horizontal and functionally oriented towards trade; it was also motivated by a variety of factors. For example, in the case of the EEC, although it was thought that economic integration of neighbouring countries, starting with the elimination of existing trade barriers, would lead to the improvement of collective welfare, the overriding determinants were more political than economic: to ensure the peace and political cohesion of Europe, recently devastated by two world wars and faced by the communist threat. However, the motive behind the formation of EFTA was generally economic. The EFTA countries were not ambitious as the EEC in both economic and political terms. The EFTA was just limited to the liberalisation of trade among members and did not include a common external trade policy.

Regionalism between the developed countries has been successful. The European countries achieved rapid growth and liberalisation through the EC and EFTA. In respect of the static effects of regionalism in Western Europe, intra-EC trade creation largely exceeds trade diversion. The process of transformation of the EC from a CU into a Europe-wide common market endured. Furthermore, the EC gradually developed its network of preferential trade arrangements with developing countries.<sup>20</sup>

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<sup>20</sup> In 1963, the EC concluded the Yaounde Convention of Association; in 1971, the Generalised System of Preferences (GSP) with overseas countries; in 1972/73, bilateral free trade areas with the six EFTA countries; in 1975, the Lome Convention; in 1975/76, preferential trade arrangements with various Mediterranean countries.



The rationale for regional trade arrangements among developing countries was more economic than political like EFTA. Bhagwati (1992, p. 539) stated that besides the success of the European examples, a different economic rationale that was formulated by Cooper, Massell, Johnson and Bhagwati motivated developing countries. As analysed in detail in the second chapter, Cooper-Massell-Johnson-Bhagwati approach argued that given any targeted level of import-substituting industrialisation against the developed countries, the developing countries, with their small markets, could reduce the cost of import-substituting industrialisation by exploiting economies of scale through preferential opening of markets with one another. The developing countries pursued import substitution industrialisation strategies to develop quickly and preferential trade arrangements were used as a policy instrument to reduce the costs of following this strategy. Those countries thought that liberalising trade among themselves could produce economies of scale effects, which would reduce the cost of their industrialisation. That is, they tried to overcome the limitations of import substitution at the national level, expanding it to larger regional markets.

Additionally, various developing countries formed preferential arrangements to reduce their economic and political dependence on advanced industrial countries and to increase their collective bargaining strength with industrial countries. The structural weaknesses and the disadvantages of the less-developed countries in international economy could perhaps be alleviated by joining a regional bloc.

In contrast to the Western European examples, regional initiatives among the developing countries failed since these countries were wedded to planning and saw trade as accommodating to a planned allocation of the import-substituting industries among the member countries. Instead, they should have let trade decide which industry went where. That is, the partner countries should have relied on market forces instead of the planned allocation of resources. Therefore, while the world was filled with formation of and proposals for preferential trade arrangements among developing countries, regionalism virtually died except the original EC and EFTA.

Actually, preferential trade arrangements among developing countries were an extension of domestic import substitution and planning policies to the regional level and were usually

proposed to achieve scale economies for protectionist policies. In contrast to the theory which was that member countries would become more specialised, developing countries tended to give each other access to their markets only in those products they imported from the rest of the world in the framework of the general philosophy of trying to produce everything at home. Preferential trade arrangements among the developing countries aimed at becoming more self-sufficient in a most inefficient manner by discouraging imports and encouraging the development of domestic industries. This strategy maximised trade diversion at the expense of the rest of the world. The preferential trade arrangements in which developing countries selectively determined specific products and quantities to be traded are examples of politically driven trade that inevitably fails to yield much benefit. Under these circumstances, it was not surprising that preferential trading arrangements among developing countries failed.

Besides their ill-formed character, Axline (1994, p. 4) argued that unfavourable global political economy for regional integration by the end of 1970s also constituted a serious problem faced by the regional attempts for being successful. The double oil price shocks, increasing debt burden, and contraction of worldwide trade presented an unfavourable context for regional co-operation among the developing countries.

### **1. 2. 1. 2. 2. Second (New) Regionalism**

While the first regionalism had almost disappeared except the Western European models, the second regionalism appeared suddenly and unexpectedly in the second half of the 1980s. This time regionalism emerged in North America: First the CUSFTA in 1989 and then the NAFTA, which the US, Canada and Mexico negotiated in 1992, came into being. In addition to the regional arrangements in North America, those established and reinforced in South America<sup>21</sup> showed that new regionalism swept the latter as well as the former. Important manifestations of the revival of regionalism occurred also in North

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<sup>21</sup> First, the Argentina-Brazil FTA in 1990, then the Southern Common Market (MERCOSUR) in 1991 between Argentina, Brazil, Paraguay and Uruguay established. There were also significant attempts to revitalise and reinforce existing arrangements. A renewal of the Andean Pact occurred in 1990 and the revival of the CACM began in the same year. Finally, President Bush's Enterprise for the Americas, an initiative aimed at creating a hemispheric free trade zone, was launched in 1991.



Africa<sup>22</sup> and in the Asia-Pacific region<sup>23</sup> where regional trade arrangement initiatives firstly emerged. (Grilli, 1997, pp. 197, 198) Surprisingly, second regionalism spread to North America and to Asia which were unaffected by this phenomenon during in the 1960s and the 1970s. As to the EU, it has continued to pursue the widening and deepening of its integration process through a reorganisation and expansion of its large network of preferential trade arrangements with both the developed and the developing countries.

Cable (1994, p. 3) noted that current wave of regionalism have some elements of continuity with, besides many elements of difference from, the earlier experiments. Continuity is provided by the basic framework of CU theory as originally set out by Viner. This theory, as examined in the second chapter in detail, acknowledges both the economic efficiency gain from regional trade liberalisation and also the ambiguous overall benefit because of the costs of trade diversion. Ideas of scale economies from larger markets, which had been prominent in the failed regional initiatives among developing countries, were also an important factor in the creation of the Single European Market. Furthermore, regional arrangements are actually geographically regional as in the case of the old regionalism. The peculiar features of the new regionalism which constitute, at the same time, its differences from the old regionalism are as follows:

In contrast to the first regionalism, the second regionalism was characterised by a manner of North-South relations, -by a new tendency to form trade groups that included both developed and developing countries. Mistry (1999, p. 124 and 1996, p. 47) treated the North-South nature of second regionalism as the rule rather than the exception. In the same vein, according to Ethier (1998b, pp. 1150, 1151 and 1998c, pp. 1216, 1217), the new regionalism typically involves one or more small countries linking up with a large country<sup>24</sup>.

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<sup>22</sup> The Union of Arab Maghreb among Algeria, Morocco, Libya, Tunisia and Mauritania was established in 1989.

<sup>23</sup> Malaysia proposed in 1990 an East Asian Economic Community (EAEC) to include the Association of South East Asian Nations (ASEAN) countries: China, Hong Kong, Korea, Taiwan and Japan. In 1991 Thailand proposed an FTA among ASEAN countries (AFTA). Australia promoted APEC in the late 1980s, with the aim of creating a regional forum for discussion of trade liberalisation and expansion among ASEAN countries, Australia, New Zealand, Japan and Korea.

<sup>24</sup> In the case of NAFTA, Mexico and Canada are each economically small relative to the US; the new members of the EU (Austria, Finland and Sweden), the candidate countries of the EU membership and the other associates of the EU (like the Maghreb and Mashreq countries under the expanded Mediterranean

Secondly, developing countries' approach to development has changed. They have abandoned basically-autarkic, anti-market (institutionally driven) policies they pursued during the first regionalism: In the current wave of regionalism, regional initiatives involving developing countries have been part of a strategy to liberalise their economies in general and to open their economies to implement export-led policies rather than to promote import-substitution. In other words, regional trade arrangements have been used to help prompt and consolidate unilateral reforms in developing country members<sup>25</sup> As a result, less developed countries have become interested in multilateralism and are now actively trying to join the multilateral trading system.

Thirdly, in forming a regional arrangement, the liberalisation achieved is primarily realised by small countries, not by large country. Therefore, the small countries get only small tariff advantages. In other words, the regional arrangements are one-sided.<sup>26</sup> Unlike the old regionalism, one of the reasons of this asymmetry is that the large countries have already low tariffs to begin with due to the successive rounds of GATT-based multilateral tariff reductions.

Another characteristic of last wave of regionalism is deep integration as opposed to the previous regionalism, which involved shallow integration. Partners do not confine themselves just to eliminating trade barriers. They also harmonise or adjust diverse assortments of other economic policies. Mistry (1999, p. 123 and 1996, p. 47) characterised the new regionalism by economic enhancements that include liberalisation of intra-regional trade in services and intellectual property, free movements of capital and labour, and the harmonisation of regulatory regimes. Current regional arrangements are concerned with other aspects of economy as well as trade on goods, and they concentrate on internal rules and regulations and institutional mechanisms to ensure implementation and enforcement as well as removing border barriers. The EU is an unambiguous and dramatic example of this feature.

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Agreements) are again small compared to the EU; Brazil dominates MERCOSUR; Japan and the US are relatively large countries among the other APEC countries etc.

<sup>25</sup> For example; the Europe Agreements' central and east European participants that had abandoned communism, the members of Mercosur and Mexico in NAFTA.

<sup>26</sup> In the case of NAFTA, the liberalisation has occurred due much more to concessions by Mexico and Canada than by the US. As to the enlargements of the EU, it has always demonstrated a take-it-or-leave-it attitude concerning its nature and structure although it has been flexible on periods of adjustment and financial responsibilities. In other words, the EU has performed virtually no concessions in its enlargements.

Furthermore, Lawrence (1997a, p. 18) pointed out that many important current regional arrangements do not have *exclusive* memberships in which insiders limit their contacts with non-members. In contrast with the previous regional arrangements, they are *inclusive* arrangements in which members either allow non-members to join or independently join them in developing similar arrangements.

**Table 1.1.** *Regionalism: Old and New*

<b>Old</b>	<b>New</b>
Import substitution as a basis of industrialisation; withdraw from world economy	Export promotion and trade liberalisation; integrate into world economy
Planned and political allocation of resources (Policy/Institutions driven)	Market allocation of resources (Market driven)
Led by governments	Led by private firms
Regional or sub-regional competition	Global competition
Emphasis on intra-regional trade	Emphasis on open trade, investment and growth
South-South or North-North membership	North-South membership
Mainly industrial products	All goods, services and investment
Deal with border barriers	Deeper integration
Preferential treatment for less developed	Equal rules (different adjustment periods)
Generally membership of one group	Overlapping membership of a country in a number of groups

*Source: Lawrence, 1997a, p. 19 and Bhalla and Bhalla, 1997, p. 21*

## **1. 2. 2. MOTIVATIONS OF REGIONALISM**

There is no single motivation for establishing a formal regional integration arrangement. The reasons why nations choose to participate in regionalism are manifold and diverse. They arise in both economic and political realms. In some cases, there are multiple objectives that drive participation in regional trade arrangements; in other cases, one or two objectives tend to be dominant. The motivation for forming those arrangements varies from region to region, and even from country to country within a regional trade arrangement. However, there is generally a combination of two or more of the following motivations that seem to play a key role:

### **1. 2. 2. 1. Conversion of the US Approach and the Single European Market**

According to many like Panagariya and Srinivasan (1998, p. 223) and Bhagwati (1992, p. 540), the main driving force for the second regionalism is the conversion of the US approach to Article 24 of the GATT. The US, which had been the staunchest proponent of multilateralism throughout post-war years and had never embarked on any regional or more truly preferential initiative, unexpectedly changed its course by pursuing regionalism and multilateralism simultaneously. First the FTAs with Israel and with Canada, then extension of the latter to Mexico in order to create NAFTA and the Enterprise for the Americas Initiative that envisages more FTAs with the nations of South America are indicators of the change in the US course. The change of the US as the leading actor in international system has major significance with respect to international trading system: Its policy of actively promoting and participating in regionalism (in both the geographical and the preferential senses simultaneously) has made the balance of forces in favour of regionalism and at the expense of multilateralism. The reasons of such a sudden conversion in the US attitude towards regionalism are examined in the second chapter under the title of “2. 2. 2”.

In addition, according to Bhagwati (1992, pp. 541-542), Single European Market (Europe 1992 project) and impending Northern and Eastern enlargement of the EU reinforced, as the establishment of the EEC had reinforced many regional trade arrangements three decades ago, North American countries who felt that a countervailing bloc must be formed

there too. Similarly, the conjunction of these two dramatic events, Single European Market and the conversion of the US approach with resulting CUSFTA and NAFTA has created a sense elsewhere in the world that regionalism is *the order of the day* and others must follow although prompted by different motivations. For example, in the Far East there was a sense that a Japan-centred regional bloc may be necessary in a bloc-infested world.

### **1. 2. 2. 2. Traditional Trade Gains**

As Whalley (1998, p. 71) argued, the most conventional objective that is thought to underlie a country's participation in any trade arrangement is the idea that through reciprocal exchanges of concessions on trade barriers there will be improvements in market access from which all parties to the arrangement will benefit. Therefore, the rise in regionalism can be attributed to the perception that it provides the gaining of the benefits of freer trade with fewer of the accompanying adjustment costs. In the case of regional trade arrangement the chances of success are seen as high because of small number of countries and key trading partners are involved. Additionally, there has been a prior history of frustrations with negotiating failures at the multilateral level. Therefore, countries prefer to participate in a regional arrangement rather than multilateral to gain benefits of freer trade as a *second-best case*.

However, theoretical research on regional trade arrangements has shown that trade gains may not always arise for the countries forming a FTA or CU since trade may also be diverted to higher-cost suppliers within the integrating area (Viner, 1950). In other words, trade-diversion losses may outweigh trade-creating gains. But Yeung *et al.* (1999, pp. 19, 20) argued that regionalism is also preferred to multilateralism to protect less-competitive or inefficient domestic industries partially from the rigours of wide-open global competition. Similarly, the structural adjustments are more easily delayed and probably less urgent under a regional trade arrangement than would be the case if markets were opened to full international competition. The idea of trade gains from regional integration motivated the establishment of much of the post-war regional trade initiatives (old regionalism). It was the key economic objective behind the creation of the EC, although the central objective was strategic.

Countries may also seek regional trade arrangements since they see economic benefits from achieving a more efficient production structure through specialisation and by exploiting economies of scale through spreading fixed costs over larger regional markets, and enhanced economic growth from foreign direct investment, learning by doing and research and development (Shiells, 1995, p. 30). As Memedovic *et al.* (1999, p. 13) stated, those reasons generally motivated less-developed countries to prefer regional arrangements with a large country or hegemon. Regional trade arrangements are seen as means of increasing the national welfare and economic development of member states by promoting intra-regional trade. This outcome is especially true for states with too small domestic markets to sustain long-term growth or to take advantage of economies of scale. Therefore, access to a larger market through membership of a regional initiative might be crucial to the further development of such economies.

### **1. 2. 2. 3. Locking-in Unilateral Domestic Policy Reforms**

As Whalley (1998, pp. 71, 72), Yeung *et al.* (1999, p. 20) and the World Bank (2000, pp. 22-26) stated, another motivation, which countries have in participating in regional trade arrangements, is that a regional trade agreement can underpin domestic policy reform and make it more secure. A regional trade arrangement may provide a government's economic or political reforms with increased credibility since they are "locked in" due to regional commitments and help to demonstrate to regional partners that the domestic reforms or policies are "for real". By locking in the country to a trade agreement any future giving-up domestic policy reform becomes more difficult to occur compared to the multilateral trading system because of their stronger enforcement mechanisms than the WTO agreements. For example, less-developed countries like Mexico have this motivation for forming a regional arrangement with a hegemon rather than for participating in multilateral negotiations: This particular benefit constituted a major motivation behind the accession of Mexico to NAFTA.

### **1. 2. 2. 4. Increased Multilateral Bargaining Power**

Another objective for countries that participate in regional trade arrangements is to improve their *bargaining power* in multilateral trade negotiations with third countries by



forming a CU which has common external barriers and common external trade policy rather than a FTA. The small countries in terms of their leverage in international trade relations may want to become strong by joining together in the framework of a regional trade arrangement.

Whalley (1998, p. 72) argued that one motivation for the formation of the EEC in 1957 was the desire to improve bargaining power relative to the US. The European countries might have had limited leverage individually in a bilateral or multilateral negotiation with the US. But they would increase their leverage if they acted co-operatively in using a common trade policy. The formation of the EEC influenced the US negotiating position first in the Dillon Round, then in the Kennedy Round, and subsequently in the Tokyo Round since the US sought to deal with issues of access to the unified European market and to mitigate the trade-diverting effects of European integration. The World Bank (2000, p. 18) stated that the EEC achieved two important bargaining objectives through increased bargaining power arising from their economic integration: They accelerated US-Europe trade liberalisation in manufactures as a net exporter of manufactures to the US while they delayed trade liberalisation in agriculture.

#### **1. 2. 2. 5. Guarantees of Market Access**

The objective of guarantees of market access is especially present in large-small country arrangements. Smaller countries may seek increased security of market access -“safe havens”-by forming regional trade arrangements with larger countries or regional groups. The safe haven argument suggests that for small countries dependent on a single large market, preferential trade arrangements may offer a more stable and secure trading environment than MFN commitments.

The legal status of the GATT/WTO agreements appears to be insufficient to satisfy the desire for certainty of market access particularly with respect to “unfair trade rules” such as anti-dumping or countervailing duties and non-tariff barriers (NTBs). As Jackson (1993, p. 124) stated, since the uses or misuses of these instruments for protection objectives have led some small countries (both developed and developing) to seek some relief from their harsh application, those countries may aim at using regional trade arrangements to make



access to the larger country market in the region more secure for themselves. In the case of Canada-US Free Trade Area, Canada's one of the most important objectives was to achieve some degree of exemption from the use of US unfair trade laws. Similar motivations were also true in the Mediterranean countries' request for a preferential trade arrangement with the EU and Mexican request<sup>27</sup> with the US.

### **1. 2. 2. 6. Increased Security**

Economic and trade objectives are crucial when it comes to explaining regional integration initiatives. Policy makers respond to the increased pressure for integration resulting from increased economic interdependence. However, such an explanation based on just economic and trade factors cannot completely provide the whole story. Regional integration arrangements are also driven by security (political) motivations. In fact, economic and security objectives are entangled and even when initial motivations are of rather a political character, economic integration may move from the status of an instrument to that of an objective.

Therefore, a further country objective in forming regional trade agreements is that such agreements can help underpin security arrangements among the participating countries. Accordingly, the World Bank (2000, p. 13) states that regions, which are highly integrated in economic terms, may tend to have less internal conflict between their constituents. Therefore, policies that promote trade within a region will increase intra-regional security. This was a central theme in early European integration in the 1950s: The dominant idea was that a European regional trade agreement that led increased trade flows between Germany and France (especially in the light of Franco-Prussian relations between 1870 and 1945) would reduce the risk of another war in Europe. Such a strategic linkage aimed at preventing an outbreak of another European war became the main motivation in forming European trade arrangements and overrode all other integration motivations since security concerns at that time were the vital interest<sup>28</sup>.

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<sup>27</sup> However, this was probably a less significant objective than that of underpinning domestic policy reform for Mexico.

<sup>28</sup> Unlike the European case, security concerns are largely missing as a country objective in recent North American trade arrangements. Since the political commitment to integration is very strong, European integration as an ongoing process of integration has been able to move progressively from a CU toward ever-

The recent World Bank study (2000, pp. 16, 17) argued that the political motivation for regional trade arrangements is not only intra-regional security, but also the need to unite against a common threat. The dominant idea is that common action in commercial sphere makes common action for security easier and more credible. The perceived potential threat is generally regional hegemon. For example, Association of Southeast Asian Nations (ASEAN) was partly formed against the threat of spreading Communism in the region. One of the major motivations of Central and Eastern European countries (CEECs) in applying for membership to the EU is gaining protection against a perceived threat from the Russian Federation. Some regional integration initiatives are motivated by both intra-regional and external security objectives like Economic Community of Western African States (ECOWAS) in which economic co-operation became the precursor to military co-operation in 1986 against conflicts both between members and from outside the membership. Briefly, it is evident that security considerations of intra-regional or external type have often been important impetus for regional trade integration.

#### **1. 2. 2. 7. Frustration with the Multilateral Trading System**

Many scholars like Bhagwati (1992), Jackson (1993) and Grilli (1997) have seen insufficient and slow trade liberalisation and regulation in the framework the GATT/WTO system as another important motivation in intensive resort to regionalism. Contracting parties have become more frustrated with multilateralism. The large number of participants and wide diversity of economic and trade interests have made it difficult to take decisions in a reasonable period of time. Those problems together with a “lowest common denominator” approach arising from its functional structure have often led to failures in achieving progress within the GATT towards resolving some of the issues that world trade developments have posed. Impatience with the pace of the multilateral trade negotiating process led groups of countries to consider moving beyond and parallel to the multilateral system with a view to developing faster and deeper regulation concerning trade relations for a subset of countries on a preferential basis.

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deeper integration. However, North American economic integration, as reflected in NAFTA, depends on a free trade area and does not provide a road map for ongoing and deeper integration. (Whalley, 1998, p. 73)

This motivation can be clearly observed in the cases of some regional initiatives by the US and the EU since they pursued regionalism (NAFTA and European Economic Area) while they were engaged in the conclusion of the Uruguay Round where they were ostensibly trying to update and strengthen the multilateral trade regime in existence since 1947. The two-track policies of the US and the EU reinforced the view that the existing international trade order was at a critical stage and that the search for alternatives was to counter in some way the feared collapse (*de jure* or *de facto*) of the GATT system. As the number of regional trade arrangements increased after the start of the Uruguay Round in 1986, this type of motivation have been actively considered since then. (Grilli, p. 199)

### **1. 2. 2. 8. Avoiding Trade Diversion**

Baldwin (1999) proposed a fundamental reason for the rise in the popularity of economic integration and regionalism. He explained this rise with the help of his “Domino Theory”<sup>29</sup>. He asserts that trade diversion effect of regionalism triggers a multiplier effect that reduces bilateral import barriers like a row of dominoes. Trade diversion may tip the political balance in third countries in favour of joining the regional trade arrangement since exporters’ interests begin to prevail over the interests of import-competing firms. As more countries join the regional trade arrangement, excluded countries may suffer additional trade diversion and incentives to join outweigh interests of import-competing firms. Eventually, the bloc is expanded accordingly and opponents of a bloc fall like dominoes. Expansion is only stopped when either the bloc decides to stop including new members (in which case a new bloc may be created by those frustrated in their attempt to join) or non-members have high resistance to membership.

### **1. 2. 2. 9. Other Motivations of Regionalism**

There might be some other motivations, which are mostly non-economic. Strengthening political ties between regional partners, managing large scale migration flows from poorer neighbours that might threaten political and social stability, conserving historical and cultural ties are also driving factors in forming and enlarging a regional trade arrangement. For example, Turkey has tried to seek a European rather than Eastern identity and future

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<sup>29</sup> This theory is analysed in the second and the third chapters in detail.

since the establishment of the Republic by Ataturk. It wants to strengthen its more or less democratic and secular system under the Western norms. Similarly, the Mexicans clearly sought an American future rather than one with their southern neighbours.

One of the motivations leading the US to form NAFTA with Mexico and the EU to create Europe Agreements with CEECs and free trade agreements with Mediterranean countries was the fear from illegal immigration. Integration with those countries in commercial terms would strengthen their economies and mitigate this migration flows from those countries to the US and the EU.

Political motivations have played an important role in most cases of regional trade arrangements. Therefore, one cannot see regional arrangements simply developing as a result of economic factors. In most cases, there are independent political motivations behind integration initiatives. These have included fundamental policy objectives like guaranteeing the maintenance of a liberal, democratic political system. For many countries like Turkey and Central and Eastern European Countries membership in regional arrangements has been seen as a means of joining the “Western” economic and political system. For the existing members of regional arrangements similar political objectives have also figured in their support for new members acceding to the arrangements. This suggests that regional arrangements do always need to be considered in terms of their political and strategic importance as well as in terms of their impact on the multilateral trading system.

## CHAPTER 2. THEORY OF PREFERENTIAL TRADE LIBERALISATION

It would be appropriate to start this chapter concerning the theory of preferential trade liberalisation with a statement by Bhagwati, Greenaway and Panagariya (1998, p. 1128) to be able to draw one's attention to the interaction between theory and policy:

“The best kind of economic theory has almost always reflected policy concerns, while informing policy in turn. This is particularly so when it comes to the theory of international trade, going back to Adam Smith's discovery of the demerits of mercantilism and his invention of economic science, both in *The Wealth of Nations*. The theory of preferential trading is no exception.”

The original burst of creative theorising about *Preferential Trade Liberalisation* which was associated with what Bhagwati (1992, *passim*) has called “First Regionalism” have come from Jacob Viner's (1950) work on what he called the “customs union issue”. This work was a result of his having been commissioned by the Carnegie Endowment to examine the appropriate design of the world trading system with the end of the Second World War. The impending formation of the Common Market, leading to the Treaty of Rome in 1957, played a role in the further development of the theory at the hands of James Meade (1955), Richard Lipsey and Kelvin Lancaster (1956-57), Richard Lipsey (1957, 1958), Harry Johnson (1958a and 1958b) and others.

In addition to the Vinerian approach, two more alternative theoretical approaches, pioneered by Viner, to the “static” implications of preferential trade arrangements are studied in this chapter: the Kemp and Wan approach and the Cooper-Massell-Johnson-Bhagwati approach. As Bhagwati (1991, p. 62) stated, while the Vinerian approach considers the welfare effects of forming arbitrarily specified PTAs, the Kemp-Wan and Cooper-Massell-Johnson-Bhagwati approaches envisage the sensible formation of PTAs to achieve Pareto-superior, or Pareto-better, outcomes.

The recent burst of theorising about *preferential trade liberalisation* is also a reflection of the new policy questions: The United States abandoned in the early 1980s its policy of avoiding PTAs and concentrating exclusively on multilateral trade negotiations (MTN). The subsequent proliferation of PTAs, which has been called “Second Regionalism” by

Bhagwati (1992, *passim*), has been a period of success while the first regionalism was stillborn efforts.

Therefore, the theory of PTAs or, in policy terms, the GATT Article 24 sanctioned FTAs and CUs have undergone two phases of evolution in two very different modes. As mentioned above, these two phases of evolution largely reflect the contrasting policy concerns of the time. On the one hand, Vinerian analysis concerning PTAs in the First Regionalism dealt with "static" questions concerning the welfare effects of unions with defined membership. On the other hand, the Second Regionalism has been preoccupied with what Bhagwati (1992) has described as the "dynamic" time-path question. In the analysis of the success of the Second Regionalism and the continuing proliferation of PTAs, the old concerns about *trade diversion* have revived.

## **2. 1. STATIC ANALYSIS: TRADE CREATION AND TRADE DIVERSION**

### **2. 1. 1. Vinerian Approach: The Traditional Welfare Analysis**

The question of CUs and FTAs, both permitted under GATT Article 24, has long been a major topic of theoretical research and it is well known that Jacob Viner (1950) pioneered the static analysis of PTA's. His analysis was prompted by policy concerns about PTAs, tracing from the Havana Charter for the aborted ITO. The formation of the EEC in 1957 and of the EFTA then gave a more direct policy dimension to this theory and led to important analytical insights especially from the work in 1950's of Richard Lipsey and Kelvin Lancaster, Harry Johnson, and James Meade.

Until Viner's seminal study, the notion that any move towards free trade, even if it is preferential, would necessarily be welfare improving, appeared intuitive. Viner distinguished between *trade creation* and *trade diversion*. His classic treatment of this showed that the PTAs were not necessarily welfare improving either for member countries or for the world<sup>30</sup>. In other words, as distinct from non-discriminatory trade liberalisation,

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<sup>30</sup> Although Viner's main contribution to the theory, as Bhagwati (1991) pointed out, was to destroy the common fallacy that a preferential move toward total free trade was necessarily welfare-improving, this does not mean that earlier classical economists did not deal with the trade restricting characteristics of PTAs.



they could harm both a member country and world welfare. “That is, the case for preferential trade arrangements was different from the case for free trade for all” (Bhagwati, 1992, p. 535). The clarification of the Vinerian concepts of *trade creation* and *trade diversion* led to the proposition that a preferential tariff reduction could never be superior to unilateral non-preferential tariff reduction. While the latter is a first-best case, the former reflects **second-best considerations**<sup>31</sup>. Therefore, Viner’s analysis is important not only for the theory of discriminatory trading arrangements, but also because it led to a better understanding of the general *theory of second best*.

Jacob Viner’s contribution is contained in the fourth chapter of *The Customs Union Issue*. Despite this book’s title, Viner emphasises that the CU is one of a number of possible preferential trading arrangements whose economic differences are slight (Viner, 1950, p. 4). The key passage concerns his explanation of the trade-creating and trade-diverting effects of a CU:

There will be commodities, however, which one of the members of the CU 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. This shift in the locus of production as between the two countries is a shift from a high-cost to a lower-cost point... There will be other commodities which one of the members of the CU will now newly import from the other whereas before the CU it imported them from a third country, because that was the cheapest possible source of supply even after payment of duty. The shift in the locus of production is now not as between the two member countries but as between a low-cost third country and the other, high-cost, member country. (Viner, 1950, p. 43)

Depending on the evaluation above, his conclusion is:

From the free trade point of view, whether a particular CU is a move in the right or in the wrong direction depends, therefore, so far as the argument has yet been carried, on which of the two types of consequences ensue from that CU. Where the trade-creating force is predominant, one of the members at least must benefit, both may benefit, the two combined must have a net benefit, and the world at large benefits; but the outside world loses, in the short-run at least... Where the trade-

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Adam Smith, Ricardo and McCulloch each denounced the *Methuen Treaty* between Portugal and Great Britain on the grounds of its trade-diverting effects (Robson, 1987, p. 5).

<sup>31</sup> In a fully competitive world economy where there were not any market imperfections, free trade would provide best policy presenting Pareto-optimal allocation of resources. But, if it is not possible to attain free trade among so many countries, a group of these countries may achieve it by forming a preferential trade arrangement between themselves. Sometimes it may be more difficult to reach free trade for all and a preferential trade arrangement instead provides freer trade which is better than none. (Akman and Dartan, 1997, p. 37)



diverting effect is predominant, one at least of the member countries is bound to be injured, both may be injured, the two combined will suffer a net injury, and there will be injury to the outside world and to the world at large. (Viner, 1950, p. 44)

His prime interest in the fourth chapter is in assessing the net impact of a CU compared with the pre-union situation, and he concludes that confident judgement cannot be made for CU in general and in the abstract, but must be confined to particular projects (Viner, 1950, p.52).

The classical Vinerian concepts of trade creation and trade diversion offer an appropriate framework to assess the immediate (static) impact of PTAs on world welfare. While PTAs create new trade between union members since they liberalise trade preferentially, they divert trade from low-cost outside suppliers to high-cost within-union suppliers. In other words, on the one hand, trade creation refers to the new flows which arise among members of the union due to lower trade barriers, thus replacing domestic production, while, on the other, trade diversion implies the replacement of previous flows between members and non-members by member to member trade. The former effect arises from a union partner undermining another union member's less efficient industry. The latter effect arises from a union member displacing a more efficient outside supplier by taking advantage of the tariff preference it enjoys in a partner country.

By introducing the concepts of trade creation and trade diversion, Viner provided tools for identifying conditions under which preferential arrangements are welfare-improving: Unions which are primarily trade creating are beneficial (welfare-improving) and those that are primarily trade diverting are harmful (welfare-reducing) to member countries taken together and to the world as a whole. A PTA, in static analysis terms, represents "freer trade" only to the extent that it results in overall *trade creation*. If the overall outcome is *trade diversion*, it represents "restricted trade". Despite some limitations in theory<sup>32</sup>, trade

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<sup>32</sup> According to Viner, whether a union increases or decreases welfare depends on the relative magnitudes of trade creation and trade diversion. But Meade (1955, chapter 2) pointed out that even the relative magnitudes of trade creation and trade diversion alone are insufficient to determine the welfare effect of the union for two reasons:

**First**, benefits of preferential liberalisation depend on not only the extent of trade creation, but also the magnitude by which costs are reduced on each unit of newly created trade. Similarly, losses are determined not just by the amount of trade diversion but also the magnitude of the increase in costs due to trade diversion.

creation and trade diversion have remained central to policy debates on PTAs. The reason of this is that economists have found these terms to be highly effective tools for focusing policy makers' attention on the ambiguous welfare effects of PTAs (Panagariya, 2000, pp. 291-293).

### **2. 1. 2. Kemp-Wan Approach: Necessarily Welfare-Increasing PTAs**

The Vinerian analysis fixes the pre-union external tariffs and allows external trade flows to adjust endogenously as intra-union trade barriers are removed. In this case, the welfare effects on the union never become unambiguously positive. However, fixing the initial extra-union trade flows and letting the external tariffs adjust endogenously, the outcome becomes opposite: Neither the union as a whole nor the rest of the world can lose from a PTA; and the union is likely to benefit regardless of whether potential members are small or large. This result was stated for a CU by Murray Kemp and Henry Wan (1976): Any arbitrarily-specified subset of countries can always devise a CU to their advantage while

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**Second**, as formalised by Gehrels (1956-57) and Lipsey (1957), even a wholly trade-diverting union may lead to an improvement in welfare under the realistic assumption of downward-sloped demand in importing country. (Meade noted that "trade creation" and "trade diversion" concepts are best introduced within a model exhibiting infinite supply elasticities and zero demand elasticities since this model avoids some of the ambiguities that arise in more general models.) Wonnacott and Lutz (1989, p. 63) stated that since tariffs are preferentially eliminated, the price to importing country's consumers may well be lower on the products newly imported from partner country, even though partner's cost of production exceed those of outside country. As result, the pattern of consumption may be less distorted. This beneficial effect may more than compensate for the fact that partner country's costs of production are higher than those of outside country. They criticise Viner to miss the possibility of an improved pattern of consumption by concentrating narrowly on the costs of production.

Further point was made by Bhagwati (1971) that even with a zero demand elasticity, a trade-diverting union can lead to a net increase in welfare under the assumption of upward-sloped supply in importing country. According to him, to eliminate the possibility of a trade-diverting union leading to welfare gains, it must be assumed that the elasticity of demand for imports in importing country is zero and the elasticity of supply from partner country and third country is infinity.

Panagariya (1999, pp. 483, 484 and 2000, pp. 293-295) supported Viner's distinction between trade creation and trade diversion by concluding that even under the assumptions of downward-sloped demand and upward-sloped supply in importing country, trade diversion is inevitable when trade is realistically multilateral, that is, imports of importing country come from both partner country and outside country but not from just one of them.

In addition to the considerations noted by Meade, Panagariya (2000, p. 293) added one further limitation. If union members are large in relation to the outside world, one can rely on trade creation and trade diversion to analyse the welfare effects of preferential trade liberalisation only if he is interested in world welfare. Trade diversion is likely to be beneficial due to the improvement in terms of trade it brings and trade creation, enhancing the union's income at constant world prices, might generate a harmful effect through deterioration in the terms of trade.

keeping the welfare of the non-members at its pre-union level by determining a suitable common external tariff on non-member countries endogenously. In other words, any group of countries can always form a CU with a common external tariff that has two desired properties:

- I. The non-members will have their welfare unchanged;
- II. The members will improve their own welfare.

Kemp and Wan (1976, p. 95) showed the following:

*“Proposition.* Consider any competitive world trading equilibrium, with any number of countries and commodities, and with no restrictions whatever on the tariffs and other commodity taxes of individual countries, and with costs of transport fully recognised. Now let any subset of the countries form a CU. Then there exists a common tariff vector and a system of lump-sum compensatory payments, involving only members of the union, such that each individual, whether a member of the union or not, is not worse off than before the formation of the union.”

As noted by Kucukahmetoglu (2000, p. 59) who analysed CU and its implications from the perspective of economic integration theory, Kemp-Wan theorem depends on two basic assumptions: Firstly, common external tariff which will be imposed on non-member countries is determined in the way that it will not lead to any change in trade existed prior to the formation of CU between member countries. Secondly, lump-sum compensatory payments and transfers are implemented between member countries.

Kemp and Wan, in their essential contribution to the theory of PTAs, drew inspiration from earlier efforts of Kemp (1964), Vanek (1965), and Ohyama (1972). Therefore, necessarily welfare-enhancing PTAs approach is also called the *Kemp-Wan-Vanek-Ohyama Theorem* in some distinguished papers (Panagariya, 2000).

The logic behind the theorem is clear: If the actual, pre-union trade (net trade vector) of the arbitrarily chosen members of a CU with the rest of the world is frozen, the non-member countries' welfare is frozen too. That is, the rest of the world can be made neither better off nor worse off by the union. This is accomplished by setting the common external tariff vector at a level just right to hold the extra-union trade at the pre-union level. Accordingly, the common external trade falls since, at constant tariff rate, trade would be diverted from

the outside country, causing imports from it and therefore welfare to decline. The external tariff must fall to maintain the imports from the outside country at their original level.

Then, if barriers on intra-union trade are fully removed, the resulting competitive equilibrium can be Pareto-superior. Such CUs reflect a Pareto-improvement over the initial pre-union situation, which was defined by Bhagwati (1991, p. 60, 61) as that “no country within the union is worse off and at least one is better off”. The exporting partner country (B) necessarily gains while the importing country (A) may or may not gain despite total absence of trade diversion due to the revenue redistribution<sup>33</sup>. Kemp derived a conclusion about the impact of forming the union on A and B that “strong inferiority aside, the creation of the preferential trading club operates to the advantage of whichever member trades only with the other member, and operates to the disadvantage of the latter” (quoted by Pomfret, 1997, p. 190). However, a member also trades realistically with the rest of the world as well as the other member<sup>34</sup>. Kemp also shows that both A and B will normally gain vis-à-vis the pre-union situation, in the case that the loser can be compensated and the gainer can retain a net benefit (cited in Pomfret, 1997, p. 190). Accordingly, the Kemp-Wan assumption of lump-sum transfers ensures that no member country gets hurt while some (at least one) member country can be made better off.

Vanek in his 1965 book concluded that not only the disadvantaged partner is compensated, but also the rest of the world is compensated by setting the union’s common external tariff so that external terms of trade are unchanged and thus welfare of A and C is held constant. Under these conditions B will be better off after forming a CU than before it (cited in

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<sup>33</sup> The abolition of tariffs within the PTA will generally lead to tariff revenue redistribution among the members. The importing partner loses its tariff revenue which it previously collected but no longer does. Previously collected tariff revenue goes to exporting firms. The loss of tariff revenue on inter-member trade can outweigh any net gain arising from trade creation. The larger the quantity of trade with the exporting partner, the larger the redistribution and the greater the loss. This analysis suggests that the member with high initial tariffs like Mexico will lose and the member with low initial tariffs like the US will benefit. (Bhagwati, Greenaway and Panagariya, 1998, p. 1130)

<sup>34</sup> In that case, B necessarily gains. However, A may or may not gain in spite of total absence of trade diversion. With outside imports held fixed, the internal price declines by the full amount of the decline in external tariff. The revenue lost on the imports from the outside country (C) (because of the reduction in the external tariff) is redistributed to A’s consumers. However, the revenue lost on imports from B is redistributed to the B’s exporting firms to the extent of tariff preference. This revenue loss to A must be compared against the gain on the new trade created with B. The gain to B is the revenue redistribution from A and the gain on new intra-union trade.

Pomfret, 1997, p. 190). Kemp and Wan restated this elementary proposition in a more general form.

The difference between the domestic price associated with the equilibrium reached after dismantling intra-union tariffs and the foreign price produces the endogenously-determined common external tariff for the union. Therefore, as Bhagwati and Srinivasan (1992, p. 287) stated, this external tariff and the lump-sum transfers (subsidy) within the union ensure that the outside countries are not damaged and that some member countries are better off while others are not worse off. In other words, these two elements together support the necessarily-welfare enhancing Kemp-Wan CU.

Viner attacked on the intuitive notion that any move towards free trade, even it is preferential, would necessarily be welfare improving. According to Bhagwati, Greenaway and Panagariya (1998, p. 1136), although Kemp and Wan appear to be restoring that pre-Vinerian intuition about PTAs, the pre-Vinerian intuition is not restored by Kemp and Wan actually: The intuition was that all kinds of trade liberalisation short of free trade and therefore all PTAs were desirable since they eliminated trade barriers, no matter how they were eliminated. However, Kemp and Wan show that a particular PTA which improves the welfare of member countries without affecting the terms and volume of trade and hence the welfare of the non-member countries can always be devised. Therefore, Kemp and Wan, through their proposition, which is potentially interesting as an economic justification for PTAs, provides analytical support to the view that CUs can always be designed as a welfare-improving device both for member countries and for world welfare, although they fall short of free trade.

However, just like all other theorems, this theorem has been criticised too.

Kucukahmetoglu (2000, p. 61) stated that validity of this theorem is subject to the feasibility of the assumptions on which it depends. However, according to him, Kemp-Wan approach has some difficulties in practice: First of all, there might be some challenges and difficulties in determining the common external tariff. Additionally, there are difficulties in providing compensatory transfer payments between the member countries of CU.



Moreover, Bhagwati (1992, p. 548) thought that the problem with the operational significance of the Kemp-Wan theorem is that it is an *existence* argument since it does not have any structure being put on it in the context of a specific model so that intuition about what the external tariff structure for such a Kemp-Wan CU would be can be developed. That is, it does not provide a clue for the structure of the endogenously determined external tariff that would emerge in the Kemp-Wan welfare-improving CU. Therefore, it can also be called a *possibility* theorem. It is nothing more and nothing less than that. Nonetheless, although Bhagwati stated the problem concerning the Kemp-Wan theorem, he emphasised that “that *any* subset of countries *could* form an unambiguously (world-) welfare-improving union is definitely established by Kemp and Wan.”

Panagariya and Krishna (1997) extended this theorem by including FTAs: Fully in the spirit of the Kemp-Wan theorem, they concluded that if two or more countries form an FTA by freezing their initial, *individual* trade vectors through country-specific tariff vectors, welfare of neither the union nor the rest of the world falls and that of the former is likely to rise.

### **2. 1. 3. Cooper-Massell-Johnson-Bhagwati Approach: Forming a Customs Union to Minimise the Cost of Import Substitution**

During 1960s there was an outbreak of PTAs between developing countries which were motivated by the different economic rationale formulated by Cooper and Massell (1965a, b), Johnson (1965) and Bhagwati (1968) as well as by the success of European Economic Community. This relates to an old issue discussed in the development literature: At those times, import substitution strategy against developed countries was targeted by developing countries for rapid industrialisation. Therefore, given any level of import substitution vis-à-vis the formers, the policy problem for the latter under the constraint of high cost of import substitution strategy was to liberalise trade preferentially among themselves and to reduce the cost of their individual import substitution strategy.

Cooper and Massell, Johnson, and Bhagwati argued that given any targeted level of import substituting industrialisation, developing countries with their small markets could diminish the cost of this type of industrialisation by exploiting *scale economies* through preferential



opening of markets with one another and therefore through enlargement of the market supplied. If a given target level of aggregate import competing industrialisation is the objective, its cost for developing countries with small markets can be reduced by forming PTAs that allowed trade and mutual exchange of industrial production among themselves with *economies of scale* exploited within the PTA while maintaining protection against the producers of the developed countries. It is apparent that this argument is different from the Kemp-Wan approach since it defines a non-economic<sup>35</sup>, “production” objective for each member country as an added constraint on the solution and does not require that the non-member countries not be worse off.

Actually, attempts were made at forming such PTAs along these lines in East Africa and in Latin America. However, as part of the aborted First Regionalism, these attempts had failed by the end of 1960s. According to Bhagwati (1992, p. 539), the reason was that the developing countries attempting such PTAs sought to allocate industries by bureaucratic negotiation and tie trade to such allocations, that is putting the cart before the horse and killing the forward momentum, rather than use trade liberalisation and thus prices to guide industry allocation.

As stated above, the Cooper-Massell-Johnson-Bhagwati argument relied on the presence of *scale economies* to advance its own theoretical underpinning. However, Krishna and Bhagwati (1999) argue that this argument can also be formulated without scale economies, which are not essential to the argument. That is, even without invoking scale economies, specialisation in manufactures within the union would be profitable. While Krishna and Bhagwati (1999, p. 272) treat any given degree of overall industrialisation as a “non-economic” objective, it has the flavour of the Kemp-Wan logic:

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<sup>35</sup> Although the objective of a nation is not only to maximize its economic welfare, economic textbooks heavily depend on *economic* objectives. However, political, cultural, and sociological objectives are also important for the governments. According to Chacholiades (1990, p. 182), there are mainly four specific *non-economic* objectives: (1) a certain level of *production* (industrialisation); (2) a certain level of *consumption* (usually to restrict the consumption of luxury goods on social grounds); (3) a certain level of *self-sufficiency* (to reduce the dependency on imports for political or military reasons); and (4) a certain level of *employment of a factor of productions* such as labour (to preserve the national character and the traditional way of life). Since these objectives essentially originate outside the economic model, they are called non-economic.

“Any subset of countries can always form a welfare-enhancing CU, while ensuring that they can maintain the degree of industrialisation that they had achieved through protective tariffs.” Two or more countries which pursue the import-substituting industrialisation objectives (certain non-economic objectives) against non-member developed countries can form a CU between themselves and be jointly better off while leaving non-member countries’ welfare unchanged. Krishna and Bhagwati (1999, p. 275) showed that the solution involves a Kemp-Wan CU complemented by *production tax-cum-subsidies* to achieve the non-economic objectives of member states as indicated by the theory of optimal intervention<sup>36</sup> in the presence of non-economic objectives:

“Welfare-improving CUs can be guaranteed even if we are constrained by specific non-economic government objectives. We have considered a “production” objective here, but it is straightforward to show that this result can be extended to other non-economic objectives too. As we would expect from the insights of both the Kemp-Wan theorem and the theory of non-economic objectives, necessarily welfare improving Cooper-Massell-Johnson-Bhagwati union requires both an appropriate common tariff and an appropriate domestic tax-cum-subsidy addressed to the non-economic objective desired.”<sup>37</sup>

Therefore, Krishna and Bhagwati provided a proper proof of Cooper-Massell-Johnson-Bhagwati proposition and saw that the argument could be proved simply as a version of the Kemp-Wan theorem with an added policy instrument thrown in to reach the targeted degree of member country industrialisation.

However, Bhagwati, Greenaway and Panagariya (1998, p. 1138) argued that the Cooper-Massell-Johnson-Bhagwati approach now principally has a historical-explanatory value because at present almost all developing countries are persuaded about the pitfalls of the import substitution strategy. They have seen that *export promotion* strategy have led them to far more rapid industrialisation rather than import oriented strategies as in the case of Far East. The renewed preference for PTAs among a subset of developing countries is currently motivated by quite different reasons as examined in the first chapter.

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<sup>36</sup> Since the attainment of a non-economic objective generally involves the violation of one or more Pareto optimality conditions, it has an economic cost in the form of a welfare loss. The optimal policy that achieves the non-economic objective at the least welfare loss is to intervene at the exact point of the distortion for correcting a distortion. For example, the government must intervene with a production tax or subsidy to remove a distortion in domestic production. This optimal rule is also the key to the present case of non-economic objectives. (Chacholiades, 1990, p. 182)

<sup>37</sup> For example, in the case of the non-economic objective of a certain level of *employment*, the supporting policy then will be an employment-tax-cum-subsidy complementing the common external tariff to form a welfare-enhancing CU which does not harm or benefit non-members (Krishna and Bhagwati, 1999, p. 275).

## **2. 2. DYNAMIC TIME-PATH ANALYSIS: BUILDING VERSUS STUMBLING BLOCKS**

Up to this point, immediate (static) effects of forming a PTA have been examined. However, the analysis of the effects of the PTAs on international trading system would be seriously incomplete if, having analysed the static effects, dynamic time-path question was not analysed. The issue of PTA effects on international trading system does not only relate to whether the static effects of a PTA are benign or harmful, but also relates to whether the dynamic time-path effects of the PTA are to accelerate or decelerate the continued reduction of trade barriers toward the goal of reducing them worldwide.

Just as the key concepts of “trade creation” and “trade diversion” as two possibilities that define the second-best nature of the static analysis of PTAs were introduced by Viner (1950), Bhagwati (1991, p. 77) introduced the key concepts in the dynamic time-path case of PTAs acting as “stumbling blocks” or “building blocks” toward worldwide non-discriminatory trade liberalisation. The PTAs that, in a dynamic time-path sense, contribute to the multilateral freeing of trade either by progressively adding new members or by prompting accelerated multilateral trade negotiations are *building blocks* toward the multilateral freeing of trade. However, the PTAs that do the opposite are *stumbling blocks* to the goal of worldwide, multilateral freeing of trade. This conceptualisation of PTAs owes to Bhagwati and has been adopted by Lawrence (1997b) and others. While Viner’s trade creation and trade diversion concepts were designed to divide PTAs into those that were good and those that were bad in the static sense, Bhagwati’s building block and stumbling block concepts are designed to divide PTAs into those that are good and those that are bad in dynamic time-path sense.

### **2. 2. 1. Formulating the Time-Path Question**

The time-path question was formulated by Bhagwati and Panagariya (1996a, pp. 43, 44) analytically in two separate ways:

### 2. 2. 1. 1. Analytical Question I.

The time-path of MTN and the time-path of PTAs are assumed separable and, therefore, do not influence each other. These two policies are independent of one another. Therefore, they neither hurt nor help each other. Then, will the PTA time-path be characterised by stagnant or negligible expansion of membership; or will there be expanding membership, with this even turning eventually into worldwide membership as in the WTO, hence reaching non-discriminatory free trade for all? In other words, it could be asked that whether the expansion of a PTA can continue until a global free trade is achieved or not. This question is originally introduced by Bhagwati (1992). A similar question can be asked for the MTN time-path and then the analysis can be extended to a comparison of the two time-paths by ranking efficiency of the two methods of reducing trade barriers to arrive at the goal of global free trade for all.

Question I was illustrated by Bhagwati and Panagariya with the aid of Figure 2. 1. that represents a sample of possibilities for the time-paths. Time is set along the horizontal axis, and world (rather than individual member) welfare is set on the vertical axis. For the MTN (or what are described as “process-multilateralism”) time-path, an upward movement along the path implies non-discriminatory lowering of trade barriers among the almost worldwide WTO membership. With respect to the PTA time-paths, it implies growing membership instead. Since The PTA and MTN time-paths are assumed to be independent from each other, the PTA time-path neither accelerates nor decelerates the course of MTN. The ultimate goal is, at a specified time, arriving at  $U^*$ , which is the worldwide freeing of trade barriers on a non-discriminatory basis.

Question I is illustrated by reference to the PTA paths I-IV. Accordingly, PTAs may improve welfare immediately in the short run (in the static sense) from  $U^0$  to  $U^2_p$  or reduce it  $U^1_p$ . In either case, if the time-path is then stagnant (as showed by time-paths II and III), this situation implies a fragmentation of the world economy through no further expansion of the initial PTA. Alternatively, as in time-paths I and IV, it may lead to multilateral free trade for all at  $U^*$  through continued enlargement and combination of the PTAs. The time-path may fail to reach  $U^*$  and fall short at  $U_m$  because of free rider problems under

“process multilateralism” which is MTN as a multilateral process of reducing trade barriers as distinct from multilateralism as the ultimate goal desired.

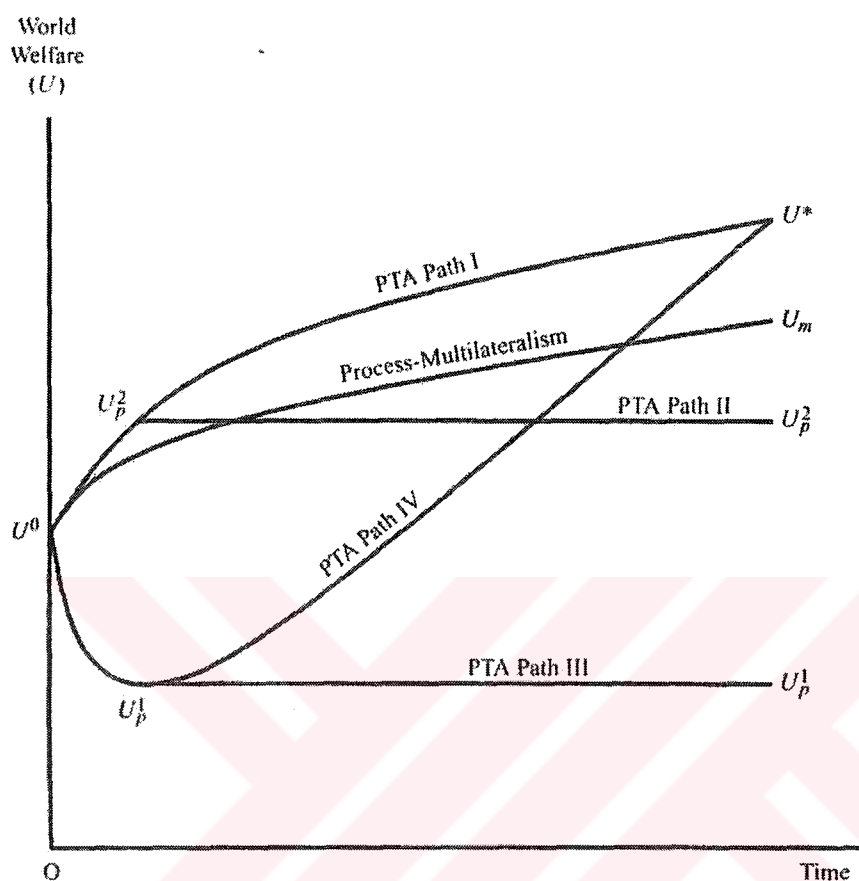
### **2. 2. 1. 2. Analytical Question II.**

This question analyses a more plausible case: Both the MTN and the PTA time-paths are assumed to be adopted simultaneously. This means that they will interact. In this situation, either the policy of undertaking PTAs will have an adverse effect on the progress along the MTN time-path, or it will have a benign impact on the MTN time-path. In other words, PTA process, as Bhagwati and Panagariya identified, will be either a “foe” or a “friend” of the MTN process<sup>38</sup>. Therefore, the question is whether PTAs make multilateral liberalisation less or more likely, that is whether it serves as a building block or a stumbling block to global freeing trade. In the case that question II can be addressed, that is if the PTA and MTN time-paths are interdependent, then the MTN time-path becomes a function of whether the PTA time-path is travelled simultaneously.

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<sup>38</sup> Bhagwati and Panagariya (1996a, p. 44), in footnotes, also mentioned the mutuality of the interaction between the two paths since the MTN path may facilitate or obstruct the expansion of PTA membership.

**Figure 2. 1. PTA and MTN time-paths**



### 2. 2. 2. Question Originating in Policy

The dynamic time-path question has arisen in policy concerns and political decisions first and then the theory which has tried to explain them has dealt with this question in the hands of Bhagwati and others. That is, policy concerns and political decisions ran ahead of the theory just as in the case of static analysis. The post-Vinerian analysis of the static question coincided with the movement that eventually created European Community via the Treaty of Rome in 1957. The dynamic time-path question has arisen in the context of the US failure to get a new MTN Round started under the auspices of the GATT Ministerial in 1982 when the Europeans blocked its initiation and of the US decision to finally abdicate its avoidance of Article 24 sanctioned PTAs.



Bhagwati (1992, pp. 540, 541) argued that the shift in US policy in favour of going through Article 24 with its free trade agreements with Israel and, more importantly, with Canada represents a change of considerable significance for international trade liberalisation: As the key defender and as the leading pro-GATT player of multilateralism throughout the post-war period, its decision to go on through the regional route (in the geographical and the preferential senses simultaneously) inclines the balance of forces from multilateralism to regionalism, as compared with the situation in the 1960s. This shift in the US attitude towards regionalism was a result of perceived potential failure of the Uruguay Round trade negotiations: In the early 1990s, concerns were growing that the Uruguay Round trade negotiations could fail and that the revival of the new protectionism of the late 1980s, reflecting to resort to non-tariff barriers rather than tariffs, could accelerate, resulting in a world dominated by trade blocs. This perception led to an anti-multilateralist environment reflecting alternative but reinforcing views:

- I. The GATT is dead or the GATT should be killed. Regionalism then is presented as an *alternative* to multilateralism<sup>39</sup>.
- II. Regionalism is a useful *supplement*, not an alternative to multilateralism. “We are only walking on two legs” is the popular argument.
- III. Regionalism will not merely supplement multilateralism. It will also *accelerate* the multilateral process: the threat of going through regional route will induce multilateral agreements.

The rationale behind the first view which was initially the policy choice of the US was that if multilateralism could not lead to worldwide removal of trade barriers, then preferential trade arrangements should be used for that purpose as an *alternative* to multilateralism. Then, the US became committed to the policy that it is possible to walk and chew gum at the same time. In other words, regionalism has been seen as a useful *supplement*, not an alternative, to multilateralism. It has become an active proponent of this view even after the Uruguay Round of MTN had been successfully completed and the WTO started to

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<sup>39</sup> This view was held by the “Memorial Drive” school. (The MIT Economics Department is at 50 Memorial Drive in Cambridge, Massachusetts.) Bhagwati (1992, p. 540, in footnotes) excludes Charles Kindleberger, Paul Samuelson and himself, and includes Dornbusch and Krugman. Memorial Drive school has by now shifted its anti-multilateral stance and joined the more common view that regionalism is a useful supplement, not an alternative, to multilateralism.

operate. Nowadays, new WTO Round of MTN is taking place and US policy embracing both the PTA and MTN paths is still under way.

It is also asserted by many circles that regionalism will not only supplement but also *accelerate* multilateralism through actual or potential use of regional arrangements for tactical purposes by countries seeking to achieve their multilateral negotiating objectives. That is, the threat of going through regional route will induce multilateral agreements<sup>40</sup>. During the Uruguay Round, it was thought that the US could threaten or actually play the regional card and engage in active discussions with prospective regional partners to deal with stubborn multilateral negotiating partners. That is, it was thought that it was to the US advantage to use regional trade negotiations under way as a threat to those who will not move fast enough to change the GATT to suit America's desires and interests. If multilateral partners were slow to react, initiation of regional negotiations would facilitate to reach the result. Because the process of change at the GATT is necessarily going to be slower than American impatience would dictate, regional card is likely to be played again and again. This has reinforced the American conversion in policy. (Bhagwati and Panagariya, 1996b, p. 85; Bhagwati, 1991, pp. 71, 72)

The questions formulated in the context of the dynamic time-path question by Bhagwati and Panagariya stem from this shift in US policy. The shift has been apparent for fifteen years starting from the "father" Bush administration. Clinton administration articulated it as a distinct policy. With respect to the "junior" Bush administration, the same trend is still dominant even by gaining strength at the expense of "multilateralism" in all aspects.

Bhagwati and Panagariya (1996a, b) systemised the theoretical literature that has developed on the dynamic time-path questions:

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<sup>40</sup> This approach which takes up regionalism as a benign phenomenon for multilateralism due to induced acceleration of MTN is analysed in detail in Chapter 3 under the title "Does Regionalism Serve as a Building Block or a Stumbling Block for Multilateral Trading System".

## 2. 2. 3. Exogenously-Determined Time-Paths: Conventional Approaches

### 2. 2. 3. 1. Kemp-Wan Argument

The Kemp-Wan (1976) theorem while provided, in static sense, the “possibility” of a necessarily welfare-increasing CU for both member countries and the world as a whole implied a monotonic PTA time-path to multilateral free trade for all in dynamic time-path sense. It is apparent in the Kemp-Wan proposition that the PTA time-path to  $U^*$  in Figure 2. 1. can be made monotonic provided that expanding membership of a PTA always satisfies the Kemp-Wan rule for forming a CU. In other words, in the Kemp-Wan model which provides the general framework of regional convergence towards world free trade, a CU that formed by a subset of countries can be enlarged progressively until it includes the entire world, only if lump-sum compensatory payments are possible between members to ensure that every country is not worse off after the expansion.

That the existence of a PTA path along which world welfare increases monotonically as analysed by Kemp and Wan, seems to be relevant to Question I. However, Bhagwati and Panagariya (1996a, pp. 46, 47; 1996b, p. 85) thought that it is not since this argument does not say, and cannot say, that the PTA will necessarily expand. It does not touch upon whether each expansion will be in the Kemp-Wan fashion, if the PTA expands. This weakness of the argument was also pronounced by its fathers, Kemp and Wan (1976, p. 96), who stated latency and insufficient strength of *the incentive* to form and enlarge CUs.

Hughes Hallet and Primo Braga (cited in Lopez and Matutes, 1998, p. 259) are the other critics of the Kemp-Wan model with respect to the two aspects: Firstly, side-payments (lump-sum compensatory payments) require intra-bloc explicit co-operation which is not always possible. Secondly, since there is a strong incentive to stop the expansion of the PTA and exploit its market power, its enlargement does not ensure the ultimate goal of global free trade even with such co-operation mentioned above. This situation is very clear in the case of less attractive applications for membership by marginal members, which will be net recipients of resources like developing countries.

### **2. 2. 3. 2. Krugman Argument**

The theoretical approach to the question of PTAs introduced by Paul Krugman (1991a, 1991b, 1993) seems to be relevant to the Question 1 too. But, as in the case of Kemp-Wan argument mentioned above, it is claimed not to be pertinent to the Question 1 by Bhagwati and Panagariya (1996a, p. 47). Krugman, by treating the expansion of membership as exogenously specified, considered the welfare results of the world mechanically dividing into a steadily increasing number of symmetric blocs and examined the monotonicity of world welfare including calculations concerning the optimal number of such symmetric PTAs (blocks).

His argument depends on a model of a large number of small, identical countries each of which specialises in the production of a distinct good and initially imposes its tariff on all imports. Then he examined world welfare when these countries join into various numbers of equal sized symmetric trading blocs each of which revise their external tariffs (which are chosen non-co-operatively in order to maximise welfare) to remain optimal against goods from the third countries. Krugman found that world welfare declines as the number of blocs decreases (and therefore countries join ever larger PTAs) until the number of blocs becomes three. Then world welfare increases since the number of blocs is reduced further to two, and it increases even more with the move to worldwide free trade in a single bloc. In other words, world welfare is at a minimum when there are three blocs.

Given a small number of blocs, the representative bloc is large, and most of its trade is intra-regional. Therefore, as long as the number of blocs decreases, the contraction of trade with the outside countries dominates the expansion of trade between the existing members and the new comers that are moved into to eliminate the old bloc. That is why the trade diversion effect must come to dominate the trade creation effect as the number of blocs decreases and vice versa. Krugman concludes that bilateralism (or more accurately, regionalism) in trading arrangements is generally undesirable since the formation of PTAs would reduce world welfare at almost every stage<sup>41</sup>.

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<sup>41</sup> An alternative approach concluding that the formation of PTA would be beneficial and that a world of a small number of blocs, even three, could not be so bad, instead lead to the maximisation of world welfare was suggested by Alan Deardorff and Robert Stern (1994):

Bhagwati and Panagariya (1996a, p. 47; 1996b, p. 85) criticised Krugman's argument due to its apparent irrelevance to the incentive-structure dynamic time-path question concerning the membership expansion of PTAs. It is in the conventional mould of taking the membership of a PTA and its expansion as exogenously specified. Therefore, it fails to throw light on the analysis of the dynamic time-path question 1.

#### **2. 2. 4. Endogenously-Determined Time Paths: Recent Theoretical Analyses**

The main problem of the Kemp-Wan and the Krugman formulation is conventional form of taking the membership of a PTA and its expansion as exogenously specified and examining its consequences. Therefore, the analysis of the time-path question has moved into formal political-economy-theoretic incentive structure modelling which endogenises the questions of membership expansion and PTA impact on the MTN time-path and which helps to address the time-path questions I, II.

##### **2. 2. 4. 1. Political-Economy-Theoretic Modelling Regarding Analytical Question I**

Richard Baldwin (1999) who focused on the incentives of non-members to join the PTA made the only contribution concerning Question 1. His model showed that the PTA will cause a "*domino effect*" since non-members will be eager to become insiders on an escalator basis. Baldwin (1999, p. 500) stated that a political equilibrium that balances anti- and pro-membership forces determines the stance of a country's government regarding membership of a bloc. Firms that export to the regional bloc are among the pro-membership forces. Closer integration between a subset of countries will activate the

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Contrary to the Krugman whose model is driven by the product differentiation, they assumed a world where differences in comparative advantage drives most trade and countries act co-operatively rather than non-co-operatively in their trade policies. The traditional model of comparative advantage means that all countries are capable of producing the same goods, but they differ in their ability to do so either due to differences in technology or differences in factor endowments. Then the effect of a PTA on world welfare depends on the differences among countries that form the PTA. As long as countries form a PTA with others who differ enough in the context of comparative advantage, they will have a significant portion of the gains from trade that would be possible with a multilateral system. In other words, a group of trading blocs can approximate the level of welfare that would be available from worldwide free trade. However, Deardorff and Stern (1994) claimed that if such blocs are too small and the trade between them is too limited, the gains will not be achieved. Through increase in bloc size the world welfare rises; and approaches the free trade level since bloc size approaches the world as a whole. Blocs must be sufficiently large to reach the free trade level. Therefore, their analysis argues in favour of trading blocs only if they are sufficiently large and only if they collectively include the whole world.

outside exporters to deal with greater pro-membership political activity since closer integration within an existing bloc or forming a new PTA is harmful to their profits. In the case of enlargement the cost to the outside exporters increases because they confront a cost disadvantage in an even greater number of markets. This is a second round effect and it will stimulate more pro-membership political activity in outside countries. This may lead to further enlargement of the PTA. Baldwin stated that those non-member countries, which seek to join the regional arrangement, have a rather small home market and depend rather heavily on exports to it.

Bhagwati and Panagariya (1996a, p. 50; 1996b, p. 85) evaluated Baldwin's argument depending on domino theory from the perspective of Question 1: This argument is basically driven by the fact that the PTA implies a loss of cost competitiveness by imperfectly competitive non-member firms whose profits in the PTA markets decrease since they must suffer the tariffs that member countries' firms are exempted from paying. These firms then lobby for admission and incline the political equilibrium in their countries in favour of membership. Provided that joining the PTA is free, the countries closest to the margin will join it. Enlargement of the market increases the cost of non-membership and stimulate countries at the next margin. Eventually, all countries want to enter the PTA as the PTA expands. Bhagwati and Panagariya (1996a, p. 50; 1996b, p. 85) concluded that under these assumptions, including continuity, this domino effect model can take the PTA time-path to  $U^*$  in Figure 2. 1. In other words, unless there are sufficiently strong non-economic factors that counter these incentives and as long as the PTA is open to new entries (as assumed by Baldwin), this process can lead to global free trade.

#### **2. 2. 4. 2. Political-Economy-Theoretic Models Addressing Analytical Question II**

The rest of the theoretical contributions address Question II which is whether the PTA time-path helps or harms the MTN time-path or whether regionalism makes the success of the multilateral process more or less likely (building blocks or stumbling block for multilateralism). The two major analyses by Pravin Krishna (1999) and Philip Levy (1999) addressed this question and reached "stumbling block" (adverse impact) in contrast to the US policy "walk on both legs".



#### 2. 2. 4. 2. 1. Krishna Model

Krishna in his article (1999) analysed the impact of PTAs on the internal incentives for multilateral liberalisation. By reaching the “adverse impact” conclusion, he challenged the view that PTAs are superior to multilateral trade liberalisation as a way of achieving the final aim of free trade for all. He, by using a model of imperfect competition (oligopolistic competition), examined bilateral PTAs from the perspective of the “political economy” which views trade policy as being determined by concentrated interest groups by lobbying. In his model, *producers* as a concentrated interest group play a strong and decisive role in determining trade policy outcomes and the government that is passive acts as a “clearing house”<sup>42</sup> in response to implicit lobbying by producers.

Krishna’s analysis reached two conclusions (1999, pp. 454-455):

- I. PTAs that are more “trade diverting” are more likely to be supported by member countries politically. This is because while producers in the PTA gain preferential access to the partner’s market where they gain both against the partner country’s producers and by diverting trade from the outside producers, the protection in the domestic market that they lose is only against the partner’s producers. However, if trade is not diverted from the outside producers<sup>43</sup>, it is then less likely that producers from the partner countries would gain from this PTA which is hence less likely to be supported. In the case of trade diversion away from the outside producers (in both of the member country markets), it is more likely that producers from the member countries gain and the PTA is more likely to be supported.
- II. Accordingly, such preferential arrangements will reduce the incentives for multilateral liberalisation. After reaching the first conclusion, it is straightforward to examine the impact of such PTAs on the incentives confronted by partner countries for multilateral liberalisation. As analysed in the first conclusion, trade diverting PTAs generate rents for its producers because of the preferences provided

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<sup>42</sup> This concept was proposed by Bhagwati (cited in Bhagwati and Panagariya, 1996a, p. 50) as a government assumption where the government is passive.

<sup>43</sup> Krishna saw this kind of preferential arrangement a bit like a *zero-sum game* since producers from each partner country gain in their partner's market and lose in their own market against the partner's producers.

by the PTA. Under the condition of that governments care sufficiently about producers and unless the increased access to outside countries' markets that would come with multilateral liberalisation does not generate sufficient rents to offset the elimination of preferences, PTAs could be preferred to multilateral liberalisation. Therefore, multilateral free trade, which would have been politically feasible in the absence of PTA, is rendered infeasible.

In sum, the greater the trade diversion resulting from the PTA, the more likely it is that member countries would support the PTA and that initially feasible multilateral liberalisation could be made infeasible by PTAs.

With these conclusions Krishna showed in his study that the PTA reduces the incentive of the partner countries to liberalise tariffs reciprocally with the rest of the world and that this incentive may be so reduced as to make impossible an initially possible multilateral free trade. By answering the question "whether an initially feasible multilateral liberalisation remains necessarily so after the PTA is formed" as negative, he found that the more the PTA benefits from trade diversion in terms of producers' profits, the more likely it will turn into a "stumbling block". Therefore, he clearly concluded that countries should be restricted to pursuing GATT type of multilateral liberalisation in order to avoid these difficulties (Krishna, 1999, p. 467).

#### **2. 2. 4. 2. 2. Levy Model**

Levy (1999) modelled the political process by using a median-voter political economy model, in which a simple majority of voters is required to pass a proposal, to demonstrate that bilateral FTAs (PTAs) can undermine political support for multilateral trade liberalisation. Levy studied that countries might agree PTAs before a multilateral agreement is made and then lose the willingness to follow multilateralism further. His study depends on two models: a two-good, two-factor, multi-country Heckscher-Ohlin model, and a richer variant of the first model which incorporates "increasing returns to scale" and adds "product varieties" as another dimension to voters' utility.

Trade itself is determined in some sectors by differences in factor endowments while in others by considerations of imperfect substitutes. As Levy (1999, *passim*) argues, trade policy is always a trade-off between the gains and the losses. The losses inflicted by a fall in the relative price of the product are less in the intra-industry sort of trade, which is generated in imperfect substitutes, than in trade based on differences in factor endowments. The reason is that the adjustment to import competition in the former case requires workers only to move from the assembly line for one product variety to the assembly line for another variety of the same product while in the latter it requires workers to move to different industries (and at lower wages in the case of capital intensive industrialised countries). Additionally, gains in the former are more than the latter since in the first case median voter's utility is afforded by increased number of product varieties while it depends just on the capital-labour ratio in the second case.

Therefore, intra-industry sort of trade is easier to accept politically than the factor-endowment sort of trade. If a vote is held first on whether to join a PTA, the proposition is more likely to pass when the potential partner has similar factor endowments. In other words, it is easier politically to achieve an EU which is among developed countries than a NAFTA or APEC which are among developed and developing countries. This is because the gains from increased trade in imperfect substitutes will be large, while the losses from a fall in the relative price of labour-intensive products will be small.

But if a vote is then held on multilateral liberalisation which involves both developed and developing countries, it will fail since those key sectors that stand to profit from trade in imperfect substitutes will already have reaped those gains, and there will be fewer political forces to countervail the sectors that lose from the additional factor-endowment trade. Here the order of offer, in other words, that first a potential PTA and then a multilateral free trade agreement are offered to voters is important and determining factor. In this way PTAs undermine political support for multilateral liberalisation in this model. That is, the option to form a PTA can make a previously feasible multilateral liberalisation infeasible. Even though median voters would have accepted multilateral agreement in the absence of PTA, they will reject the former in the latter's presence. Only the cases in which such balances are impossible, as in the Heckscher-Ohlin model in which a voter's utility depended just on the capital-labour ratio, make these concerns abate.

Levy (1999, p. 448) reached a general principle that the more politically popular a PTA is, the more likely it is to undermine political support for further multilateral liberalisation. He pointed out the importance of multilateralism for trade liberalisation by concluding that all these concerns stated above are avoidable when countries are restricted to pursuing multilateral liberalisation instead of preferential liberalisation. He argued that the WTO must accommodate strong desires and attentions of its most powerful members like the US and the EU to survive as an institution for multilateral trade liberalisation.



### **CHAPTER 3. REGIONALISM VERSUS MULTILATERALISM**

A distinctive feature of the contemporary world trading system which experiences the development of a worldwide trend towards increased regionalism is the co-existence of regional trade arrangements alongside multilateral trade negotiations. In the light of the underlying reasons and the nature of the current wave of regionalism mentioned in the first chapter in detail, one can easily come to the conclusion that, as argued by many scholars like Bhagwati (1992, p. 542; 1991, p. 71), it will endure this time unlike previous wave of regionalism since it shows many signs of strength and few points of vulnerability.

In the first three decades of the GATT, from the late 1940s into the late 1970s, the support for and the trend toward multilateral free trade dominated the tendencies toward preferential trading arrangements. Indeed, most of the preferential trading arrangements that were formed during this time were relatively unimportant or complete failures except the EFTA and the EC.

However, attitudes have changed regarding the balance between preferential trade arrangements and multilateral negotiations toward free trade since the early 1980s especially due to the conversion of the US approach to Article 24 in favour of regionalism as examined in the second chapter. When a GATT Ministerial Meeting in 1982 was broken off without agreement on a new round of trade negotiations, the US response was to announce that the US would seek a more open trading system with “two-track” approach. On the one hand, the US has continued to seek further multilateral liberalisation; on the other, it has joined in preferential arrangements with like-minded countries that were willing to open up their markets to an extent greater than that agreed to under the GATT. This shift is of major significance since, as the key defender of multilateral trade liberalisation during the post-war years, the US decision to pursue a regional policy along with a multilateral one tilts the balance of forces away from multilateralism to regionalism.

It is evident that the emphasis of the world trading regime has shifted from one in which trade relations between states were almost entirely multilateral to one in which the open multilateral system coexists with a series of preferential trade arrangements. This co-existence of the WTO and multilateral trading system in tandem with a proliferation of

preferential trading arrangements raises important questions. International economists, international political economists and policy-makers have long debated whether, and more importantly under what conditions, the proliferation of preferential trade arrangements is compatible with further strengthening and liberalisation of the multilateral trading system. Two major questions in relation to the effects of preferential trade arrangements on multilateral trading system need to be answered for this debate to reach a satisfactory conclusion: Firstly, how do preferential trade arrangements of new wave of regionalism affect welfare of *non-members* in static sense? Secondly, does PTAs accelerate or decelerate the continued reduction of trade barriers toward the goal of reducing them worldwide?

There is considerable disagreement on these questions. Some international economists like Bhagwati (1995) have concluded that preferential trade arrangements threaten the multilateral trading system and should be severely circumscribed, if not forbidden, under the WTO. Others argue that such arrangements are a step towards multilateral liberalisation (non-discriminatory multilateral free trade for all) and inherently strengthen the WTO and international trading system.

### **3. 1. WELFARE EFFECTS OF REGIONALISM ON NON-MEMBERS**

The classical Vinerian concept of trade diversion offers an appropriate framework to assess the impact of regionalism on welfare of non-members. Each preferential trade arrangement, which discriminates in favour of its members, has two faces: They liberalise trade among its members whereas they protect against non-members. The important issue in this thesis is that whether the liberalisation among the members occurs at the expense of non-members rather than which aspect of a preferential trade arrangement is dominant: Would such discriminatory arrangements be harmful to non-members through trade diversion?

Trade theorists have usually evaluated static effects of PTAs either on world welfare as a whole by asking whether the trade creation outweighs the trade diversion or on members' welfare by asking how to maximise the gains from trade creation. However, in this thesis static effects of PTAs are evaluated in terms of non-members. Since welfare effects of



PTAs are taken into consideration from the non-members' point of view, this approach renders the size of any trade creation irrelevant and any trade diversion detrimental, thus undesirable, regardless whether the trade creation outweighs the trade diversion. Therefore, finding an answer to the question "whether PTAs affect *non-members' welfare* -instead of *members' or world welfare*- in a harmful or benign manner" is one of the objectives of this chapter.

Any change in trade policy produces gainers and losers. By the same token, PTAs by reducing barriers to trade among their members can create new opportunities for gains from trade while by discriminating against non-members can lead to losses. If the increase in trade within the arrangement occurs at the expense of trade formerly with non-member countries, then the third countries are harmed unless the member countries are sufficiently small in relation to the outside world so as not to affect world prices of their traded goods regardless of their behaviour. The classical gains-from-trade theorem says that freer trade results in a larger pie, but it does not say anything about how the pie is to be distributed. It says there exists a potential Pareto-improvement, but it does not show how to realise it. For the gains from trade to be spread around the population, some of the gains must be redistributed to those who would otherwise suffer from the policy change. Within a PTA there exists a range of instruments to achieve these redistributions. However, between the PTA and non-members there is much less scope for redistribution. (McMillan, 1993, pp. 294, 295)

While a predominantly trade diverting PTA can still improve a member country's welfare mainly through its dynamic effects like economies of scale and improvement in competition or through a shift in intra-union terms of trade in its favour, any trade diversion, even if it does not outweigh trade creation harms outside countries. That is why our main focus in this thesis is on the trade diversion effect of PTAs on outside countries and how to contain it, which is elaborated particularly in the fourth chapter.

#### *Debate on Trade Diversion*

One of the chief concerns over preferential trade arrangements is that they are detrimental to non-members because of the trade diverting effect that will arise from the discriminatory

tariff behaviour. Therefore, trade-diverting effect constitutes one of the main criticisms of regionalism asserted by the proponents of multilateralism like Bhagwati and Panagariya. While opponents of regional arrangements find that the static welfare effect as a key and best understood component, their proponents claim that the conventional static welfare analysis that depends on trade diversion is too narrow a criterion to judge their economic desirability for non-members:

Advocates of regionalism argue that trade diversion is not the only economic effect on non-member countries. The formation of regional arrangement may also increase aggregate real incomes in the arrangement through increased efficiencies within the members' industries generated by dynamic effects of integration (like economies of scale or increased competition). Unlike the price effects of the discriminatory reductions in trade barriers, these real income effects are almost certain to benefit non-member countries collectively because of the increased demand for imports of most goods into the regional arrangement. Therefore, advocates of regional arrangements criticise the emphasis placed on trade diversion by Viner and most of the early writers since it ignored other effects on non-member countries and hence, created a pessimistic bias in the presumed outlook for the net impact of regional arrangements on non-members<sup>44</sup>.

In addition to dynamic effects of integration, trade creation effect increases Gross Domestic Product (GDP) too. If there is potential trade creation, and if the PTA members pursue a sensibly expansive monetary policy<sup>45</sup>, then realised GDP expansion within the PTA will ordinarily translate into a boost of imports from non-members. Taking into consideration the fact that some empirical *ex post* studies on regional arrangements, except cases involving PTAs between statist-protectionist countries (for example, Latin American nations in the 1960s), have shown a positive effect in terms of trade creation larger than trade diversion. In this setting, non-members benefit from trade creation among the insiders.

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<sup>44</sup> Similarly, Wonnacott and Lutz (1989, pp. 62, 68) criticised the Vinerian way of analysing welfare effects of a PTA by stating that the correct way to judge the economic (welfare) effects of a PTA on non-members is to compare real income under a PTA with the real income which would occur with the status quo. However, according to them, such a complete and comprehensive approach is difficult, which is why Viner's distinction between trade creation and trade diversion remains at the core of the theory of PTAs.

<sup>45</sup> This feature is missing in the recent experience of EU and in the NAFTA.

However, the proliferation of these arrangements in the past years raises doubts on whether this excess of trade creation over trade diversion will also be the general outcome in the future. Additionally, as stated by Hufbauer (1994, pp. 118, 119), an increase in real incomes in the PTA, arising from an excess of trade creation over trade diversion or dynamic effects of integration, does not mean automatic pleasure among non-members. Even if there is an **“overall”** boost to imports from non-members, **“particular”** exports from non-members may suffer from trade diversion and this is what mainly concerns the non-members.

Proponents of regional arrangements have also claimed that “trade diversion” should not be worried about while considering PTAs. Among them Summers (1994) finds it surprising that this issue (of trade diversion) is taken so seriously – in most other situations, economists laugh off second best considerations and focus on direct impacts. Such a statement might be interpreted as reappearance of the pre-Vinerian attitudes “any move towards free trade, even if preferential, would necessarily be welfare-improving”.

However, according to opponents of regional arrangements, like Bhagwati, Greenaway and Panagariya (1998, pp: 1130, 1131), trade diversion is not something that can be laughed off or taken lightly:

*Firstly*, some empirical studies show that trade diversion is not necessarily a negligible phenomenon in current PTAs. World Bank study on MERCOSUR (among Uruguay, Argentina, Paraguay and Brazil) by Yeats (1997) is a significant evidence of wholesale trade diversion. With respect to NAFTA, the diversion of textile trade in favour of Mexico and at the expense of the Caribbean should also be taken seriously. In the same vein, Frankel and Wei (1998a) reached the conclusion that various extensions of the EC were accompanied by a considerable trade diversion. Concerning the expansion of the EC through the accessions of Greece (in 1981), Spain and Portugal (in 1986), Frankel and Wei found that “imports from non-member countries in 1990 were 30% lower than in 1980”. According to them, this is a massive trade diversion that has resulted from the membership expansion.

*Secondly*, despite multilateral trade rounds under the auspices of the GATT, external trade barriers are still very high both in developed and in developing countries. The Uruguay Round left several peak tariffs in specific products in the formers. With respect to the latter, countries in South Asia and in Latin America are not free from high trade barriers either. Therefore, preferences can still lead to significant trade diversion.

*Lastly*, in addition to the external trade barriers, “administered protection” which consists of instruments such as anti-dumping actions and technical standards has become the favourite policy of protectionists who frequently abuse the notion of “fair trade” to gain protection and advantage against foreign competitors unfairly. Since such administered protection which is selective and elastic has not been severely regulated by the multilateral trading system yet, PTA members have an important incentive to protect each other through such protection at the expense of non-members. In other words, protection against non-members then becomes *endogenous* to the PTA. The consequence is that the endogenous raising of protection converts trade creation into trade diversion instead. Therefore, enhanced discipline on administered protection, especially AD actions and standards, is necessary to reduce the damage from PTAs.

### **3. 2. DYNAMIC TIME-PATH EFFECTS OF REGIONALISM ON THE MULTILATERAL TRADE LIBERALISATION**

In addition to the effects of regionalism on non-members’ welfare, its effects on multilateral trade liberalisation are also important for the analysis of this thesis. In other words, the issue of PTA effects is not only related to whether a PTA is harmful for non-members, but also related to whether the PTA accelerates or decelerates the continued reduction of trade barriers toward the goal of reducing them worldwide. This question was formulated analytically in two separate ways by Bhagwati and Panagariya (1996a) as examined in the second chapter:

### **3. 2. 1. Can Regionalism Lead to Global Free Trade Through Continued Expansion of Regional Blocs?**

This question is what Bhagwati and Panagariya (1996a) labelled Question I relating to the dynamic time-path issue: By assuming the PTA and multilateral processes to be independent, that's not to influence each other, it asks and tries to find an answer to whether the expansion of a PTA continues until turning eventually into world-wide membership as in the WTO, thus arriving at non-discriminatory free trade for all, or whether regionalism will fragment the world economy.

As noted by Bhagwati and Panagariya (1996a, pp. 46, 47), neither the analysis by Kemp and Wan nor the analysis by Krugman, which were examined in the second chapter, are pertinent to Question 1. Because, this question is neither about the existence of a PTA path along which world welfare increases monotonically as analysed by Kemp and Wan, nor is it about the relationship between the number of trade blocs and welfare as analysed by Krugman. Instead, as Panagariya (1999, p. 491) argued, this question actually concerns the monotonicity of incentive to seek admission on the part of non-members and to offer admission on the part of insiders until ultimate goal of multilateral free trade is achieved.

Bhagwati, Greenaway and Panagariya (1998, p. 1144) stated that a rigorous political-economy-theoretic incentive structure analysis which endogenises the question of membership expansion and thus helps to address the dynamic time-path question is actually what is needed. Accordingly, Bhagwati (1992) advanced several arguments concerning the incentive structure within specific PTAs to expand or to stagnate. For the answer to Question I, Bhagwati (1992, pp. 548, 549) distinguished several arguments in the framework of the *incentive structure* that any PTA provides, through interests, ideology, and institutions, for expansion or stagnation of its membership:

#### **3. 2. 1. 1. Incentive Structure Arguments**

Bhagwati (1992, pp. 548, 549) argued that a meaningful examination of the incentives to form and expand PTAs have to be in the field of political-economy-theoretic analysis. The reason is that the incentives in question may not be necessarily economic. The incentives

might be political rather than economic. It is really implausible that any group of countries are dependent on economic arguments as their key determinants for forming a PTA. A PTA might be formed and expanded to seek political allies by using trade as foreign policy and to target the benefits of trade to politically favoured countries.

Politics is an important factor in the PTAs made by the EU through Association Agreements with the smaller countries on its periphery and beyond. Again, it is not a negligible factor in the transformation of the original Canada-US FTA into NAFTA with Mexico and then into the Enterprise of Americas Initiative. However, it is not implausible that economic factors contribute to the incentives for such PTAs to be formed. Therefore, as Bhagwati argued, analysis of the incentives to form and expand FTAs and CUs should be taken up from the perspective of political economy that examines the interaction between politics and economics.

Accordingly, Bhagwati (1992, pp. 549, 550) distinguished among three different types of “agents” and offered the following analysis to think about the incentive structure for membership expansion in political-economy-theoretic terms:

#### *I. Incentives of Member Countries' Governments:*

Whether a PTA will expand or not will depend partly on the desire of the governments of the member countries to realise this. Ideas and ideology that governments possess will affect their desire. According to Bhagwati, PTAs will be under pressure not to expand because governments may feel that they already have a large market. This is what he called the “Our Market Is Large Enough” syndrome. Martin Wolf has often noted that large countries have tended to be more inward looking while the small countries have gone the outward-looking route (cited in Bhagwati and Panagariya, 1996a, p. 48).

#### *II. Incentives of Interest Groups in Member Countries:*

How interest groups in member countries will behave with respect to PTA expansion has to also be considered. They may be for or against new members. Therefore, they either lobby for or against PTA expansion. The exporting firms which are internationally oriented



may be expected to endorse newcomers whose markets then become preferentially available to them against non-member exporters to these newcomers. However, the firms that profit from diversion of trade away from efficient outside suppliers to themselves will not want the PTA to expand for including those suppliers. Bhagwati called this problem “These Are Our Markets” syndrome (1992, 549).

The former incentive was apparent in the debate concerning NAFTA in the US and reflected in many pronouncements. Even President Clinton claimed that the US would have preferential access to Mexico vis-à-vis Japan. With respect to the latter incentive, the statement of Signor Agnelli of Fiat is a good example: “The single market must first offer an advantage to European Companies. This is a message we must insist on without hesitation.” (Quoted in Bhagwati and Panagariya, 1996a, p. 49)

### *III. Incentives of Non-Member Countries' Interest Groups and Governments:*

The third type of “agents” categorised by Bhagwati is the non-member countries. The example of a PTA may lead outside countries to emulate or to seek admission. The fear of trade diversion may also induce non-members to seek admission. This incentive serves in favour of expansion of PTA.

### **3. 2. 1. 2. Counter Arguments to the Model Concentrated on the Incentives of Non-Members for Membership**

The single political economic theoretical contribution in terms of *incentive structure* that focused on Question I (the incentive to add members to a PTA) was modelled by Richard E. Baldwin (1999) who concentrated on the incentives of non-members to join the PTA. As examined in detail in the second chapter, this approach stresses the disadvantage that non-member producers face as a result of a PTA and their interests in forcing the admission through lobbying. As the bloc enlarges, non-member exporters are further harmed and therefore more in favour of admission. Unless there are sufficiently strong non-economic factors that counter these incentives, as the PTA expands, eventually all countries want to enter the PTA. Then, as long as admission to the PTA is free, as assumed by Baldwin, this process can lead to global free trade.

However, Baldwin formalised just the incentive of outside countries to enter the PTA. Formalisation of the incentives of members to be open or close to new members that have been informally discussed by Bhagwati (1992, pp. 549, 550) does not exist. Instead, Baldwin assumed that insiders do not have incentive to block the new entries. Actually, the Baldwin domino effect model itself implies that member firms are in advantageous situation vis-à-vis the non-member ones arising from the gain of cost competitiveness. Therefore, the formers have an opposed interest in rejecting the non-members to join the PTA. Similarly, it may be claimed that member countries will have an incentive to reject further entries after the PTA reaches a certain size.

This point was the message of a study by S. Andriamananjara (cited in Panagariya, 1999, p. 492) who modelled the incentives facing non-members to seek admission and desire of insiders to give admission. He showed that when the PTA expands, profits of insiders first rise, reach a maximum and then decline with the assumptions of the outside tariff is fixed and decisions to seek and offer admission are driven by profits. Besides, the maximum profit point is reached before the PTA comes to embrace all countries. However, as the PTA expands, profits of non-member countries decrease monotonically. Therefore, while member countries stop short of taking all of non-members inside the PTA, the latters have an increasing incentive to seek admission. Briefly, the PTA fails to enlarge into a global club.

In the same vein, Bond and Syropoulos (1996) in their study asked the related question that if one of the blocs begins to expand by drawing one country from each of the remaining blocs, will the expanding bloc eventually turn into a global bloc or stop short of it. They reached the conclusion that as this bloc expands, the welfare of its members peaks before it absorbs the other blocs in their entirety. In other words, the process stops short of yielding global free trade.

Another criticism came from Carolina Albero Lopez and Jacint Soler Matutes (1998, pp. 259, 260). Baldwin's Domino Theory relies on the existence of *disadvantages* for non-members that encourage lobbying in favour of admission. However, Lopez and Matutes argued that there will not be any incentive to seek admission except the dynamic benefits of integration like larger markets and economies of scale if trade arrangements minimise

their trade diversion. With respect to the dynamic benefits, they might be balanced against the costs arising from admission and represented by the requirements to be met by the applicants like the transposition of the regional *acquis*.

As a result, a thorough analysis of the political economy of both members' incentives for expanding the PTA and non-members' incentives for seeking admission into the PTA might lead to the conclusion that new regionalism means the stagnation of PTA membership. Regional blocs cannot continuously expand until universal free trade is reached. In other words, new regionalism will not lead to non-discriminatory multilateral free trade for all through ever-expanding regional blocs until a worldwide CU is accomplished.

### **3. 2. 2. Does Regionalism Serve as a Building Block or a Stumbling Block for the Multilateral Trade Liberalisation?**

Contrary to the first question, this question assumes that the PTA process interacts with the multilateral process. It addresses how the formation of preferential trade agreements affects the multilateral trading system and, in particular, whether it undermines or underpins further multilateral trade liberalisation. This is what Bhagwati and Panagariya (1996a) labelled Question II relating to the alternative time path issue, which has been analysed in the second chapter in detail.

Economists differ dramatically in their thinking about how regionalism will affect the multilateral trading system. While some believe that PTAs are a facilitating intermediate step on the path to greater global trade liberalisation, others claim that regionalism undermines movement toward multilateral trade liberalisation. Therefore, there are two basic schools of thought concerning the relationship between multilateral and regional trading arrangements:

### **3. 2. 2. 1. Regionalism as a Building Block**

Those who consider regionalism as *“building block”* to further multilateral trade liberalisation, that’s the proponents of regionalism, have put forward a variety of arguments:

#### **3. 2. 2. 1. 1. Building Blocks as “Bargaining Threat”**

PTAs may be used as a bargaining threat to force unwilling parties to negotiate at the multilateral level. That’s the threat of going regional may encourage multilateral trade agreements that may otherwise be held up. Frankel and Wei (1998b, pp. 210-212) called this argument “competitive liberalisation” while World Bank in its study (2000, pp. 102-103) named it as “multilateralism as a response to regionalism”. It states that countries outside PTAs may react to their exclusion by attempting to accelerate multilateral liberalisation. Many commentators like Lawrence (1997b) and WTO (1995a) suggest that the creation of the EEC in 1957 and the completion of its CET led to the Dillon and the Kennedy Rounds of multilateral trade negotiations which brought about a worldwide reduction of customs duties since the US sought to mitigate the EEC’s potential for diverting trade from the third countries towards the member states.

In the same vein, Demaret (1997, p. 832) and WTO (1995a) argued that the CUSFTA and then the NAFTA were important factors leading to the successful completion of the Uruguay Round, which has significantly broadened the coverage of the multilateral trade system, and which has increased the role played by the rule of law in the conduct of world trade. This was because the fact that their scope went much beyond the scope of the GATT of 1947 was a warning that unless the GATT was revised, the organisation of world trade would then more and more depend on the balance of power between large regional blocks.

However, there are counter views against these examples supporting the argument:

Regarding the Dillon and the Kennedy Rounds, World Bank (2000, p. 102) argued firstly that the EEC affected the timing, not the occurrence of these Rounds since given the global reach of the US during the 1960s it does not seem likely that multilateral negotiations would have stopped completely if the EEC had not been formed. Secondly, regarding

agriculture the EEC was probably more successful in resisting that sector's liberalisation in the multilateral trade negotiations than its individual members would have been. This means that future liberalisation will probably be more difficult. Thirdly, whether the outcome is beneficial for the multilateral trade system depends critically on the willingness of the partners to fold by negotiating rather than fight by raising tariffs and to respond multilaterally rather than regionally. Therefore, this is a dangerous game and it is quite possible that it may result in a very harmful situation for the multilateral trading system.

With respect to the Uruguay Round, World Bank (2000, p. 103) argued that whether the perception that failure of the Round would lead to regional fragmentation pressured the two major parties to agree is not clear since they were the prime 'regionalists', and they would certainly have not been the principal victims of fragmentation. Moreover, Krueger (1999, p. 118) stated that the soundness of the argument depends on circumstances; for example, a nation that belonged to a number of PTAs might feel less need to help make multilateral trade talks reach a successful conclusion. Also, Winters (cited in Laird, 1999, p. 1186) stated that using regionalism as a means of coercing partners to the multilateral negotiating table is risky even if it may be an effective strategy.

It has been claimed that the 1993 Seattle APEC Summit induced the EU finally to concede on agriculture and to conclude the Uruguay Round. The formation of the APEC signalled to the EU that if they did not agree at the Uruguay Round, the US would go ahead with an FTA with Asian countries. The EU has been motivated to reach an agreement due to the concern that they would face a trading block emerging out of APEC or in the western hemisphere. Therefore, this threat led the EU to conclude the negotiations. (Bergsten, 1994, pp. 21-25)

However, Bhagwati (1996) disagrees with this interpretation of events. He argues that the Uruguay Round was completed essentially because the US decided to close the deal, taking the offer on the table rather than seeking more concessions. Additionally, according to him (1992, p. 541 and 1991, pp. 73, 74), this could be an optimistic view since threats that have to be repeatedly implemented, as has been the case with US regionalism, are not efficient threats and, combined with actual resort to regional arrangements, they will produce the negative perception that regionalism is antithetical to the GATT. Similarly, Frankel and

Wei (1998b, p. 210) stated that the trouble with making credible threats is that sometimes they must be carried out. The result may be the “competitive regionalisation” process where the formation of a regional arrangement puts pressure on other countries to form a bloc of their own, rather than to liberalise unilaterally or multilaterally (Frankel and Wei, 1998b, p. 210).

### **3. 2. 2. 1. 2. Small Number of Regional Blocs versus Large Number of Individual Countries**

It has been argued by Summers (1994, p. 198) and others that a small number of regional blocs, for example three, which have a lot to gain from a successful negotiation are more likely to be able to reach agreement than a large number of individual countries, each with only a small amount to gain. The logic behind this argument depends on the fact that in a platform like multilateral trade negotiations, which have “a large number” of small parties and the associated “free rider” problem, the process of reaching an agreement is slow and difficult:

The more countries that are involved in a multilateral negotiation, the more difficult and time consuming it will be to draw up a negotiating agenda and to negotiate separately with a large number of parties and conclude a negotiation. In view of the numerous parties involved in a multilateral negotiation and the size and complexity of the negotiating agenda, individual countries may find themselves less able to focus on issues that concern them directly. It is possible that there may be foot dragging and a tendency for negotiating results to reflect the “lowest common denominator” of the negotiating parties. Moreover, concessions may be granted to the individual countries without there being any *quid pro quo*<sup>46</sup> in multilateral negotiations because of MFN principle. Therefore, free riding may occur unless measures are taken to make concessions conditional. It has been argued that these difficulties can be avoided (or, at least, can be limited in the case of free riding) if the number of negotiators is reduced through formation of trade blocs. In other words, if small countries form themselves into larger groupings, which presumably have to be CUs with common external trade policies, they can negotiate as a group. This is thought to increase

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<sup>46</sup> *Quid pro quo* means a favour given in return for something: something for something.



the efficiency of the negotiations and to make a satisfactory worldwide agreement more likely.

Some authors like Bhalla and Bhalla (1997, p. 38) and Hufbauer (1990, p. 5) argued that the historical example of the EU supported the argument since it has been easier to make trade concessions along with other partners in such a CU than unilaterally. The existence of the EU facilitated negotiations under the Kennedy Round. Similarly, Uruguay Round negotiations might have been revived by the NAFTA trade negotiations and given an impetus by the APEC.

However, there are some counter views about this argument too: As Panagariya (1999, p. 494) rightly stated, if regional blocs take the form of FTAs instead of CUs, they do not have any effect on the number of participants since FTA members retain their own external trade policies and must negotiate trade issues individually at multilateral level unlike CU members which have common trade policy and speak with single voice. Therefore, the only PTA, which participates as a single unit in multilateral negotiations, is the EU so far.

Additionally, this argument prejudices the issue of whether blocs are genuinely unified in their approach to trade negotiations. But this is not usually so: Any gains from having fewer players in the last stage of a negotiation are offset by the complexity and difficulty of reaching common positions in the first phase. For example, Winters (cited in Laird, 1999, p. 1186) criticises the argument by stressing the difficulties that the EC had in reaching and maintaining a common position regarding some trade issues negotiated in the Uruguay Round. Especially in tough issues like agriculture and textile which concerns some member countries' vital interests (France in the case of agriculture and Portugal in the case of textile) the EC had not been able to provide its internal cohesion for a long time and this situation led to postponement of the conclusion of the Uruguay Round. Again, it was the EC, which delayed the launching of the Uruguay Round because of its internal problems. Therefore, it might be possible that if the EC members were participating individually in negotiations, they would see greater merit in multilateral liberalisation and be more willing to negotiate.

Considering the difficulty in arriving at a common position even on the part of the most developed integration model which has necessary internal procedures for this and the fact that many of the CUs have not even developed procedures for determining their negotiating positions yet, PTAs do not seem likely to facilitate multilateral trade negotiations at least in the foreseeable future. Furthermore, as WTO has extended its scope, it has embraced subjects in which most central CU authorities do not have mandate to negotiate. In conclusion, one of the strongest arguments in favour of regionalism has been weakened by the counter arguments.

### **3. 2. 2. 1. 3. Building Blocks as a Way to “Lock in” Reforms**

Developing countries try to “lock in” their trade reforms and induce trade and investment flows from large countries through membership to PTAs. Developing countries have recently made, or are making, significant unilateral reforms to liberalise their trade regimes. Regional trade arrangements have been used to help prompt and consolidate economic and political reforms in prospective members. Currently, PTAs under the new wave of regionalism are characterised by a manner of North-South relations, that is, viewed as typically including both developed and developing countries with the latter motivated to lock in their liberalised trade regimes. Therefore, from the perspective of this argument PTAs are a symptom of the success of the open multilateral system and are fully compatible with further multilateral liberalisation.

Frankel and Wei (1998b, p. 209) gave Mexican experience as an example to this argument: Mexican President Salinas reversed a half-century of protectionism in Mexican trade policy and imposed extensive unilateral reduction in external restrictions accompanied by internal liberalisation in the late 1980s. Seen in the light of this argument, NAFTA was argued by many like Aspe (cited in Summers, 1994, p. 197) and Lawrence (1997b, p. 413) that it locked in the Salinas reforms in a manner that would be difficult to reverse this liberalisation by future presidents and provided credibility and permanence to Mexico’s liberalisation measures. Hence, the NAFTA is seen in this respect as an important complement to an outward-oriented policy which is based on attracting foreign investment.

#### **3. 2. 2. 1. 4. Building Blocks as “Learning Process”**

Regional integration can accustom officials, governments and nations to the liberalisation process and increase the probability that they will subsequently take similar actions at the multilateral level. It is argued that *learning by doing* can be experienced both more easily and more extensively in the regional context with far fewer negotiating partners. So, PTAs permit members to liberalise beyond the extent that can take place multilaterally. When negotiations on further multilateral liberalisation are blocked in the WTO, countries can use PTAs to go further and provide a demonstration of the benefits, which may in turn induce other countries to soften their resistance to multilateral liberalisation. Similarly, learning about the benefits from open trade that may come about from PTAs may convince voters that are frightened of opening up their markets.

Additionally, Organisation for Economic Co-operation and Development (OECD) (1995a, p. 63) noted the importance of regional integration as contributor to a *learning process* in international policy formulation for governments, regulators and interest groups. Through regional agreements interest groups and decision makers may have an opportunity to come to terms with the kind of trade-offs that may have to be made when trade and domestic policies clash. Then the experience and expertise gained via PTAs may be used in wider multilateral negotiations. Therefore, PTAs may have a positive effect on multilateral processes by helping to equip the interested parties with the models and skills needed to reach agreements. Both OECD (1995a) and Cable (1994, p. 13) present the Uruguay Round plurilateral Agreement on Government Procurement as a good example of the argument and therefore as an evidence of a regional liberalisation initiative (the EC) acting as a forerunner of wider liberalisation at the multilateral level in this respect.

#### **3. 2. 2. 1. 5. Building Blocks as “Laboratory” for Multilateral Liberalisation**

It is argued that regionalism is a useful laboratory for new approaches to deeper integration which can be applied multilaterally in relation, for example, to product and technical standards, services, public procurement, state subsidies, competition policy, dispute

settlement and enforcement<sup>47</sup>: Since regional integration addresses some challenges similar to those faced by the multilateral trading regime, regional agreements may serve as models or laboratories not only for other regional agreements, but also for the multilateral trade system itself.

However, as stressed by Demaret (1997, p. 835), although regional experiences regarding liberalisation and deeper integration in different sectors serve as an example for approaches which will be applied by the multilateral trade regime and although WTO provisions reflect the influence of the EC experience<sup>48</sup>, the effectiveness of regional and multilateral application may not be the same since the political, economic and institutional contexts are quite different. Moreover, Demaret (1997, p. 833) debated whether the European (EU) and North American (NAFTA) experiences in trade liberalisation as laboratories are relevant for multilateral application. While the EU has aimed the creation of a fully integrated market through “supranational” institutions, in the NAFTA bargains have to be made between “unequal” partners since the US dwarfs the other two members. Therefore, it can be concluded that neither the EU nor the NAFTA, although seem appropriate experiences as laboratories for trade liberalisation, may not properly serve as a point of reference or test bed due to the fact that they are not entirely relevant models for the multilateral trading system.

### **3. 2. 2. 1. 6. Building Blocks as Contributor to “Awareness of Interdependence”**

OECD (1995a, pp. 62, 63) argued that regional integration initiatives contribute to an awareness of the need for international rules and regimes by national governments and interest groups. Regional integration has broken down economic nationalism and increased

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<sup>47</sup> OECD (1995a, p. 64) gives the North American approach to enforcement and dispute settlement as example to how regional agreements generate new ideas. One of the central issues in multilateral trade is how to enforce agreements. The GATT system, which is based on consensus and political negotiations, is unfortunately ineffective. The approach applied by CUSFTA has enhanced national enforcement in which national authorities and jurisdictions retain their sovereignty but are subject to independent review procedures. Since this approach was seen as much more effective, it was taken as an example by the NAFTA and also influenced the GATT negotiations on dispute settlement. Again the manner applied by the NAFTA regarding the effective enforcement of existing norms in the environmental and labour fields may serve as an example for the WTO in the future. Additionally, it has been suggested that future work at the multilateral level should follow the NAFTA and Australia New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) approach with respect to services whose merits compared to the General Agreement on Trade and Services (GATS) approach have been stressed.

<sup>48</sup> As examined in the last chapter under the title “Effects of the EU on the Multilateral Trade Negotiations”.

awareness of economic interdependence in public opinion. Interest groups and politicians may more easily recognise the need to accept international rules and disciplines under international regimes since the impact of interdependence is more immediate in regionalism compared to multilateralism. Multilateralism is not effective and efficient enough to contribute to the acceptance the need to change established state or national practices on the part of national interest groups because the benefits are generally too remote and uncertain compared to the immediate costs. Therefore, regionalism underpins multilateralism in this respect better than multilateralism does by itself.

OECD gave the EU and the NAFTA as examples in this respect: The EU has contributed to a broad acceptance of the need for international agreements in, for example, competition policy, consumer protection and environmental policy due to its high level of interdependence<sup>49</sup>. With respect to the NAFTA, it has brought home the impact of interdependence on labour and environmental interests, and the political need to address the problems resulting from differing national labour and environmental policies if the benefits of regional integration are to be achieved. Such an awareness of the need for international agreements is not new for international business or trade diplomats<sup>50</sup>, but there was not a broad awareness in public opinion of the impact of interdependence. Regional integration has heightened this awareness.

### **3. 2. 2. 1. 7. Building Blocks as Mobilising “Lobbies” to Lower Tariffs on Raw Materials or Intermediate Goods**

Another argument in favour of regionalism, as stated by Krueger (1999, p. 118), deals with the effects of FTAs on producer lobbies in member countries that have tariffs above those in their partners. If those tariffs are imposed on raw materials or intermediate goods, the increased competition with producers in the lower input tariff country can cause producers to lobby for lower tariffs in their country. Therefore, according to Krueger, an FTA is better in encouraging multilateral trade liberalisation in this respect than a CU: While all producers face the same external tariffs in a CU, producer pressure may lead to lower

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<sup>49</sup> As examined in detail in the last chapter under the title “Effects of the EU on the Multilateral Trade Negotiations”.

<sup>50</sup> For example, international competition policy was an issue in the Havana negotiations on the ITO and international environmental policy started being discussed in the OECD as soon as the early 1970s.

multilateral tariff levels to the level of the PTA partner in an FTA where they face differential external tariffs.

### **3. 2. 2. 1. 8. Gains from Increased Competition in Building Blocks**

The last argument states that firms gain the confidence necessary to accept truly global competition after facing foreign competition through a PTA and are not against multilateral liberalisation. Similarly, it is argued that regional competition eliminates many of the inefficient firms and, therefore, reduces demands for protection. These views suggest that at the end firms are likely to see greater interest in securing further market access via further regional and multilateral liberalisation initiatives. The EC's simultaneous pursuit of the Single Market programme and the ultimately successful UR negotiations is consistent with this line of argument.

### **3. 2. 2. 2. Regionalism as a Stumbling Block**

On the stumbling blocks side, it is argued by Bhagwati, Panagariya and others that the spread of PTAs is likely to damage the multilateral trading system. In the extreme, they foresee the possibility of a world of trading blocks with relatively high barriers between them in which trade diversion becomes the norm and trade war is always a possibility. There are a variety of arguments as to how the formation of a PTA may undermine movement towards multilateral liberalisation:

#### **3. 2. 2. 2. 1. Stumbling Blocks as Diverting the Attention from Multilateral Liberalisation**

The first argument is that the concentration of scarce political capital and energy on promoting regional trading arrangements will divert the attention from multilateral liberalisation in favour of these second best schemes. The scarce-negotiating-resources argument points out the fact that negotiations are not costless and resources in trade ministries are not unlimited. If they were, then the world would have achieved global free trade by now. Use of those scarce negotiating resources to focus on formation of PTAs may distract attention of traditional supporters of the global system.



It was argued that during the NAFTA negotiations US trade representatives spent all their time and all the White House's political capital with Congress on this regional agreement. As a result there were less time, motivation and capital left over to spend on the Uruguay Round and thus the US could not support multilateral efforts as much as it would otherwise have done. This means that regional trading arrangements may set back the process of negotiating worldwide trade liberalisation under GATT regime.

### **3. 2. 2. 2. Decrease in the Interest of Members in Further Multilateral Liberalisation Due to the “Enlarged Market” Condition**

The formation of a PTA may decrease the interest of member countries in further multilateral trade liberalisation: Since the enlarged market among the partner countries is sufficient to achieve an efficient scale of operation, other market access opportunities in third countries may become less of a priority. The enlarged market may be big enough and competitors from the partner countries may not be too aggressive since they are likely to have roughly similar cost structures. In this situation firms may think that the regional market should not be disrupted by permitting further access even if it is counterbalanced by improved market access in third countries. (WTO, 1995a, p. 51)

### **3. 2. 2. 3. Political Economy Considerations Leading to Stumbling Blocks**

A third line of argument reflects political economy considerations: Krueger (1999, pp. 117, 118) argued that although a PTA is predominantly trade-creating, such trade-creating PTAs may still be unsupportive for further multilateral liberalisation as contrary to some claims. Additional exports created among PTA partners may lead to interests that would fear losing sales in favour of third country exporters if multilateral liberalisation were to succeed. Therefore, beneficiaries of some preferential schemes who are concerned about the erosion of preferences may form a political lobby against multilateralism. For example, Mexican exporters to the US who utilise from the preferences arising from the formation of the NAFTA may oppose further multilateral liberalisation due to the concern that they would lose their preferences to their competitors from Latin American countries like Brazil. The point is that whether the new trade within the PTA is opened up between globally low cost producers in which case they do not have to fear additional multilateral

competition or whether it is an attempt to protect high cost producers within the PTA from third country competition.

Similarly, Krishna (1999) in his formal political economy model<sup>51</sup> shows that more trade diverting (discriminatory) the PTA, the greater the backing it receives and more it reduces the incentive for multilateral liberalisation. Concentrated interest groups (producers) benefiting from trade diversion through preferences will tend to oppose further multilateral liberalisation since they would lose their newly-obtained markets to lower cost, thus more efficient, producers from outside countries. Unless the increased access to outside countries' markets that would come with multilateral liberalisation does not generate sufficient rents to offset the elimination of preferences, PTAs could be preferred to multilateral liberalisation. Therefore, multilateral free trade, which would have been politically feasible in the absence of PTA, is rendered infeasible.

Beneficiaries of trade diversion effect in PTAs, like beneficiaries of trade creation effect mentioned above, will form protectionist lobbies as effective obstacles against multilateral liberalisation. Therefore, as Lal (1993, p. 350) stated, PTAs will lead to retrogression rather than being a step towards multilateral free trade. Even export interests will provide less political support for multilateral liberalisation, once they have already gained access to additional markets within a PTA.

#### **3. 2. 2. 4. Incentive of Members to Protect Intra-Regional Market**

Some strongly argued that PTAs lead to a rise in trade barriers against non-members because of several reasons although the standard experiment presumes that the level of trade barriers against non-members remains unchanged when a PTA is established. This is "incentive to protect". One reason is related to political economy and depends on the political process at work in a given situation: Members of PTAs become more likely to raise barriers against third countries since intra-block trade increases under a PTA as in the case of NAFTA, the EU, MERCOSUR, and others. Bhagwati (1992) argues that liberalisation through PTA is likely to be replaced by increased protection against third

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<sup>51</sup> This model is examined in a detailed way in the second chapter under the title "Endogenously-determined Time Paths: Recent Theoretical Analyses"

countries in a political economy setting in which producers play the central role in determining trade policies. If the country's external tariff is below its GATT binding, the increase in protection can be accomplished through increased tariffs. But if the actual tariff corresponds to the bound tariff, the country can accomplish this protection by increasing non-tariff barriers.

Second reason is incentive for maximum exploitation of terms of trade on the side of large blocs like the EU. Large blocs have monopoly power and, therefore, are more tempted to seek shift the terms of trade in their favour by increasing tariffs against the rest of the world as long as the size of the blocs rises. This temptation will be minimised in a world of many small trading groupings or in a world of MFN.

Another reason is tariff revenue objective of countries in the case of FTA: Panagariya (1999, p. 498) stated that if a country (like the countries in Africa, South Asia and even Central and Eastern Europe) is dependent on tariffs for revenue purposes, an FTA which requires the removal of a tariff on the partner country may force it to increase the external tariff to maintain fiscal balance. The more the country imports from its partner, the larger the loss of revenue, and therefore the greater the increase in the external tariff and the greater the trade diversion. Similarly, if an FTA member experiences a fiscal crisis, it will have to increase tariffs against third countries and the necessary increase in the tariff rate is likely to be much larger than in the absence of the FTA.

In spite of the existence of Article 24, which allows deviations from the MFN principle only for FTAs and CUs that do not increase the average level of their trade barriers against non-members, there still exists concern that blocks' incentive to protect survives since -as Bhagwati (1992) and Bagwell and Staiger (1993, n. 25) stated- Article 24 is often ignored and covert forms of protectionism can be resorted to when explicit tariff increases are not possible. For example, Bhagwati (1995) has stressed that trade diversion happens even when tariffs are low through such means as anti-dumping measures against East Asian countries when American imports from Mexico increase under NAFTA. This rise in protection against third countries can render an otherwise welfare-improving PTA a welfare-reducing grouping and the world trading system less liberal.

### **3. 2. 2. 2. 5. Possibility of Manipulation of Regional Agreements for Protectionist Objectives**

The last argument states that the process of instituting a PTA provides abundant opportunities, compared to multilateral liberalisation, to manipulate the process for protectionist objectives. Firstly, partner countries frequently seek to exclude from PTAs precisely those of sectors that would be most threatened by welfare enhancing trade creation (Wonnacott and Lutz, 1989, pp. 65-66). Grossman and Helpman (1995, pp. 680-87) by using their lobbying model argued that the possibility of such industry exclusions increases the probability of PTAs being preferred to and, therefore, undermining multilateral liberalisation. Although Article 24 requires “substantially all” barriers within the region to be removed, PTAs have tended to comply less than completely with this provision in practice. Secondly, Krishna and Krueger (1995) emphasises the exploitation of rules of origin: Countries in the FTA negotiation can enhance the extent of protection they receive when their governments use rules of origin to enable them to capture their FTA partner’s market in addition to their own, thus diverting trade from foreign suppliers. Therefore, CUs are always Pareto superior to FTAs since they have no rules of origin that can be exploited in this way.

## **CHAPTER 4. APPROACHES TO CONTAINING THE DETRIMENTAL EFFECTS OF REGIONALISM ON NON-MEMBERS' WELFARE**

In the light of the discourse analysis made in the previous chapter regarding the effects of regionalism in the form of PTAs on international trading system in reaching worldwide free trade, it can be concluded that new regionalism is potentially a harmful phenomenon for multilateral trading system in spite of its more pro-multilateralist nature compared to the previous ones. It is evident that since PTAs are inherently discriminatory in favour of members, their proliferation leads to legitimate concerns that they have detrimental welfare effects on *the other* participants of the multilateral trading regime, which are left outside the reciprocal preferences granted to members. The similar concerns are true in terms of adding new members to the PTAs and regarding multilateral trade negotiations toward worldwide non-discriminatory trade liberalisation due to the reasons argued in the previous chapter.

Even if a PTA is net trade creating and, thus, is welfare enhancing in terms of both members and world as a whole, it is treated in this thesis harmful in terms of non-members as different from the usual diction of trade economists like Viner and others. Trading partners who do not participate in a preferential arrangement will be hurt even when global welfare as a whole is enhanced<sup>52</sup>. In this respect, existence of any size of trade diversion is relevant regardless of whether trade creation outweighs trade diversion. Depending on the discriminatory nature of PTAs and resulting trade diversion effect, which is considerable in the most cases<sup>53</sup>, the objective of this chapter is to be able to contain trade diversion effect of regionalism on non-members with a view to making regionalism a benign phenomenon particularly for non-members. To reach this objective reform of the relevant rules of the GATT is proposed as the most appropriate solution after searching among some alternative proposals.

Although prime interest of the conventional approach is in assessing the net welfare impact of a PTA compared with the pre-union situation, it cannot make a confident judgement

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<sup>52</sup> Unless the non-members are too large or preferential trading area is too small for the arrangement to effect world prices, non-members as a whole will be harmed because their terms of trade are likely to deteriorate as a result of the trade diversion. (Lawrence, 1996, p. 26)

<sup>53</sup> See Yeats (1996) and Wei and Frankel (1996).

about that and confines it to special cases. Therefore, it does not provide a proposal to have unambiguously net trade creating PTA. However, the approach of this chapter examines and then proposes a confident judgement about what form of PTAs are non-trade diverting which is unambiguously desirable for non-members and, of course, for members. This approach is inclusive rather than exclusive in terms of solution, which it tries to find: While it is directly concerned with non-members' welfare interests, it indirectly addresses welfare interests of members too. What is good for non-members' welfare is necessarily good for members', but the reverse is not true.

With respect to its dynamic time-path effects, regionalism is more likely to be stumbling blocks toward worldwide non-discriminatory trade liberalisation. By focusing on its negative static effects (trade diversion) on non-members and by proposing reform of the relevant GATT rules in accordance with this focus, this chapter indirectly aims at a benign regionalism in terms of its dynamic time-path effects too. So, such a proposal focused on detrimental welfare effects of regionalism on non-members takes us to a solution for dynamic time-path as well as static welfare sense.

Therefore, considering the political appeal and popularity of CUs and FTAs as the order of the day, the important thing about the issue is what can be proposed as the most appropriate way of containing adverse welfare impacts on non-members derived from their formation and enlargement. In other words, the main objective is, and should be, to provide the most sufficient -while feasible- way to ensure that those PTAs do not become trade diversionary. In this respect, to evaluate the suggestions that have been made to counter trade diversion effect is a necessary exercise before proposing the most appropriate way in ensuring benign regionalism in static sense and for all participants of the multilateral trading system:

#### **4. 1. "NATURAL TRADING PARTNER" ISSUE**

Since the theory of second best implies that the rapid growth in the internal trade between members of a PTA does not mean global welfare is being increased and, therefore, this insight leads to the prescription that only those PTAs that are less trade diverting and more trade creating should be concluded, economists have tried to generalise about countries



best suited to form PTAs or about rules that would offset some of the negative (trade diversion) effects of these agreements<sup>54</sup>.

The most prominently claimed and questioned rule indicating partners for whom PTAs would raise welfare has been that *if PTAs are formed among “natural trading partners”, then they can be expected to be less trade diverting and more trade creating*. The phrase “natural trading partners” and hypothesis that PTAs among them are more likely to be beneficial are originated by Wonnacott and Lutz (1989, p.69-71).

This hypothesis depends on two inter-related premises, which have been endorsed by Summers (1994) and Krugman (1991b): Firstly, a PTA is more likely to raise welfare, the higher is the proportion of trade with the country’s PTA partners and the lower is this proportion with the non-members. In other words, high initial volume of trade among prospective members will be reinforcing natural trading patterns, not artificially diverting them. Secondly, countries sharing borders, or closer geographically to one another, have higher proportions of trade with one another than countries which are distant. In the light of these premises, it might be argued that natural trading partners, which is explained by high volume trade and proximity between the potential members, should be encouraged to form PTAs and countries which do not have such a feature should be discouraged from doing so since the latter would be more likely to be trade diverting.

However, according to Bhagwati and Panagariya (1996a, pp. 29-36), Bhagwati, Greenaway and Panagariya (1998, pp. 1132-1135), and Bhagwati (1992, p. 544), the first premise is treacherous for several reasons: *Firstly*, high volume of trade criterion is neither symmetric nor transitive. Concerning lack of symmetry, country A may be a natural trading partner of country B, but the reverse may not be true. For example, while the United States is Mexico’s largest trading partner, the reverse is not true. With respect to a lack of transitivity, even if A is a natural trading partner of B, and B is a natural trading

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<sup>54</sup> Among the literature which has searched for rules that would indicate partners for whom PTAs would raise welfare, there is a general determination adopted by many scholars like Lawrence (1996, p. 25), Krueger (1999, p. 116) and Wonnacott and Lutz (1989, p. 69) and depends on the principle that a preferential trade arrangement is predominantly trade creating or not may vary depending on the levels of tariffs prevailing prior to the preferential trade arrangement: *When the tariffs of prospective members are high before the establishment of the preferential trade arrangement, then it seems more likely to cause trade creation since the volume of trade with non-member countries was already small to be diverted and a lot of trade is likely to be created within the preferential trade arrangement.*

partner of C; A may not be a natural trading partner of C. While the US is the largest trading partner of both Canada and Mexico, Canada and Mexico have little trade with each other.

*Secondly*, the volume of trade criterion is premised on the view that high initial volume of trade between potential partners reduces the potential for trade diversion. This presumption is presumably based on the argument that if there is little trade with non-members, the *scope* for trade diversion is reduced. In other words, the higher is the partner country's initial share, the lower is the outside country's share and therefore the smaller is the *scope* for diverting trade. However, what one needs to determine is how likely the actual trade diversion instead of the scope trade diversion is. For example, between two alternative situations, the scope for trade diversion in an instance may be twice as high as in another; but the actual trade diversion that occurs may be only half as much. The actual trade diversion will reflect the underlying fundamentals like elasticities of substitution between non-member goods and domestic goods, not the average initial trade volumes.

*Thirdly*, initial high volume of trade does not necessarily occur because of being "natural" trading partners. Initial high volume of trade may reflect earlier preferences granted. For example, the volume of trade between the US and Mexico has certainly increased thanks to the Offshore Assembly Provision especially in favour of the latter. Similarly, the trade between Canada and the US has increased because of the auto agreement between them. In this case, that is, if the large volumes are attributable to preferences granted earlier, then they are not "natural". This fact leads the proponents of natural trading partners argument to advocate more preferences on the basis of existing preferences. It is totally wrong to think in such a way that additional preferences, which are actually at the expense of non-members, are "therefore" harmless.

*Finally*, the fact that comparative advantage in specific goods often changes in different locations is another objection to the argument that a high initial volume of imports from a partner country will work to avoid trade diversion. For example, country A imports a product from country B under a non-discriminatory tariff. If a PTA is formed between the two countries, the product will continue to be imported from B. However, if B loses its comparative advantage to country C on a future date, there will be trade diversion. Imports

into A will continue to come from B with the volume of trade remaining unchanged. Because of the preference, B replaces C as the exporter of this product.

In the light of the above-mentioned reasons, the first premise is found clearly as rejectable by the prominent trade theorists like Bhagwati and Panagariya (1996a, p. 31). They agree that while the volume-of-trade criterion is flawed, linking it to *regionalism* and therefore declaring that regional PTAs to be more benign than non-regional PTAs is additionally wrong: There is not evidence at all that groups of close countries, or countries with common borders, have higher volumes of trade with each other than do groups that are not so situated.

For example; Chile shares a common border with Argentina, but in 1993 it shipped only 6.2 percent of exports to Argentina and received only 5 percent of its imports from it (Panagariya 1996, tables 3 and 4). By contrast, the US does not have a common border with Chile but accounted for 16.2 percent of its exports and 24.9 percent of its imports in 1993. Therefore, the volume-of-trade criterion would make the US, not Argentina, the natural partner of Chile. Similarly, Bhagwati (1992, p. 544) compared the trade through the 1960s between India and Pakistan with that between India and the UK or the Union of Soviet Socialist Republics (USSR). The former trade has been smaller than the latter. Borders can be a factor of hostility between neighbours and therefore obstruct trade, just as alliances among distant countries with shared causes and interests can promote trade. Additionally, the asserted correlation between geographical proximity and high volume of trade might be a result of trade diversion since proximity may lead to preferential grant of concessions at the expense of other countries. Therefore, this correlation does not have a firm empirical or conceptual basis. Moreover, by ruling out distant country arrangements, this correlation makes the PTAs more exclusive and less open to new members. This undermines the objective of moving towards free trade at the global level.

While firstly Krugman (1991b) and Summers (1994) equate volume of trade with regionalism and then Frankel and Wei (1998b) supported Krugman-Summers assertion by concluding that “proximity is in general an important determinant of bilateral trade around the world notwithstanding exceptions like India-Pakistan and other cases”, Bhagwati and Panagariya (1996a, p. 34) argued that there seem to be just a *partial* correlation between

distance and trade volumes. For a thorough analysis, the *total* initial volume of trade has to be taken into consideration and this does not correlate simply with distance as required by the “natural trading partners” assertion of the volume of trade criterion for forming PTAs.

*In conclusion*, natural trading partner approach is not trustworthy and sound to determine which PTAs are not trade diverting. Natural trading partner issue generalises rules to exclude CUs and FTAs, which are *likely* trade diversionary. Therefore, it is dangerous to try to rely on such generalisations as if they provide completely dependable guides to ensure harmless PTAs. Additionally, this approach evaluated PTAs from the point of view of members by asking how to maximise the gains from trade creation. However, the focus in this chapter is on harmful effects of regional arrangements on the welfare of non-member countries, not the effects on members’ welfare of trade blocs: it puts preventing harm to non-members ahead of preventing members from harming themselves. Although natural trading partner approach deals with trade diversion from members’ point of view, not from non-members’ point of view, it indirectly concerns non-members in terms of its results. However, if a PTA is to be evaluated by its external effects -by whether it causes harm to non-members-, then the best approach is the one, which deals with trade diversion from the point of view of non-members -which directly concerns non-members-. In other words, avoiding harmful effects of PTAs on non-members should be the aim, not the result of the approach.

## **4. 2. OPEN REGIONALISM**

One of the recent suggestions to counter trade diversion effect on non-members is open regionalism. “Economic ideas are shaped by, and in turn help to shape, economic reality.” (Garnaut, 1996, p. 16) Accordingly, the concept of “open regionalism” has emerged from and has helped to shape the practice of economic co-operation in the Asia-Pacific region. It was formally introduced during APEC<sup>55</sup> discussions and has been adopted from its creation in 1989 as its fundamental principle for the future development of economic relations in the Asia-Pacific region. At the Bogor Summit (Indonesia) in November 1994 APEC

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<sup>55</sup> APEC was initiated by the US and Japan in 1989 to include Thailand, the Philippines, Malaysia, Indonesia, Australia, New Zealand, Singapore, Republic of Korea, Canada and Brunei. In the 1990s, a group of new members joined APEC, including the People’s Republic of China, Hong Kong, Chinese Taipei, Mexico, Papua New Guinea, Chile, Peru, Russia and Vietnam.

emphasised its strong opposition to the creation of an inward-looking trading bloc that could divert from the pursuit of global free trade. It also pointed out that the outcome of trade liberalisation in the Asia-Pacific will not only be the actual reduction of barriers among APEC countries but also between APEC countries and non-APEC countries. In other words, it is thought to entail a structure that minimises trade diversion. Since APEC is a major and influential factor in the world trading system<sup>56</sup>, its introduction of “open regionalism” has driven the concept into global prominence.

Open regionalism is generally conceived as regional economic integration without discrimination against non-members. Therefore, it represents an effort to resolve that how to achieve compatibility between the explosion of discriminatory PTAs<sup>57</sup> and the multilateral trading system and to assure that PTAs will be building blocks for further global liberalisation rather than stumbling blocks that deter such progress. Since it can be contrasted with “discriminatory” regionalism<sup>58</sup>, it might be seen as an alternative to the disintegration of the multilateral trading system into exclusive discriminatory blocs. Accordingly, while open regionalism has emerged from the discussion and reality<sup>59</sup> of economic co-operation in the Asia-Pacific region, its proponents like Bergsten (1997, pp. 546, 549) and Garnaut (1996, pp. 16, 17) argue that it can have wider application and view it as a device for regionalism to be able to be employed to accelerate the progress toward global liberalisation and rule-making: Open regionalism should also be adopted by other evolving regional arrangements such as the proposed Free Trade Area of Americas (FTAA) and any new North Atlantic Economic Community.

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<sup>56</sup> Its 21 nations account for about one half of the world output and world trade. The institution includes the three largest economies in the world: the US, Japan and China. APEC decided at its Bogor summit to achieve free and open trade and investment in the region no later than 2010 for its industrialised members, which account for about 90 per cent of its trade, and 2020 for its developing economies. In terms of APEC's size, this is potentially the most far-reaching trade agreement in history. (Bergsten, 1995)

<sup>57</sup> Over 60 percent of world trade takes place within PTAs. (Bergsten, 1997, p. 545, footnote 1)

<sup>58</sup> Article 24 types of traditional trade agreements: CUs and FTAs.

<sup>59</sup> Firstly, Asia has been devoid of regional trading agreements. Prior to the creation of the APEC, the only subregional agreement that includes Asian countries is the ASEAN Free Trade Area, which became a serious economic enterprise only in the middle 1990s. Therefore, the Asian countries, led by Japan and Korea, have placed more exclusive emphasis on the global trading system than have almost any of the WTO's other members. Secondly, trade liberalisation in Asia has a unilateral character: Much of the area's reduction in barriers has been implemented by countries in the region as part of their national development strategies without reference to international negotiations at either the global or regional levels. These elements of trade liberalisation in Asia reveal a strong preference and tendency in the region to avoid discrimination and discriminatory trading arrangements. (Bergsten, 1997, p. 550)



Although references to open regionalism as an alternative to discriminatory regionalism are repeatedly made, few attempts have been made to define the term systematically. Even Bergsten (1997, p. 545, 546) acknowledges:

Yet neither APEC nor any other official body has defined “open regionalism.” There has been no explicit application of the principle to date. Indeed, there are several competing notions of what it means and how it should be implemented. There is thus considerable confusion about the implications, and even the relevance, of the basic idea.

There are several possible definitions of “open regionalism” come out of the rare attempts at defining the term. They are open membership, unconditional MFN, conditional MFN, global liberalisation and reduction in external barriers. All those definitions regarding open regionalism can be implemented simultaneously as well as independently. The Eminent Persons’ Group (EPG), appointed by the APEC suggested a four-part formula<sup>60</sup> to pave the way for defining “open regionalism” in its second report in 1994. The policy proposed by the EPG for APEC to be “open regionalism” combines all but the first of those options. With respect to the APEC’s recent situation in terms of those options as the forum where the idea of open regionalism originated, it has not had to decide among them since any APEC liberalisation has not yet taken place<sup>61</sup>.

To be able to provide an answer to the question whether open regionalism is a solution to the discriminatory regionalism, it is necessary to evaluate those definitions.

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<sup>60</sup> The EPG recommended that APEC adopt a non-mutually exclusive four-part formula to implement its commitments to open regionalism:

- the maximum possible extent of unilateral liberalisation;
- a commitment to continue reducing its barriers to non-member countries while it liberalises internally on an MFN basis;
- a willingness to extend its regional liberalisation to non-members on a mutually reciprocal basis;

and

- recognition that any individual APEC member can unilaterally extend its APEC liberalisation to non-members on a conditional or unconditional basis.

In principle, any one of these elements by itself could effectively implement the principle of open regionalism. In the real world, the EPG believes that all four will be needed to do so. The EPG believes that the combination provides an operational definition of the concept of open regionalism that will be both effective and practical.

(Quoted by Bergsten, 1997, p. 560)

<sup>61</sup> However, some scholars like Panagariya (1999, p. 505) and Lopez and Matutes (1998, p. 256) define APEC as non-discriminatory based on unconditional MFN liberalisation.



#### 4. 2. 1. Open Membership

The first proposed definition of open regionalism is “open membership” whereby the regional agreement announces that any country willing to abide by its rules may join<sup>62</sup>. This means that trade liberalising effects of the regional agreement would expand to an increasing number of countries and at some point regional arrangement would give up its regional character. In other words, open regionalism opens the possibility that if non-members find it attractive to seek membership, a PTA can eventually cover the entire world and thus lead to multilateral free trade. Therefore, it represents dynamic time-path effect of regional arrangements on multilateralism analysed in the second and third chapters.

In spite of the possibility of reaching global free trade through open membership, there are important limitations, which give critics reason to be sceptical of open regionalism in respect of open membership. First of all, Article 24 variety of regional arrangements, that’s CUs and FTAs, by definition, still have to discriminate against non-members at any point in time for the arrangement to have any meaning. Hence, open regional arrangements are still likely to harm non-members.

Secondly, as Panagariya and Srinivasan (1998, p. 234) stated, even if it might still be argued that freedom of admission might be potentially substantive -in spite of this limitation- since many non-members seek to join the existing PTAs, membership in regional arrangements is hardly free: The price of admission can be set separately for each candidate and include several unpleasant side payments essentially unrelated to trade for example acceptance of a stronger intellectual property rights regime, investment rules and higher labour and environmental standards in the case of developing countries. This can lead to asymmetric agreements in which benefits to developing country candidates are reduced and possibly appropriated by existing members, and therefore makes membership burdensome.

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<sup>62</sup> Frankel and Wei (1997, p. 121) mention an extremist version of open membership, which does not permit current members to veto the admission of any eligible newcomer.

Additionally, open membership does not necessarily mean automatic and speedy approval of applicants for membership. It has taken the EU about 50 years to expand from 6 members to 25. Turkey has been struggling to be a member of the EU for more than 40 years. Similarly, NAFTA's membership has grown to only three so far and attempts by even a small country like Chile have faced serious resistance. Therefore, it is evident that it will take a very long time, if ever, countries in South Asia and Africa to be accepted to either the EU or the NAFTA. Until that occurs, the world trading system can become fragmented with complex rules of origin and phase-outs.

World Bank in its recent study on "Trade Blocs" (2000, pp. 99, 100) relates this hard membership (infeasibility of open access) to the depth of the scheme: For deeper agreements like the EU open access is harder to envisage. Since the more complex aspects of PTAs have to be negotiated, access can never be automatic and unconditional. By the same token, Bergsten (1997, p. 552) states that expansion of membership of any regional arrangement inherently complicates the process of deepening of its integration. This is particularly crucial concern for regional arrangements, which are at the stage of deepening. As a result, they may reject or delay applications for membership made by non-members.

Moreover, analytical treatments of this issue are not optimistic too. As discussed in the third chapter, there is generally an optimal size for a PTA from the point of view of existing members, and member firms have an interest in rejecting the membership of non-members since the formers have advantage against the latters arising from the gain of cost competitiveness. In this situation, it is not clear why members should want unrestricted access.

However, since open membership can ensure regional arrangements to serve as building blocks of, rather than stumbling blocks to, GATT-wide free trade in dynamic time-path sense, all these drawbacks should be handled. They can only be avoided through designing international trade laws. In this respect, reforming and, therefore, strengthening of the GATT rules on regional arrangements would be the best solution. As both Bhagwati (1991) and Nunnenkamp (1993) proposed, Article 24 must be extended by a commitment towards open membership so that PTAs could be rejected as GATT incompatible due to restrictive accession provisions. Regional integration arrangements had better be open to

new members, which are ready to comply with the obligations of the regional trade accord. To this end, accession procedures of regional arrangements would have to be modified in favour of non-members willing to join. This can only be possible via a commitment built into Article 24. However, it should be noted that in spite of such a commitment provided in Article 24, just open membership is not sufficient way of open regionalism in leading regionalism to the target of worldwide free trade. It does not only provide escape from discriminatory treatment for non-members, but also ensures moving towards multilateral free trade for all in dynamic time-path sense. However, a more direct, faster and overall solution with respect to protecting non-members from harm arising from formation and enlargement of PTAs should be proposed.

#### **4. 2. 2. Unconditional Non-Discriminatory Liberalisation (Unconditional MFN)**

The second “open regionalism” concept is unconditional MFN treatment. The idea is that while member states liberalise trade within the regional arrangement, they simultaneously cut trade barriers on imports from non-members too. In other words, trade liberalisation within the regional arrangement is extended unconditionally (nonreciprocally) to all of the members’ trading partners without any new preferences or discrimination. Unconditional MFN treatment is the broadest definition of open regionalism. It was advocated or implied for APEC in some of the early academic and private sector circles (Bergsten, 1997, p. 553).

However, although the concept of “unconditional MFN” is considered by its advocates as the pure and sole faithful definition of “open regionalism”, there are important drawbacks to this option and thus it does not seem likely to make headway. The main issue is “free rider” problem. The extension of the intra-bloc liberalisation to all other WTO members on an MFN basis raises doubts about its long-term feasibility. Any regional blocs refrain from allowing free riding by extending trade concessions to others automatically especially in the case of sizable non-members like the EU. Lopez and Matutes (1998, pp. 256, 257) find unilateral MFN liberalisation feasible only in large integrated regions like APEC and only if the weight of free riders does not increase. Otherwise, even those regions tend to give trade concessions just to those offering reciprocal concessions either through multilateral trade negotiations or under Article 24 in the framework of an FTA or a CU.

Bergsten (1997, p. 554) pointed out political economy considerations in this respect. Many countries' trade policy depends on mobilisation of exporters to counter the resistance of import-competing industries and workers. They find it essential to use such demonstrable benefits for liberalisation -and therefore to have reciprocal trade agreements- to persuade its domestic opponents. Accordingly, within APEC, the US, Canada and a number of developing countries, whose political economy of trade liberalisation rests heavily on reciprocity conditions, opposed to unconditional MFN.

More generally, the WTO system by itself is firmly based on the principle that trade liberalisation as a concession is to be granted in return for some concession by trading partners (principle of reciprocity). Therefore, the idea of unconditional MFN seems unlikely to be adopted. Accordingly, it is rare that benefits of regional trade liberalisation have been extended to non-members on a non-reciprocal basis<sup>63</sup>.

Another limitation pointed out by Bergsten (1997, p. 553) is that unconditional MFN treatment necessitates sacrifice by regional arrangement in terms of the use of its negotiating leverage, arising from its size, to negotiate reciprocal liberalisation by the non-members. For example, APEC's extending its liberalisation could reduce the possibility that other countries or regional arrangements would respond in kind if their trade policy are driven primarily by mercantilist rather than welfare concerns as often seems to be the case. Additionally, Srinivasan (1997) finds a bit odd to call unconditional MFN treatment as regionalism: When regional liberalisation is to be extended on the same timetable to non-members on an MFN basis, it would be multilateral and not regional. If that is the case, there are not any particular advantages in initiating such liberalisation on a regional basis in the first place.

#### **4. 2. 3. Conditional Non-Discriminatory Liberalisation (Conditional MFN)**

Conditional MFN extension of intra-bloc liberalisation has been considered as another type of open regionalism definition with a view to avoid the above-mentioned problems of unconditional non-discriminatory liberalisation. It means the generalisation of within-

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<sup>63</sup> Exceptions to this claim are Mexico's decision to globalise its investment liberalisation under NAFTA and the current proposal of the US Administration to generalise some US trade liberalisation under NAFTA to small Caribbean countries. (APEC, 1994)

group liberalisation to all non-members that agreed to take similar actions. It is expected that non-members would reciprocate in order to avoid being discriminated against by countries that, for example, account for half of the world economy in the case of APEC. Bergsten (1997, p. 554) pointed out that the extension of APEC liberalisation would take place in the WTO and represent a multilateral liberalisation if the bulk of the non-members accepted to reciprocate. However, no regional arrangement has ever adopted this kind of open regionalism.

As Bergsten (1997, pp. 554, 555) stated, conditional MFN treatment has two difficulties: Firstly, if non-members reject to reciprocate, regional arrangement will become a preferential arrangement with resultant trade diversion. Secondly, even if non-members agreed to reciprocate, they may feel to be exposed to a *fait accompli* by regional arrangement in which they had no voice and relationships may be hurt. As a result, conditional MFN may not be feasible and, therefore, a sufficient strategy alone as a workable alternative to discriminatory regionalism to solve the problem of trade diversion although it seems an appropriate alternative to unconditional MFN when taking into consideration the latter's limitations.

#### **4. 2. 4. Global Liberalisation**

Bergsten (1997, p. 556) and Panagariya (1999, p. 504) analysed "global liberalisation in the framework of the GATT/WTO" as another definition of open regionalism. It would be to simply continue reducing barriers multilaterally under the auspices of WTO while pursuing regional goals. Since all regional arrangements have participated in the post-war multilateral trade negotiations under the GATT, they actually *de facto* adopted this strategy in the name of being "open". Therefore, new regionalism is considered more open than earlier ones in the sense that they are taking place in an environment in which trade barriers have been substantially decreased through eight rounds of multilateral trade negotiations. In this respect, some define open regionalism as recent FTAs and CUs with low trade barriers on non-members.

However, although non-members confront low barriers, they are still subject to discrimination compared to members who face no barriers. Therefore, this kind of open

regionalism definition cannot be a solution for the fundamental contradiction between openness and discrimination. On the other hand, global liberalisation represents a weaker definition of open regionalism than the others since intra-region liberalisation may proceed more quickly (as in the case of the EU and the NAFTA) than multilateral liberalisation and, therefore, creates new trade diversion. As a result, this strategy is a necessary but far from sufficient criterion for ensuring the openness of the world trading system.

#### **4. 2. 5. Reduction in External Barriers**

The last definition of open regionalism refers to a simultaneous reduction of external barriers to non-members while liberalising internally. Such kind of open regionalism would go considerably beyond the other definitions mentioned above except unconditional MFN. Actually, the most ambitious one among the definitions of open regionalism serving to the aim of reaching universal free trade is unconditional MFN treatment. However, as mentioned above, due to its serious drawbacks making its implementation unlikely, reduction in external barriers seems the best option among the others to reach free trade for all when taking into consideration their limitations. Contrary to the other options, it is sufficient alone in ensuring the openness of the regional agreements provided that relevant changes of multilateral trading rules guaranteeing its implementation are realised. Therefore, the key factor in ensuring the openness of the regional agreements is to reform the multilateral rules in accordance with this option, that is, to redesign disciplines in the framework of the GATT/WTO system to avoid trade diversion effect as the best defence against the formation of inward-looking regional agreements.

After determining “reduction in external barriers” as the best way to have open regionalism, the important points arising are what the level of liberalisation against non-members at which closed regionalism turns into open regionalism is and how this level of liberalisation can be obtained. It was referred to in modest and less strict terms by some scholars like Frankel and Wei (1998a; 1997, p. 123) who are concerned with the effect of trade blocs on the total world welfare: Minimisation of trade diversion effect is not necessary. Instead, just a modest external liberalisation leading to a partial reduction in trade diversion is sufficient. They claimed that even a relatively small partial liberalisation



by regional blocs with respect to outside countries can usually ensure a welfare increase (Pareto improvement) for the world as a whole.

However, in this chapter particularly and in this thesis generally the focus is on harmful effects of regional arrangements on the “welfare of non-member countries”, not their effects on the “total world welfare”. PTAs are usually evaluated either from the point of view of the world as a whole by asking whether the trade creation outweighs the trade diversion, or from the point of view of the members by asking how to maximise the gains from trade creation. Instead, the thesis considers them from the perspective of non-members by asking how to avoid the losses from trade diversion. Thus, the size of any trade creation among member countries is irrelevant and any amount of trade diversion effect on non-members is undesirable. In other words, for this perspective preventing harm to non-member countries constitutes primary concern, and is more important than preventing members from harming themselves<sup>64</sup>.

Therefore, just a modest external liberalisation is not sufficient for non-members not to be harmed although it might be sufficient for total welfare improvement as Frankel and Wei (1998a) showed. The lower the external barriers, the less the scope for trade diverting effect. In accordance with this finding, the aim should be to propose ways ensuring the minimisation, even elimination, of any trade diversion not just reducing it modestly. Therefore, with the acknowledgement of the feasibility of this definition of open regionalism for containing the detriments of trade diversion on non-members’ welfare, its more specific and stricter form is proposed in this chapter as a solution to the contradiction between regionalism and multilateralism. By strengthening the definition with reference to the impact of the PTAs on non-members and by proposing an improvement in the multilateral trading rules accordingly, preventing harm to non-members’ welfare is aimed.

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<sup>64</sup> In the same vein, the GATT/WTO system emphasises that the parties to PTAs should avoid creating adverse effects on the trade of other contracting parties to the greatest possible extent. GATT’s rules (Article 24) are designed to ensure that regional trading integration should not be at the expense of non-member countries.

#### 4. 2. 5. 1. Admissible Preferential Trade Arrangements

Since PTAs are evaluated in this chapter by their external effects, that is by whether they cause harm to the welfare of non-member countries, the best test for this evaluation, as McMillan (1993, pp. 292-310) suggested and as adopted in this thesis, is Kemp-Vanek admissibility: *It is always possible for a preferential trade arrangement, formed among an arbitrary group of countries, to structure itself in such a way as to make the member countries better off without making any of the non-member countries worse off.*

Although the question whether regional integration should be regarded as a step toward global free trade or not was first addressed in 1950 as an old question by Viner, his answer was indecisive: A PTA represents freer trade to the extent that it results in trade creation and more-restricted trade to the extent that it results in trade diversion. Whether trade creation outweighs trade diversion is an empirical question in any particular case. Kemp (1964), Vanek (1965)<sup>65</sup>, Ohyama (1972), and Kemp and Wan (1976) tidied up the theory. Their theorem claims that PTAs can be unambiguously a good thing (trade-creating) while Vinerian analysis is inconclusive in this respect. The latter fixes the pre-union external tariffs and allows external trade flows to adjust endogenously as intra-union trade barriers are removed. In this case, the welfare effects on the union never become unambiguously positive. However, as Kemp-Vanek analysis offers, fixing the initial extra-union trade flows and letting the external tariffs adjust endogenously, the outcome becomes opposite: Neither the union as a whole nor the rest of the world can lose from a PTA; and the union is likely to benefit.

Kemp-Vanek theorem says that it is always possible for a PTA to be structured in such a way as to create gains for the member countries without harming any non-members by keeping trade volumes with the rest of the world at their pre-integration levels: First of all, the imports and exports between members and non-member countries should be hypothetically frozen at their pre-integration levels. Then any pre-existing barriers to trade among the member countries should be reduced or eliminated and internal prices should be let to adjust freely so as to equate supply and demand of each item. This reallocation

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<sup>65</sup> "Compensating common tariff" is defined by Vanek as the CET that equals trade diversion and creation with third countries, thus keeping the rest of the world as well off as it was before the union, and leaving the union with the trade creation gain from the removal of their internal barriers.

makes all the member countries better off with the help of compensatory payments from one member country to another if it is needed. Finally, what common external tariffs the newly formed PTA would have to set should be determined so that import demands and export supplies will be exactly at their pre-integration levels<sup>66</sup>. This necessitates a “considerable” reduction in previously imposed external tariffs.

Since the PTA’s tariffs are set at these levels, the same amount of trade with the non-members as before integration will be realised. Therefore, the members gain from the regional integration and the non-members have the same level of welfare as it had before the formation of the arrangement. Once the PTAs’ tariffs are set at this optimum level for both member and non-member countries, universal free trade can be reached over time through the continued participation of regional arrangements in the future multilateral liberalisation initiatives which will be realised within the framework of reformed and thus strengthened institutional structure of the GATT/WTO system.

Kemp-Vanek admissibility requires that there are not any reductions in any of the PTA’s imports. As McMillan (1993) stated, this would be difficult to check in practice since it would be necessary to check thousands of commodity classifications. Therefore, Kemp-Vanek admissibility is unimplementable although it is ideal and has normative significance for evaluating PTAs. A less stringent requirement than Kemp-Vanek admissibility in defining admissible PTAs might be proposed to provide implementable admissibility: A PTA is admissible if the volume of trade between members and the rest of the world is not lower after integration when measured in terms of the total volume of external trade. But, as in the case of the EU and as stated by McMillan, aggregated trade-volume statistics are not reliable measures of PTAs’ impact on the rest of the world compared to disaggregated statistics. With aggregative measure of admissibility, we cannot be sure that there are no losers among non-member countries in contrast to Kemp-Vanek admissibility. That is, admissibility defined in terms of the total volume of trade is probably inadequate to ensure the absence of detriment to non-members.<sup>67</sup>

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<sup>66</sup> These tariffs equal to the difference between the new internal market-clearing prices and world prices.

<sup>67</sup> However, aggregative measure of admissibility provides a yardstick of the PTA impact: If the PTA is admissible just in terms of total trade volume, then the income the non-members earn by selling to the members is not lowered following integration. Therefore, admissibility in aggregative terms is a necessary condition for Kemp-Vanek admissibility: If a PTA fails an aggregative admissibility test, we can conclude that there are likely to be some losses in the rest of the world.

In the light of these findings, a more satisfactory but still implementable approach should be proposed: A PTA is admissible if the volume of trade between members and non-members is not lower after integration when measured in terms of broad product categories; for example, trade volumes might be broken down into agricultural products and industrial products. In order to make Kemp-Vanek admissibility more implementable, it is necessary to have some degree of aggregativeness. However, unsatisfactory nature of the total volume of trade approach should be also taken into consideration. Therefore, the important point is the determination of the level of aggregation. Since that the finer the degree of aggregation the better subject to limitations on data collection, the level of aggregation should admit some sector-by-sector differentiation. The definition of admissibility depending on sector-by-sector evaluation makes Kemp-Vanek admissibility more implementable and, therefore, stronger since it envisages some degree of aggregation more than the latter; but still satisfactory since its aggregation degree is less than the total volume of trade approach.

However, the Kemp-Vanek model as a theoretical approach may not have any relevance for real world. The fact that it is possible, as the theory says, for regional agreements to avoid harm to non-members while improving their own welfare does not mean that they do not actually harm non-members. Due to the political economy and the terms of trade considerations, PTAs might restrict external trade in practice. Therefore, in order to make Kemp-Vanek model a good description of how harmless integration occurs in practice, it is essential to redesign the inadequate GATT disciplines so as to ensure avoiding of harmful effects of the PTAs for the international trade.

#### **4. 2. 5. 2. Developing Countries and the Objective of Industrialisation**

In the case of a PTA formed between the developing countries -or with the developing countries- that follow import substitution strategy for the aim of industrialisation<sup>68</sup>, reducing the external tariffs considerably –at the same time with the progressive elimination of internal tariffs- in accordance with the Kemp-Vanek admissibility seems

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<sup>68</sup> However, as Bhagwati, Greenaway and Panagariya (1998, p. 1138) argued that at present almost all developing countries are persuaded about the pitfalls of the import substitution strategy. They have seen that *export promotion* strategy have led them to far more rapid industrialisation rather than import oriented strategies as in the case of Far East.

contradictory with the policy of import substitution that generally depends on imposing high tariffs on imports. At first sight, it is perceived that this requirement for preventing harm to the non-members' welfare jeopardises reaching the industrialisation objective. That is, development prospect of the developing countries are sacrificed in order to eliminate detrimental effects of PTAs on the non-members' welfare.

Actually, it does not have to give up industrialisation objective for the sake of non-members' welfare. The developing countries can still pursue import-substitution strategy led by the development concerns while meeting the requirement. The CUs that are harmless to the non-members' welfare can be guaranteed even if members are constrained by specific non-economic government objectives. Any subset of countries can always form a welfare-enhancing CU without harming non-members' welfare, while ensuring that they can maintain the degree of industrialisation that they had achieved through protective tariffs. Two or more countries which pursue the import-substituting industrialisation objectives (certain non-economic objectives) against non-member developed countries can form a CU between themselves -and with the developed countries- and be jointly better off while leaving non-member countries' welfare unchanged.

In order to satisfy the development considerations of the member developing countries while protecting the non-members' welfare interests, Krishna and Bhagwati (1999) approach, which is analysed in the second chapter in detail, can be proposed. The approach showed that the solution involves a Kemp-Wan customs union complemented by *production tax-cum-subsidies* –instead of protective external tariffs- to achieve the non-economic objectives of member states as indicated by the theory of optimal intervention in the presence of non-economic objectives. Imposing protective tariffs is not the only policy tool to pursue the objective of industrialisation. In fact, it is not the optimal policy that achieves the non-economic objective at the least welfare loss<sup>69</sup>. According to Chacholiades (1990, p. 182), the optimal policy is to intervene at the exact point of the distortion for correcting a distortion. A production tax or subsidy to remove a distortion in domestic production can be the optimal policy. Therefore, the *production tax-cum-subsidy* is not

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<sup>69</sup> Since the attainment of a non-economic objective generally involves the violation of one or more Pareto optimality conditions, it has an economic cost in the form of a welfare loss.



only the alternative policy helping to protect the non-members' welfare interests but also the optimal policy instrument for reaching the objective of industrialisation.

Krishna and Bhagwati approach serves in favour of both the industrialisation considerations of the member developing countries and of welfare interests of the non-members as a version of the Kemp-Wan theorem with an added policy instrument thrown in to reach the targeted degree of member country industrialisation.

#### **4. 3. REDESIGNING GATT/WTO DISCIPLINES TO ELIMINATE ADVERSE IMPACTS OF PTAs ON NON-MEMBERS' WELFARE<sup>70</sup>**

To prevent regionalism from becoming at the expense of the rest of the world, PTAs should be designed in a way to dissipate fears of adverse welfare effects on non-members. This requires strictly disciplining the PTA-route towards trade liberalisation within the framework of the WTO. Therefore, stricter GATT monitoring of PTAs under precise and satisfactory GATT disciplines is necessary. However, as studied in the first chapter, inadequate requirement of Article 24 regarding "no raising of barriers to trade with non-members" is far from avoiding adverse welfare effects (trade diversion effect) on non-members, as contrary to the intention of its inclusion. Therefore, redesigning of the GATT/WTO disciplines directly or indirectly related to PTAs will solve the problem regarding potential detrimental effects of PTAs on non-members. Since the purpose should be reducing the preferential elements or the size of the preferences, which are at the expense of non-members, any proposal to redesign GATT/WTO disciplines regarding PTAs must mainly rest on external liberalisation of the regional arrangements as proposed above.

The implementation of the features of "open" regional arrangements, which are described above in terms of avoiding harmful welfare effects to non-members, requires relevant

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<sup>70</sup> This is a different approach, which seems more robust compared to the "natural trading partner" issue. It is more defensible regarding robustness since it examines different situations in which trade diversion could arise and then establishes disciplines that would impede its incidence rather than pretends to find rules to exclude PTAs likely to be welfare decreasing. Moreover, according to this approach whether trade creation is larger than trade diversion depends on the level of tariff and non-tariff barriers against third countries after the implementation of the regional arrangement instead of on the levels of tariffs prevailing prior to the regional arrangement provided that internal trade creation has already been achieved through removal of barriers among member countries.



changes in the multilateral framework. In other words, in order to implement the proposal regarding “admissible PTAs” presented above, multilateral trading system had better undergo necessary reforms. As the Uruguay Round dealt with NTBs and set the limits for unilateral protective measures, a new global effort is needed to discipline growing regionalism and ensure its beneficial impacts. These changes in accordance with ensuring considerable external liberalisation of regional arrangements concern Article 24, which directly governs the issue of PTA, the UR Agreement on Anti-Dumping Measures and the UR Agreement on Technical Barriers to Trade, which are indirectly relevant disciplines.

#### **4. 3. 1. Redesigning of Article 24 of the GATT to Eliminate Trade Diversion Effect**

Article 24 (paragraph 5) seeks to establish discipline that would minimise the incidence of trade diversion by requiring that a newly forming or an enlarging PTA (CUs or FTAs) should ensure that its common external tariff in the case of CU, and duties and other restrictive regulations of commerce in the case of FTA must be no higher than the average level of pre-existing tariff equivalents in the joining countries prior to the formation of such an arrangement. It is based on the concept of balancing or compensating mechanisms: Increases in certain sectors are compensated by decreases in other sectors.

It is evident that Article 24’s injunction “not to raise the average external tariff” -that is, maintaining average level of external tariff unchanged as it was at its pre-integration level- may not minimise trade diversion although it was designed with this aim. Even if tariffs were held at their average pre-integration level, integration may result in considerable trade diversion. In other words, compatibility with this provision of Article 24 is not a guarantee of open and therefore harmless regionalism to non-members’ welfare. Even if Article 24’s current provisions against raising external tariffs are fully met, non-member countries that have an economic structure similar to one or some of the member countries are likely to be harmed since competitiveness of non-member countries is lost to the member country or countries having similar economic structure. It is possible for a PTA to be consistent with Article 24 if not raising average external tariffs, but still to be harmful to the non-members. Therefore, Article 24 must be redesigned so as to prevent any possibility of occurrence of detrimental welfare effect by the formation or enlargement of PTAs on non-members. It is evident that its existing design is inadequate to this task.

A desirable and clear proposal in this respect is highly needed. The objective of avoiding harm (trade diversion effect) to any non-members' welfare should be focused on when designing a satisfactory proposal in the context of non-members' concerns. In accordance with this, "not lowering prior trade volumes with the non-members" must be the basis of the proposal as shown above in the title "Admissible Preferential Trade Arrangements": A preferential arrangement would be admissible and therefore harm to non-members' welfare avoided only if the external tariffs on the potentially trade-diverted goods were considerably reduced. Avoiding harm to the welfare of the rest of the world requires a newly forming or enlarging PTA to lower its external tariffs together with the internal tariff reduction<sup>71</sup>. The lower the external barriers are, the less the scope for trade diversion is. Therefore, a satisfactory and desirable discipline for Article 24 to be imposed on PTAs would be the requirement of "simultaneous reduction of the external barriers with the progressive elimination of internal trade barriers".

As Bhagwati (1992, p. 546) proposed, the first step of ensuring this might be to modify Article 24 to rule out FTAs with diverse tariffs by members and to permit only CUs with common external tariffs as an indirect discipline. Since most tariffs are bound, this would ensure that for the most part a substantial downward shift in tariffs would be a consequence. For example, Argentina or Brazil would be lowering its trade barriers while the US would not be raising its trade barriers. It should be noted that regionalism is a matter of low-trade-barrier hubs like the EU and the US joining with their respective regional spokes. It is evident that it would be easier to obtain a reduction of external protection from the creation of a CU rather than from an FTA. Therefore, such insistence on CUs instead of FTAs may lead to an influential solution in the first hand.

Another justification concerning insistence on CUs instead of FTAs was provided by Krueger (1995). Her central argument addresses the negative impact of *rules of origin*,

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<sup>71</sup> An alternative suggestion, made by Nunnenkamp (1993), requires for compensation if regional integration results in trade diversion at the expense of non-members. According to this suggestion, the compensation for trade diversion should be paid by a reduction of protectionist measures against extra-regional imports. External liberalisation would be required to an extent that produces a rise in extra-regional imports equivalent to the calculated trade diversion effect. To assure that, Nunnenkamp proposed Article 24 to be extended by a provision. However, while the proposal made by Bhagwati and McMillan aims at preventing the incidence of trade diversion and, therefore, avoiding any harm to non-members' welfare before occurring; the objective of this proposal is to compensate trade diversion and, therefore, harm to non-members after occurring. Thus, the latter proposal is inferior to the former one.

necessary in FTAs to prevent trade deflection: In order to comply with the existing rules of origin, producers within the area have the incentive to replace inside-the-bloc suppliers for outside-the-bloc suppliers, thus leading to trade diversion, along with the additional costs involved in documenting and proving the origin of all goods. A CU does not have negative effect of rules of origin due to the existence of one common tariff (Krueger, 1995, p. 15). Thus, a CU is Pareto-superior and preferable to an FTA as a trade diversion minimising arrangement unless the new external tariff produces additional trade diversion.

Bhagwati proposed (1992, p. 546) not only insisting on CU, but also writing into Article 24 the requirement that the lowest tariff of any union member on an item before the union must be part of the common external tariff of the union<sup>72</sup> as a practical and surer way to guarantee reduction in external tariffs. Even where the average level of tariffs in the member countries does not change as required by Article 24, the alignment of the rates of duty between the members will have a detrimental effect on non-members. In considering the CU formed by two countries and the common external tariff is fixed as the average of the different national rates, while the country whose duty is raised through tariff alignment will suffer a price rise which will lead to decline in imports from non-members (trade suppression), the process operates in reverse in the formerly high tariff country leading to external trade creation as imports from non-members increase. In the countries, which formerly had high national tariffs, external trade creation may offset the trade diversion effect. By contrast, in the low tariff countries trade suppression would add to the loss of imports from non-members resulting from trade diversion. (Hine, 1985, pp. 76-78) As a whole, the effect of the CU on non-members is harmful. To prevent this, the lowest tariff of any union member on an item before the union might be proposed as common external tariff of the union for that item.

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<sup>72</sup> In the same vein, Goto and Hamada (1999, pp. 559-562), in their paper on the economic impact of regionalism under the assumptions of constant tariffs and asymmetric bloc formation, also showed that “Even if external tariffs of the economic bloc remain the same, as Article 24 of the GATT requires, the welfare of the third province which is left out of the bloc unambiguously declines.” This proposition implies that Article 24 of the GATT is not a sufficient safeguard against the welfare loss of the third countries. Under the assumption of “constant tariffs”, they stated the need to modify Article 24 and their finding is in full conformity with Bhagwati’s proposal, in that the current provision of Article 24 is not enough to protect the welfare of outside countries, and that it should be modified to ensure the reduction of CETs of members in order to achieve the ideal world whose existence was accepted in this thesis under the Kemp-Vanek theorem.

However, it should be noted that reduction in external tariffs, which are provided by making the lowest tariff of any union member on an item prior to the union the common external tariff of the union for that item, may not be sufficient to keep trade volumes with non-members at their pre-union levels. To secure the same level of trade volumes with the rest of the world as their pre-integration levels, a more reduction in external tariffs might be necessary. The level at which a CU's common external tariff is fixed has an important effect on the volume of trade by non-members. The lower the common external tariff is, the lesser the potential for trade diversion will be. Therefore, a "considerable" reduction in tariff barriers might be essential to assure the same level of trade volumes with non-members as the pre-union levels. Article 24 must be redesigned in accordance with this fact: The requirement of reducing the external tariffs -simultaneously with the progressive elimination of internal tariffs- to the extent that it secures the same level of external trade volumes as the pre-integration level must be written into Article 24. In general terms, a proposed PTA, in order to be compatible with the GATT, must promise to introduce trade policies that result in external trade volumes being kept at their pre-integration levels. This would be the surest way to avoid harmful welfare effects to the rest of the world.

In the same vein, if any enlargement of an existing PTA is required in Article 24 to be done in such a way as to keep external trade volumes at their previous levels, the PTA can be unambiguously a step toward open trade on a global scale, given compatibility with the rule that external trade volumes not be lowered. If after some years the PTA is seen to have reduced its imports from non-members, it would be required to adjust its trade restrictions so as to reverse this fall in imports from non-members.

#### **4. 3. 2. Redesigning of the GATT/WTO Disciplines Regarding Contingent Protection and Technical Barriers**

Just redesigning Article 24 in accordance with ensuring external liberalisation of regional arrangements may not be sufficient in order to avoid harming the rest of the world. Together with reforming of Article 24, GATT disciplines governing unfair capture of fair trade measures like intensively used AD actions and standards relating to health and environment should also be improved. As long as the importance of tariffs as protective measures reduces with the multilateral trade liberalisation under the auspices of the

GATT<sup>73</sup>, countries increasingly prefer to resort to such selective and more elastic instruments of protection in the absence of Voluntary Exports Restraints (VERs), which have been gradually dismantled as agreed in the Uruguay Round. The lack of precise multilateral rules in these fields, as well as a system of credible sanctions and dispute settlement procedures, encouraged this non-co-operative behaviour by single countries and regional agreements like the EU.

Contingent protection is a controversial area where some of the WTO-sanctioned measures have a number of conceptual and operational weaknesses. Although the UR negotiations led to the adoption of new Agreements dealing with the major instruments of contingent protection, for example anti-dumping, countervailing and safeguard measures, this has not diminished the intensity of the controversy surrounding the use of contingent protection, especially AD actions. The economic rationale of the AD Agreement itself is open to question. As Koulen (1995, p. 232) notes: "... as illustrated by the absence of preambular considerations on questions of fundamental objectives and principles of anti-dumping action, the Uruguay round Agreement on Anti-dumping is an agreement to disagree. Sooner or later this debate is likely to be resumed in the WTO." The criticism concerning the AD regulations and practices has been elaborated in a number of studies.<sup>74</sup>

Recently there has been a spectacular proliferation in the use of AD actions particularly by the EU against the developing countries and newly industrialised countries (NICs) which are filing about half of the total number of AD cases. Since the current AD system is basically a flexible tool to prevent imports from causing injury to domestic industry and is being used as an easier safeguard to implement, it is about to become the most important trade-restricting device in the post-Uruguay Round world. (Tharakan, 1999a, p. 1151) In view of the serious shortcomings of the current WTO-sanctioned anti-dumping mechanism, the proliferation of its use, and the dangers it poses for multilateral trade liberalisation, it had better be reassessed thoroughly and redesigned, in the ongoing Round,

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<sup>73</sup> Although the successive multilateral rounds of liberalisation have reduced tariff levels to an average of 4 per cent in OECD countries, still some developing and newly industrialised economies maintain relatively high tariffs, especially prohibitive and peak tariffs in sensitive sectors. This justifies the concern about the trade-diverting effect of FTAs and CUs among these countries (for example ASEAN Free Trade Area (AFTA), Mercosur, or even NAFTA for the case of Mexico).

<sup>74</sup> See Finger (1993b) and Tharakan (1999b).



not only to provide a more liberal international environment in this respect in general but also to minimise negative impacts of PTAs on non-members in particular.

Similarly, ecological standards<sup>75</sup> and standards on health grounds are increasingly being resorted to as a new protectionist device by industrialised countries and regional blocs against suppliers from developing countries and have quite great potential for causing trade wars between industrialised countries and blocs especially since the UR Agreement on Technical Barriers<sup>76</sup> provided that members have the right to determine protection for human, animal and plant health and the environment at levels they consider appropriate by way of technical regulations and standards. Therefore, the agreement has a persuasive effect on the usage of standards and technical regulations as “covert” protectionist measures. Trade specialists argued that legislators of the accord created the WTO who have the primary goal of keeping foreign products far from their houses were passing disingenuous laws that lacked a scientific rationale.

Developing countries suffer from outright import bans imposed by developed countries and regional agreements on their goods whose production is claimed to cause serious “environmental” degradation and “health” problems; for example, the Tuna-Dolphin challenge by the US against Mexico<sup>77</sup> and the Shrimp-Turtle Dispute between the US and 16 less-developed countries (13 in Latin America plus Indonesia, Nigeria, and, Thailand)<sup>78</sup>.

In the same vein, the developed countries and regional blocs are resorting to standards on the grounds of “health” against each other, and these trade barriers have strong potential to lead to trade wars. For example, in July 1999, the US applied 100 percent tariffs on \$116.8 million worth of European imports including fruit juices, mustard, pork, truffles, and Roquefort cheese as response to a ban imposed by the EU on the American imports of meat, which was claimed to be treated with growth hormones, on the grounds of human health. This fierce transatlantic food fight is an example of a new kind of global trade conflict, in which health and environmental laws, rather than traditional trade barriers such

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<sup>75</sup> On the relations between trade and the environment, see GATT (1992b).

<sup>76</sup> The Agreement on Technical Barriers concluded at Tokyo Round was revised and extended in the Uruguay Round to clarify the key concept of “unnecessary obstacle” providing that technical regulations and standards will not be more protective than necessary to perform legitimate objective.

<sup>77</sup> see French, 2000, pp. 116-121.

<sup>78</sup> see French, pp.121-123 and Ekins, 2003, pp.174, 175.



as tariffs and quotas, are now at stake. The EU refused to revoke the ban in spite of a WTO ruling that this ban was an unfair barrier to US and Canadian beef exports. This means that the refusal by the EU defied the WTO ruling. (French, 2000, pp. 111, 112) This case shows that WTO's enforcement mechanism does not work in this respect and should be reformed through redesigning the relevant discipline.

Developed countries and regional agreements having strict environmental and health safety laws, particularly US, individual EU countries and the EU, can frequently abuse these laws as intentional trade barriers against less developed countries and each others. The important point is to determine whether countries resort to these laws truly with the aim of protecting environment and health indeed or deceitfully with the aim of, in fact, protecting domestic goods from cheaper foreign competition. To prevent protection on the grounds of health and environment from degenerating into trade protectionism, the UR agreement should be reformed to provide stricter rules for resorting to these standards and more effective dispute settlement mechanism to enforce those rules.

Therefore, just the redesigning Article 24, with a view to ensuring a discipline in which the external tariff barriers decrease as a price for CUs to be permitted under GATT rules, may not be a certain solution to the problem of potential trade diverting effects of PTAs. Because, protection against non-member countries can be still possible through trade barriers other than tariffs particularly frequently resorted AD actions and standards. In other words, when those measures are freely used by member countries vis-à-vis non-members, trade creation can degenerate quickly into trade diversion.

To be able to prevent potential trade diversion and, thus, inherently discriminatory regionalism greater discipline than just redesigning Article 24 for GATT rules is needed: For stricter rules for AD actions and standards, the UR Agreement on Anti-Dumping Measures and the UR Agreement on Technical Barriers to Trade need reform. Necessity of redesigning Article 24 and disciplines regarding contingent protection and standards with a view to minimising adverse effect of PTAs implies the need for a stronger multilateral trading system against regionalism.

## **CHAPTER 5. CASE STUDY: EFFECTS OF THE EU ON THE MULTILATERAL TRADING SYSTEM**

The EU's trade policy has been "walking on two legs" partly by necessity, partly by design since its early days: the EU has pursued multilateral liberalisation and regional integration simultaneously. On the one hand, it has been involved in regional liberalisation both through the long-standing pursuit of deeper integration and enlargement in relation to its own borders, and by concluding PTAs with the non-member countries outside its borders. On the other hand, it has actively participated in multilateral trade liberalisation negotiations under the auspices of GATT/WTO regime.

The EU is the most developed regional initiative in the world. Its ambitious policy of deeper integration in all aspects along with its widening size through both inclusion of new countries in its existing structure and involvement in preferential agreements with the non-members makes the EU's experience unique. The EU has lived long enough and is big enough to have had a sizeable influence on the multilateral trading system. Its position as the world's leading exporter of goods and the second largest importer is testimony to its significance for both non-members' welfare interests in particular and multilateral trading order in general<sup>79</sup>.

In accordance with the subject of the thesis, the effects of the EU on the multilateral trading system are examined in this chapter in static and dynamic time-path senses. In static sense, since the thesis focused on the effects of the PTAs on non-members' welfare, the EU is analysed from the perspective of its effects on non-EU countries' welfare. When it comes to the EU's welfare effects (trade diversion effects) on third countries, the main subjects to be addressed are tariffs, some other frequently used trade policy measures which can easily be used as effective protective tools at the expense of the non-members, and of course the Common Agricultural Policy (CAP). Besides these matters, trade agreements with the third countries (including accession treaties as the highest level of preferential trade patterns) are also matters of concern in terms of non-members' welfare in static sense. This chapter acknowledges as given the notion of the thesis that the simplest ground for fearing that PTA will have a protectionist effect is the analysis of trade

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<sup>79</sup> See Annex V.

diversion, which implies an automatically negative effect on the rest of the world from the formation of a bloc, even if the bloc does not have higher external trade barriers on average than did its constituent members. That is why the protectionist -discriminatory- practices of the EU against non-EU countries are analysed in this chapter.

With respect to the dynamic time-path effects of the EU, firstly its enlargements so as to integrate new countries into its existing structures are under consideration. Whether the EU as the expanding regional bloc can lead to global free trade through its enlargements, or in other words, whether the EU will continue to enlarge until leading to global free trade is discussed in this chapter. Secondly, the effects of the EU on the multilateral trade liberalisation as an important participant since its formation are examined. It is tricky to judge whether the formation and enlargement of the EU have undermined or underpinned multilateral trade liberalisation. In some instances, it has facilitated and supported trade liberalisation under the GATT rounds. For example, many argue that the formation of the EEC led directly to the Dillon and Kennedy Rounds, as other countries were concerned by the trade diversion consequences. But, in some other cases, the EU has undermined multilateral trade liberalisation efforts as it successfully resisted for decades to the inclusion of agriculture in trade liberalisation negotiations. It is difficult to say which effect has been dominant over the other.

In the light of the examination of the EU's trade policies, it might be concluded that it is still a frequent user of some trade tools (particularly contingent protection instruments and standards) with protectionist objectives and it is still quite protectionist in some sensitive sectors like agriculture. However, it is obvious that a more liberal inclination is under way both in its trade practices and, more importantly, in the minds of its leading policy makers. Moreover, awareness regarding the importance of multilateral trade liberalisation for its trade interests (particularly to increase market access for its imports) has recently risen and, accordingly, its support towards multilateral trade liberalisation efforts has increased as evidenced in the preparations for the DDR.

In the last section of this chapter, it is proposed that considering the above-mentioned switch to a more liberal trade understanding, an increase in European commitment to multilateralism and its increased absolute economic size through several enlargements and

its relative economic size vis-à-vis all partners individually and, even vis-à-vis groups of them, the EU has the capacity to provide effective exercise of the WTO leadership. The failure of the last (Cancun) Ministerial Conference of the WTO in September 2003 to proceed the Doha Round of multilateral trade negotiations poses an immediate necessity for the EU to assume leadership in the absence of effective American leadership. In other words, the EU is emerging as the sole alternative to the strong need of leadership for the successful conclusion of the MTNs in view of the leadership vacuum arising from American retreat in spite of its simultaneous pursuing of preferential trade policy and therefore the lack of full concentration on multilateralism.

### **5. 1. STATIC EFFECTS OF THE EU ON THE NON-MEMBERS' WELFARE**

The EU is the world's leading exporter of goods and the second largest importer. This position in international trade poses significance for particularly the non-members' welfare interests. Analyses of the customs union between the original six members of the EEC indicate that the EEC promoted intra-bloc trade, at the expense of the non-members' welfare, through a combination of trade creation and trade diversion<sup>80</sup>. For trade in agricultural products there was much trade diversion exceeding trade creation. Although trade diversion in manufactures was exceeded by trade creation<sup>81</sup>, the existence of the former had detrimental effects. Since welfare effects of PTAs are taken into consideration, in the thesis, from the non-members' point of view, this approach renders the size of any trade creation irrelevant and any trade diversion detrimental, thus undesirable, regardless whether the trade creation outweighs the trade diversion. This means that the EU, as a PTA, is detrimental to non-members' welfare due to trade diversion effect arising from its enlargements, preferential trade agreements with third countries and internal integration. Its trade creation effect is not relevant in this context.

In accordance with the notion of the thesis that the simplest ground for fearing that PTA will have a protectionist effect is the analysis of trade diversion, the protectionist

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<sup>80</sup> See Bayoumi and Eichengreen (1997). This conclusion is reinforced by their results for the first two enlargements of the Community, for which they also find both trade creation and trade diversion effects.

<sup>81</sup> See Lloyd (1992) and Srinivasan *et al.* (1993). These estimates take into account the reductions agreed in the Dillon and Kennedy Rounds.

-discriminatory- practices of the EU against non-EU countries are analysed in this section. The EU has a high degree of discrimination with respect to its external trade relations, through the following practices<sup>82</sup>:

- The application of trade policy tools like measures of contingent protection and technical barriers to trade, which are or can be targeted at individual partner countries and even at specific exporting firms.
- The Common Policy regarding Agriculture, which has traditionally been the most protected sector in the EU.
- The conclusion of trade agreements (including accession treaties as the highest level of preferential trade relations) with preferences extended to individual countries and to specific country groups. The number, range and nature of the PTAs have led to a “pyramid of preferences”.

### **5. 1. 1. External Tariffs of the EU**

For a PTA to be a CU, member countries must agree to charge the same rate of customs duty (common external tariff) on their imports from non-members product by product. As a CU in origin, the EU has operated a common external tariff against the non-EU members for each industrial product<sup>83</sup> since 1968 after a long transition period<sup>84</sup>. The CET of the EEC was determined at the level of the arithmetical average of the duties applied in the four customs territories covered by the Community (France, Italy, Germany and Benelux). The averaging formula meant that most French and Italian duties had to be lowered while

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<sup>82</sup> Substantially similar categorisation regarding the roots of the discriminatory nature of the EC was made by Heidensohn (1995, pp. 69, 70) as;

- Common Commercial Policy
- Pyramid of preferences
- Protectionism on a sectoral basis

<sup>83</sup> CET includes just industrial goods and external tariffs in agricultural goods (variable levies) are governed by the CAP. Variable levies that are equal to the difference between the world price and politically established internal price may cause total insulation from the world market. This made it very difficult to penetrate the EC market while intensifying instabilities on the world market more than an ordinary tariff would.

<sup>84</sup> Initially, the EEC’s trade policy was mainly formed by tariffs. The Rome Treaty’s ambivalence about external quotas reflected the early post-war practice of dealing separately with tariffs in the GATT and quotas in the Organisation for European Economic Co-operation (OEEC). The EC members continued to use a set of national quotas long after the transition period of CU (1958-1970) was over. This situation lasted until the completion of the internal market in 1993. It is therefore appropriate to say that the EC was closer to a FTA than a CU in those goods where national quotas were heavily used. In other words, the EC’s CU was a mere tariff union. (Pelkmans and Carzaniga, 1996, pp. 82)



German and Benelux duties were raised. As analysed under the section “4. 3. 1.” of the fourth chapter, in France and Italy external trade creation could offset the trade diversion effect while in Germany and Benelux countries trade suppression would add to the loss of imports from non-members resulting from trade diversion. This means that the formation of the EEC would lead to a considerable detrimental welfare effect on the non-members although it seemed compatible with the Article 24’s requirement “not to raise the average external tariff”.

Throughout the years since the adoption of the CET, its height was dealt with through multilateral trade liberalisation rounds under the auspices of the GATT. When debating the market access implications of the EEC’s CET, third countries claimed compensation on the grounds that the net effect of the alignment of tariffs was to seriously diminish market access. Inconclusive legal debate under Article 24(6) over who had the right to claim what compensation for construction of the common tariff became a factor leading to the Dillon Round and provided an impetus for the Kennedy Round. (Patterson, 1966) Although the Dillon Round achieved little, at the Kennedy Round industrial countries agreed to tariff reductions of about one-third of the initial level on about one-third of their total or two-thirds of their dutiable manufacturing imports. (Finger, 1993a, p. 137) As a result of these two rounds, the average level of the CET was reduced 35 per cent and the Community ended up with fewer and lower tariff peaks than the US, at least in non-food industrial products. However, any reduction of tariffs in agricultural products was hardly agreed.

In the Tokyo Round, although most of the discussions were concerned with non-tariff issues, a general reduction of over 30 per cent was agreed for industrial tariffs. These reductions left the nominal level of tariffs under the CET at about 6 per cent. With the implementation of the reductions agreed in Tokyo Round, the height of the EEC’s common tariff on industrial goods became relatively a minor issue in international trade. But tariffs on agricultural goods continued to constitute a considerable protection against non-members.

As a result of the Uruguay Round, tariffs have continued increasingly to lose importance as trade policy instruments. In addition to overall increase in bindings, which reduces the use of tariffs as a discriminatory policy instrument, enhanced market access will be ensured by an



overall reduction of tariffs of almost 40 per cent. Additionally, the share of duty-free imports in developed countries will be more than double after the implementation of the cuts, rising from 20 to 44 per cent of imports. (OECD, 2000, p. 35) With respect to the EU, the last Trade Policy Review (TPR)<sup>85</sup> of the EU (WTO, 2002) indicates that the EU has bound 100 per cent of its tariff lines in the WTO, and tariffs applied on products are closely aligned to bound levels. Additionally, the overall simple average MFN tariff declined from 9.5 per cent in 1996 to 6.4 per cent in 2002. The simple average applied tariff on manufacturing products is 4.1 per cent<sup>86</sup>, slightly lower than at the time of the previous TPR in the mid 2000<sup>87</sup>, due to tariff reductions for certain chemicals, textiles, iron and steel products, and toys. In non-food manufactured products, in which all tariffs are *ad valorem* tariffs, tariff peaks are all lower than 20 per cent. Tariff peaks will be lower than 15 per cent by the end of the implementation period except for trucks and a few footwear items.

This picture supports the idea that in terms of tariffs European markets can be considered quite open except some sensitive sectors like agriculture and textiles: OECD (2000, p. 36) points out that in spite of considerable average rate reductions and the phasing-out of duties in several sectors, tariffs have remained high for certain manufacturing products like textile and clothing, leather, rubber, footwear and travel goods, fish and fish products, and transport equipment. In textiles and clothing products, tariffs are well above the overall simple average, which is 6.4 per cent for 2002. Additionally, following the “tariffication”<sup>88</sup>, high tariffs and tariff peaks have replaced non-tariff barriers in agriculture and processed food.

The last TPR stated that another sector, which is subject to considerable protection in terms of tariffs, is agriculture. Tariffs applied are quite above the average in this sector, too. The simple average tariff on agricultural products is, at 16.1 per cent, about four times higher

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<sup>85</sup> Note that years of completion of the last four Trade Policy Reviews of the EU, rather than years of their publication are consistently used throughout this chapter including the “references”.

<sup>86</sup> The simple average tariff rate for manufacturing products was actually scheduled to decline to about 3 per cent by the year 2000 (Tharakan, 1999c, p. 830).

<sup>87</sup> See WTO 2000.

<sup>88</sup> By the UR Agreement on Agriculture, Members are committed to convert all non-tariff barriers into tariff equivalents. This means tariffication. In almost all instances, the new tariffs consist of specific duties, for which the *ad valorem* equivalent cannot be easily calculated. Overall the tariffication requirement resulted in high levels of initial tariffs, due to both the high level of protection in the base period and to the level of prices used to calculate tariff equivalents.

than that on non-agricultural products. An important problem regarding tariff barriers for this sector is tariffification with its negative effects on the trade policy in general in terms of the image of “openness”. OECD (2000, pp. 36, 39) points out that tariffification process in the EU resulted in prohibitively high tariffs on agricultural sectors like dairy products, sugar, fruit and vegetables. The noticeable increase in the EU simple average applied tariff from 7.6 per cent in 1993 to 9.5 per cent in 1996 reflects the impact of tariffification process in agricultural sector, which outweighed the reductions elsewhere. The use of specific tariffs has increased due to the process of tariffification and recently such tariffs amounts to 12.1 per cent of all tariffs for the EU. Overall, the “tariffication” process leads to an increase in the “quantified” average tariff level and to higher levels of distortion in the tariff structure. Although tariffification has been followed by reductions on a simple average basis, OECD (1997a) shows that these reductions for agricultural products have been widely concentrated in less sensitive, low tariff product categories and been kept at minimum for sensitive high tariff product categories.

Recently, as a result of tariffification of agricultural imports, tariff dispersion<sup>89</sup>, which is the variance in tariff rates across products, has increased in most developed countries. Developed countries have presented lower levels of overall tariff protection due to the implementation of the UR conclusions. However, their tariff structures have been becoming more distorting with the tariffification process, as high tariffs have been cut less than lower ones. This trend has been more accentuated in the EU, which presented a more distorted tariff schedule. Tariff dispersion, as measured by the overall standard deviation, reached 20.7 per cent in the EU. This is in line with the increase in tariff spikes in the EU, which are tariff rates in excess of a given domestic reference level, from 2.3 to 4.8 per cent. (OECD, 2000, p. 39)

Tariff “escalation” has been another traditional feature of the covert EU protectionism. The EU’s tariff structure has shown considerable escalation, favouring domestic processors in certain sectors. Tariff escalation takes place when the level of protection increases as goods undergo further processing. That is, the more processed the imported product is, the higher the tariff on it when enters the European Common Market. This kind of protectionism

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<sup>89</sup> The dead weight losses associated with a country’s tariff structure depend not only on the average tariff rates and elasticities of demand and supply, but also on the tariff dispersion.

targets developing countries especially. Those countries can sell the developed ones many goods far cheaper than the latter since workers there get paid little and even nothing. The developed countries claim that they have to protect themselves from this unfair trade and put forward this excuse to justify the implementation of tariff escalation.

However, the actual reason behind tariff escalation is that the developed countries make a lot of money out of manufacturing by using raw materials from the less-developed countries to make finished products. That is why the developed countries let raw materials (like cocoa bean), whose prices have been steadily dropping, come in without tariffs but put high tariffs on manufactured goods (like cocoa powder or chocolate bar). (Pennartz, 1997, pp. 12-15) Therefore, tariff escalation in developed countries is a great concern for the developing countries since higher rates of protection of processed goods in the developed countries may hurt their potential to develop processing industries.

OECD (1995b and 1997b) states that tariff escalation prevails in a number of agricultural product chains (like coffee, cocoa and nuts) while it has been reduced in other cases. However, it still remains in textiles, clothing, leather and rubber, and has disappeared only in paper, iron and steel. The last TPR of the EU also finds that evidence of tariff escalation remains on processed goods. As a result of all these indicators about tariffs, it can be concluded that the EU tariff schedule in the post UR continues to exhibit peaks and tariff escalation and even show an increased level of distortion.

If the presence of preferential treatment of the EU arising from preferential agreements with some non-member countries, instead of just MFN treatment, was also taken into consideration when evaluating the effects of tariffs on non-members, both the use of tariffs and the level of protection by the EU would seem to be less. But this would be underestimating and, thus, misleading with respect to the detrimental effects of tariff barriers of the EU on the non-EU countries which are not subject to preferential treatment by the EU.

Preferential treatment in favour of some non-EU countries cannot be generalised -in terms of its effects- for all of the non-EU countries since preferential trade agreements are, by definition, discriminatory at the expense of non-members. It is obvious that preferential

treatment by the EU in favour of some of the non-EU countries is used efficiently as protection device against other non-EU countries. That is why MFN applied tariff rates instead of collected tariff rates, which include preferential tariff rates, are referred in this chapter so as to evaluate the current level of protection of the EU on imports.

## **5. 1. 2. Effectively Used Non-Tariff Trade Policy Measures by the EU**

### **5. 1. 2. 1. Measures of Contingent Protection**

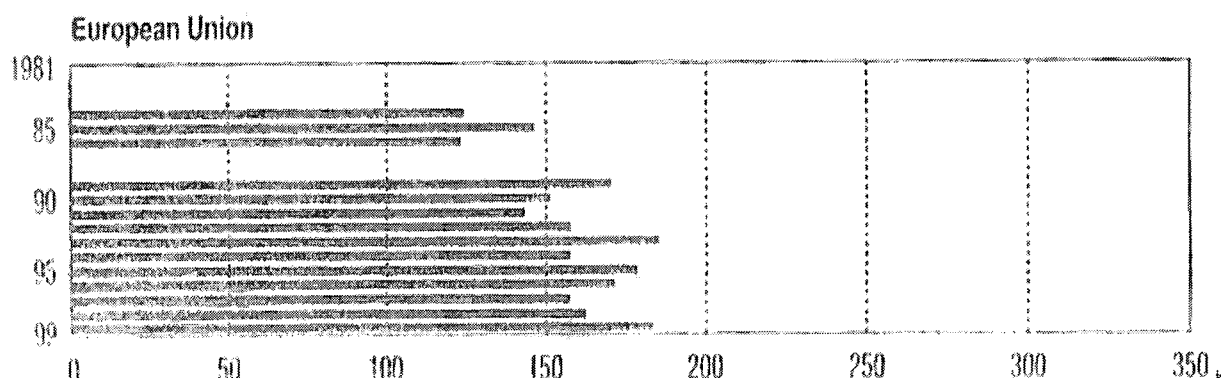
The EU has frequently resorted to contingent protection measures under the GATT, and has used anti-dumping actions -as the second most frequent user behind the US- much more than others (safeguards<sup>90</sup> and countervailing duties). Although the use of anti-dumping measures is less intense in sectors subject to higher tariffs and other measures affecting imports, it remains the key trade protection instruments. Definitive anti-dumping measures (duties and/or undertakings) on 175 product categories, down from 192 in 1999, were in force by July 2002. About 40 per cent of the anti-dumping investigations initiated by the EU are terminated without measures being taken. (WTO, 2002) While the number of the outstanding AD actions has risen markedly in the US since the early 1980s, it has remained relatively stable in the EU although the gradual dismantling of VERs<sup>91</sup> led to the fears that the use of the AD measures would sharply increase in the EU to offset this reduction in protection (Figure 5. 1.).

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<sup>90</sup> Explanations for the large difference in the use of anti-dumping actions and safeguard measures stems from the fact that anti-dumping actions can be requested directly by the industry, and that they can be adopted more easily than safeguards given the broader definition of dumping.

<sup>91</sup> One of the major achievements of the UR has been the prohibition of the use of VERs and phasing-out the existing ones within four years. The EU-Japan VER on automobiles, the last one, was phased out in December 1999.

**Figure 5. 1. Number of outstanding antidumping actions 1981-99**



*Source: WTO and GATT*

The frequent resort to traditional AD measures along with technical barriers for protection against outside competition stems, to a great extent, from the additional adjustment pressures created by intra-bloc liberalisation. Bhagwati (1992) pointed out that much of the protectionist threat from blocs arises from the possibility that trade creation and increased competition within the bloc creates a demand for increased protection from extra-bloc competition, and that selective and contingent protection, such as anti-dumping, effectively responds to such demand. In the same vein, Hindley and Messerlin (1993) found that internal liberalisation resulting from the completion of the Single Market was accompanied by more vigorous anti-dumping against outside countries. That is why the EU has been a very active user of anti-dumping actions against Japan, the East Asian NICs, other less-developed countries and recently China. While throughout 1990s the AD actions were mostly directed towards Japan, NICs, the former Soviet Union countries, CEECs<sup>92</sup> and the Mediterranean countries, the last TPR (WTO, 2002) states that products imported from China are recently the most frequently affected ones.

<sup>92</sup> With the fall of communism and the gradual move towards market mechanisms in Eastern Europe, there has been a relative and absolute decline in the number of actions against these countries, and from 1994 onwards the Commission has treated them as market economies. After an Association relationship with all of these countries and their following candidacy process, majority of them (except Bulgaria and Romania) are going to become full member of the EU in May 2004.



As regards the product categories, AD measures have been concentrated more heavily on chemicals, iron and steel, consumer electronics and of course textiles and clothing. Among those the most affected product category is textiles and clothing from the less-developed countries. Potentially, many of the benefits from the phase-out of the Multi-fibre Arrangement (MFA) quotas will be undermined if the EU and the other developed countries continue to make greater use of the AD measures against imports from the less-developed countries. Much of the trade in textiles and clothing sector, which has great interest to the developing countries, has, since the early 1960s, been subject to bilateral quotas negotiated under the MFA, which is a special discriminatory trade regime. The MFA regime enabled the developed countries to limit problems of market disruption in this sector by means of quantitative restrictions against the developing countries<sup>93</sup>. The UR Agreement on Textiles and Clothing ensures a legal framework for the phasing-out of the MFA, securing the eventual integration of the textiles and clothing sector into the GATT on the basis of the strengthened GATT rules and disciplines at the end of a 10 year-period<sup>94</sup>. Nevertheless, the absence of the high value-added items in the list of the products for integration on textiles and clothing into the GATT and the high rate of imposition of the AD measures on textiles imports could lead to the frustrations felt by the developing countries concerning the EU policy in this sector in spite of the elimination of MFA quotas. (WTO, 1997)

AD measures are meant to be remedies against unfair competition, but often perceived as protectionist instruments with industrial policy objectives in mind. In order to implement the 1994 Anti-Dumping Agreement of the GATT, the Council of the EU adopted a new AD Regulation<sup>95</sup>. However, the recent changes introduced by the UR into GATT Anti-Dumping Code did not entail radical modifications of EU AD procedures. Additionally, some of the WTO-sanctioned measures still have a number

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<sup>93</sup> Developed countries sought an arrangement that would permit them to escape certain GATT obligations and to negotiate quantitative restraint arrangements on a discriminatory basis when developing countries and Japan began to penetrate the world market for textiles.

<sup>94</sup> Following its WTO commitments arising from the conclusions of the UR, the EU integrated a further 18.08 per cent of textiles and clothing products on 1 January 2002, bringing to 51.39 per cent the imports integrated into GATT 1994 since 1995. It involved the lifting of restrictions on 11 product categories, accounting for 15 per cent of products restricted in 1990. Until 2002, the EU lifted restrictions on 20 per cent of products restricted in 1990, leaving the elimination of the remaining 80 per cent of restricted imports "back-loaded" for the final stage at the end of 2004 as agreed in the UR. (WTO, 2002)

<sup>95</sup> Council Regulation 3283/94, as corrected and amended by Council Regulation 384/96, Official Journal L 56/1, 22 December 1995.



of conceptual and operational weaknesses. Therefore, AD actions remain a very sensitive and controversial issue in trade policy circles, and their number has not decreased -as can be seen from Figure 5. 1. - in spite of the improvements introduced by the new AD Regulation<sup>96</sup>.

As the third TPR of the EU (WTO, 1995b) noted, the EU legislation regarding AD measures covers issues not regulated under the WTO Agreement. While EU rules are broadly in line with the WTO Agreement, significant differences remain in the areas of absorption of duties, Community interest, *de minimis* import levels, lesser duty rule and non-automaticity in the attribution of anti-dumping relief. The first issue not regulated under the WTO agreement but addressed by the EU legislation is that of actions against absorption of duties. The Community was criticised for rules, which allow the authorities to impose anti-absorption duties where exporters have absorbed all or part of an anti-dumping duty<sup>97</sup>. Another criticism can arise from its *de minimis* clause defining “negligible imports” to be excluded from an initiation. According to the EU rules, countries representing a market share of less than 1 per cent of Community consumption of a product are excluded, unless the collective share of such countries amounts to 3 per cent or more as compared with WTO limits of 3 and 7 per cent share of total imports respectively.

Besides criticising the AD rules of the EU in terms of their inferiority compared to WTO rules, the Community should also be evaluated with respect to the “lesser duty” rule, “non-automaticity” in the attribution of anti-dumping relief and “Community interest”. The Community is alone among major trading partners in having introduced the “lesser duty” rule, under which the level of the measure applied is the minimum necessary to remove the injury. However, under the WTO rules, countries continue to impose anti-dumping duties corresponding to the entire amount of the dumping margin even if a smaller amount is sufficient to remove the threat of injury to a domestic industry. Additionally, in the EU existence of injury does not give automatic

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<sup>96</sup> These improvements are fairer price comparisons to determine the dumping margin, stricter injury requirements, anti-circumvention measures and a broader role for “Community interest test” taking into account all interests including those of users and consumers.

<sup>97</sup> EU producers may complain that an AD measure has brought no or insufficient changes in resale or subsequent selling prices in the EU and ask for an examination of the price effect. The Council may, by simple majority, amend the measure in force, if the examination confirms increased dumping (WTO, 1995b).

entitlement to anti-dumping relief. Anti-dumping measures are only taken if they are considered to be in the Community interest in contrast to WTO and US anti-dumping rules. (OECD, 2000, p. 44)

Another issue in which the EU is claimed to be better is the fact that EU's AD provisions contain a "Community interest" clause. According to this clause, which was subsequently strengthened by the new Regulation, the overall interests of the Community including those of users and consumers are taken into account in deciding whether or not to apply anti-dumping measures. However, there is no compulsory uniformity when applying a "public interest" test as set out in the WTO Agreement. In spite of the existence of a "Community interest" clause, some authors<sup>98</sup> pointed out that in a majority of the cases the Commission seems to have equated the producers' interest with that of the Community. OECD (2000, p. 45) noted that growing criticism that EU AD procedures are rigid and one-sided led to an upgrading process to be initiated in early 1997. This new approach is based on a consultation of all the interested parties including importers, retailers, and users in order to prevent the AD investigations to rely primarily on information from the European producers, which initiated complaints.

### **5. 1. 2. 2. Technical Barriers to Trade (Standards)**

Technical barriers to trade<sup>99</sup> have recently risen in relative importance in international trade together with the liberalisation of border measures and, therefore, demand greater attention and action than in the past. The removal of technical barriers to intra-EU trade, which is one of the three main elements<sup>100</sup> of the completion of the Single European Market, has led to trade diversion to a great extent at the expense of the non-EU countries while leading to trade creation in favour of EU members. Bearing in mind the focus of the thesis, it could be noted that completion of the single market, as

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<sup>98</sup> See Messerlin (1991), Vermulst (1987) or Tharakan (1999c).

<sup>99</sup> Technical barriers to trade can take the form of technical regulations imposed by national governments, mainly for health, safety and environmental protection for the consumers. Such barriers require either the application of technical specifications or standards to products, or the testing and certification of products or suppliers. Technical barriers impose additional costs on importers that are not faced by domestic suppliers. The magnitude of these costs may vary and can make imported products not competitive or unacceptable in the target market.

<sup>100</sup> The other elements are the removal of fiscal barriers and the removal of physical barriers.

an important deeper integration project, has brought about important trade diversion effects particularly with respect to technical barriers since recently they have been frequently resorted to by the EU and its members on the grounds of the protection of health and environment against the third countries.

The new approach of the EU to the removal of the technical barriers to trade (introduced with the internal market)<sup>101</sup> rests on the principle of mutual recognition: This approach requires harmonisation of minimum essential requirements, but over and above this, mutual recognition of national standards is applied. This means that once a non-EU product has been accepted in one member country, it can be sold throughout all of the member countries. (Woolcock, 1993, p. 546) The different national standards create problems for less-developed countries concerning their exports. Those countries often do not know what standard to choose. Besides EU-wide checks and investigations, on-the-spot bureaucratic harassment by customs officials can be increased. When the standards are harmonised, a high minimum level will be chosen and less-developed countries will find it difficult to meet these standards.

The new WTO agreement on Technical Barriers to Trade, which was concluded in the Uruguay Round, was followed by a continuing rise in the number of notifications of compulsory standards and by an expanded coverage of conformity assessment procedures since it provided that members have the right to determine protection for human, animal and plant health and the environment at levels they consider appropriate by way of technical regulations and standards. Therefore, the agreement has a persuasive effect on the usage of standards and technical regulations as “covert” protectionist measures. Accordingly, ecological standards and standards on health grounds are increasingly being resorted to as a new protectionist device by industrialised countries and regional blocs against suppliers from developing countries and have quite great potential for causing trade wars between industrialised countries and blocs.

The last TPR of the EU (WTO, 2002) states that during the period since the previous Review in mid 2000, the EU and its members have put in place new regulations for certain

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<sup>101</sup> Environmental and health policy measures covered by a general exemption under Article 36 of the Rome Treaty provided a means of introducing national regulations which distorted competition. Therefore, the EC first sought to harmonise national regulations and when this proved too slow shifted to the “new approach”.

products -notably in relation to the safety of products and the disposal of waste- requiring economic operators, including those outside the EU, to adapt. Although international standards may be used as the basis for regulations to facilitate trade, the Commission stated “standards cannot replace governmental responsibility to maintain a high level of protection regarding health, safety and the environment”. Certain trading partners of the EU perceive these new product regulations as significant trade barriers, and are concerned with preserving the feasibility of the international standard-setting process. The burden of conformity assessment procedures is reduced for certain non-EU countries through Mutual Recognition Agreements (MRAs)<sup>102</sup>. New MRAs were recently concluded with Japan and Switzerland, and already in force with Australia, Canada, Israel, New Zealand, and the US.

### **5. 1. 3. Common Agricultural Policy of the EU**

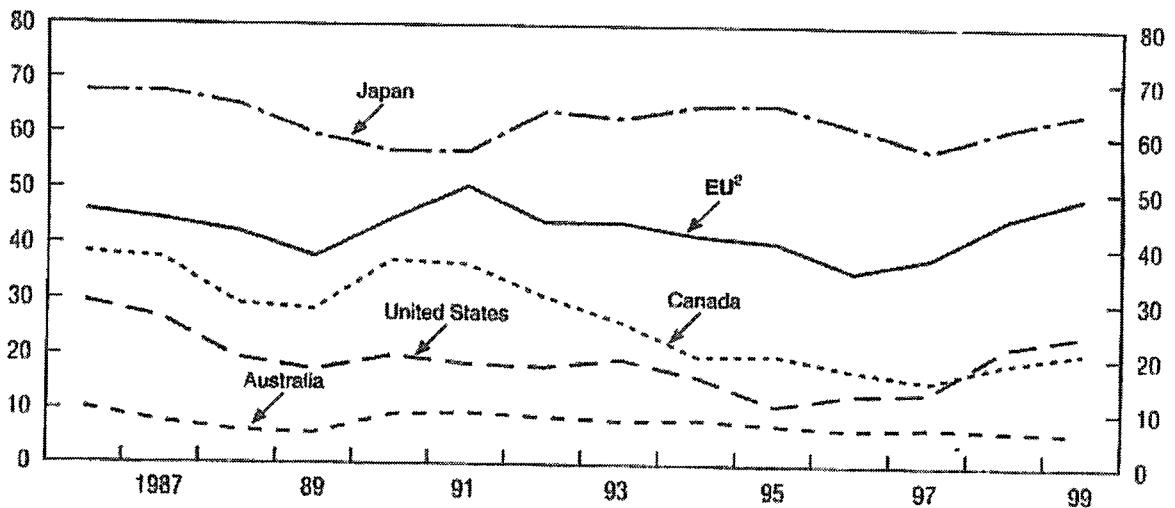
Any analysis of the EU’s trade policy effects on non-members cannot ignore agriculture, which has traditionally been the most protected sector in the EU although the EU is a major player in the world market. Among the large agricultural producers, the EU has been the second most protectionist after Japan. High levels of protection, as measured by Producer Support Estimates, persisted in Japan and the EU while they declined considerably in the US since the mid-1980s and later on in Canada; and protection was always low in Australia (Figure 5. 2.).

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<sup>102</sup> MRAs are agreements on the mutual recognition of conformity assessment procedures for regulated products.

**Figure 5. 2. Protection of the agricultural sector**

Producer support estimates (PSE), per cent<sup>1)</sup>



1. The percentage PSE is the annual monetary value of gross transfers from consumers and taxpayers to agricultural producers (measured at farm gate level) as a per cent of the value of total gross farm receipts, measured by the value of total production (at farm gate prices), plus budgetary support.
2. EU12 for 1986-94 and WU15 from 1995 onwards. EU includes ex-GDR from 1990.

Source : OECD (2000)

The Rome Treaty included trade in agricultural goods in the common market, which was to be created, and provided for the establishment of a common agricultural policy among the member countries. Since the creation of the CAP, this sensitive sector has been governed by this separate<sup>103</sup> and the first genuinely EU-wide economic policy.<sup>104</sup> The CAP is a paradigmatic example of “trade diversion” and is the origin of much of the rest of the world’s fears about the protectionism of the EU. In spite of its economic and budgetary costs for the EU and unacceptability to the EU’s trading partners, negotiation to modify

<sup>103</sup> Agricultural goods, as different from non-agricultural goods, are not under the sphere of Common Commercial Policy.

<sup>104</sup> Although the Rome Treaty envisaged the creation of the CAP, did not specify the mechanics for this policy. As the policy developed, an important element in it became the establishment of minimum prices for agricultural products, to be maintained by government purchases and by variable levies on imports. These levies equal to the difference between the world price and the politically established internal price. As countries exporting agricultural products feared, implementation of this policy compromised access of third countries’ agricultural products to the EC market and led to EC surpluses that that competed in third markets.

this policy was long made difficult by the EU's unwillingness during the GATT trade liberalisation talks. Indeed, it was the major obstacle to the completion of the UR.

However, increasing internal<sup>105</sup> and external pressures, the Internal Market, new accessions and the prospects of further enlargement to the East, and commitments arising from the UR Agreement on Agriculture have forced a number of significant changes. The 1992 reform of the CAP led to a significant fall in the level of price support for the linchpin of the CAP -grain- by about one-third and brought smaller reductions for dairy and beef. In order to compensate for decreasing market price support, direct income compensation payments and set-aside measures were introduced. It has been observed that whenever world market prices were strong, the reform led to a steep decline in support to producers. But, whenever adverse market conditions existed, support to producers has risen again. (OECD 2000, p. 45) Therefore, the 1992 reform did actually not lead to a greater access for grain imports. The UR Agreement on Agriculture has brought a number of changes to the EU trade policy in this area. First of all, all border measures, including variable import levies, had to be converted to tariffs (tariffication) while any further use of non-tariff barriers has been prohibited. Secondly, since the end of the implementation period on 1 July 2000, all tariffs have been bound after they were cut by an unweighted average of 36 per cent between 1 July 1995 and 1 July 2001 with a minimum reduction per tariff line of 15 per cent. Thirdly, the Agreement provided that by the end of the implementation period, export subsidies per product line were reduced by 36 per cent and subsidised volumes by 21 per cent<sup>106</sup>. Finally, total trade distorting domestic support, aggregated across all goods, had to be reduced by 20 per cent in the six years following the Agreement.

Despite these major achievements of the Agreement, immediate effect on agricultural trade is likely to be limited particularly because periods of historically high levels of support and protection were chosen as the base periods from which reductions in barriers to market access, in domestic support and in export subsidies were negotiated. High base levels

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<sup>105</sup> Particularly aggravated budgetary burdens.

<sup>106</sup> The EU is the largest user of export subsidies and during 1997-1999, it accounted for 90 per cent of the export subsidies notified to the WTO among the OECD countries that have export subsidy commitments, as compared to 1 per cent for the US. It subsidises a wide range of agricultural goods and processed products. Therefore, the trade liberalisation effects of this new discipline envisaged by the UR Agreement on Agriculture are likely to be of more consequence. While overall export subsidies for all goods decreased substantially, important export subsidies remain in these sectors like sugar, dairy products and beef that have been less affected by the CAP reform.



translate into actual cuts, which are smaller than would be the case if more “representative” base levels had been used. (OECD, 2000, p. 46 and Pelkmans and Carzaniga 1996, p. 91, 92)

Reduction of trade distorting domestic supports, tariffication of variable import levies and binding and reduction of tariffs have not provided an effective liberalisation and significant improvement in market access although these developments have contributed to greater transparency. Stronger efforts are needed for further liberalisation in this very sensitive sector. Accordingly, the agricultural liberalisation agenda is moving forward both in the world and in the EU. WTO members initiated multilateral trade negotiations for continuing the agricultural trade reform process in early 2000 (one year before the end of the implementation period) as a follow-up to the UR. These talks aiming at further liberalisation have now been incorporated into the broader negotiating agenda set at the November 2001 Ministerial Conference in Doha, Qatar. They became part of the single undertaking in which virtually all the linked negotiations are to end by 1 January 2005.

On the side of the EU, a big challenge will come from eastward enlargement, which will lead to an expansion of the agricultural area by half and a doubling of the agricultural labour force. To address these issues as well as concerns about the preservation of the European model of agriculture, a new process of CAP reforms was launched as part of Agenda 2000, which was agreed in March 1999. The Agenda 2000 reforms deepen and extend the 1992 CAP reforms by a further shift from traditional price-support measures to area and headage payments. Besides internal pressures that have intensified by the concerns regarding the fifth enlargement, external pressures to adapt CAP to new requirements stem from in the context of the DDR negotiations on agriculture. In view of these escalating pressures, it is inevitable that the EU will have a more liberal and a more acceptable agricultural policy for the rest of the world.

#### **5. 1. 4. Preferential Trade Regime of the EU: Trade Agreements with the Third Countries**

In the post-war period, the EC has been central to the proliferation of PTAs. While it has indirectly led to formation of some other PTAs in the world, it has contributed directly to the spreading of preferentialism through its PTAs with third countries since its inception.

The EU grants preferential access to most of its trading partners for some or all imports. In 2002, only nine WTO members are subject to exclusively MFN treatment by the EU in all product categories. In other words, the EU has not concluded any preferential trade agreements with just nine WTO members: Australia, Canada, Chinese Taipei (Taiwan), Hong Kong, China, Japan, Republic of Korea, New Zealand, Singapore, and the US. These countries accounted for 45.2 per cent of EU's total merchandise imports in 2001. (WTO, 2002)

As categorised by Sapir (1998, p. 718-720) and Messerlin (1999, p. 47), the EU's complex three-layer system of preferential trade relations with third countries has led to a hierarchy among those relations and, therefore, the infamous "pyramid of preferences" has emerged. The first layer represents reciprocal and contractual preferential agreements: In this respect, accession treaties leading to enlargement of the EU signify the most developed trade agreements and therefore are at the highest level in the hierarchy. The second most developed trade relationship corresponding to the European Economic Area (EEA) is with Iceland, Liechtenstein and Norway<sup>107</sup>. It represents a kind of single market model since it involves four freedoms<sup>108</sup> with the exception of application of common trade policy.

Then the EU has CUs with Turkey<sup>109</sup>, Cyprus, Malta, Andorra and San Marino. According to the level of integration, Europe Agreements with CEECs come after the EU's few CU agreements since the formers are FTAs lacking common customs tariff<sup>110</sup> like FTA with

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<sup>107</sup> The move towards completion of the internal market till the end of 1992 coincided with new efforts to intensify the existing co-operation based on free trade agreements between the EC and EFTA countries (Sweden, Switzerland, Norway, Finland, Austria, Iceland, Liechtenstein) and led to the establishment of the EEA. The EEA comprising the EU and all EFTA states except Switzerland came into force on 1 January 1994. Just one year later Sweden, Finland and Austria became full members of the EU.

<sup>108</sup> Free movement of goods, services, labour and capital.

<sup>109</sup> CU with Turkey covers industrial and processed agricultural products and excludes agricultural products. Steel and coal products are in free circulation, whereas concessions have been exchanged by both parties in trade in agricultural products. Further negotiations started in 2000 to liberalise trade in services and public procurement.

<sup>110</sup> The fall of the Berlin Wall has triggered major downgrading and upgrading shifts in the pyramid of EC preferences. In particular, the ten "Europe Agreements" signed by the EC and each of the CEECs have downgraded the close competitors of the CEECs, mostly the Mediterranean countries or Group of ACP countries. The EU has been linked to all ten CEECs by Europe Agreements since 1999. As a result, industrial products are now in free circulation between the signatories and the EU since the beginning of 2001. Restrictions remain in only a few sectors, such as agriculture. In addition, those agreements provide for legislative approximation with EU legislation particularly in the areas relevant to the internal market.

Switzerland<sup>111</sup>. Close to this level of integration, Euro-Mediterranean Partnership with southern Mediterranean neighbours<sup>112</sup>, which aims at the creation of a Euro-Mediterranean free trade area by 2010 through the Euro-Mediterranean Association agreements<sup>113</sup>, was established at the Barcelona Conference in November 1995. Free trade agreements are also being used as an instrument to integrate the Western Balkans<sup>114</sup>. Recently concluded free trade agreement with Mexico<sup>115</sup>, association agreement with Chile<sup>116</sup>, and currently negotiated Interregional Association Agreement with Mercosur represent non-regional preferential agreements of the EU. The second layer comprises non-reciprocal preferences granted contractually to African, Caribbean and Pacific Group (ACP) countries under the Lome Conventions<sup>117</sup>. As to the third layer, non-reciprocal and non-contractual (autonomous) preferences are granted to the other less-developed countries under the GSP mechanism<sup>118</sup>.

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<sup>111</sup> The EU expanded its free trade agreement with Switzerland through the conclusion of seven bilateral agreements, which entered into force in 2002, on land-based transport, air transport, free movement of people, agriculture, research, procurement and technical barriers to trade.

<sup>112</sup> The Mashreq countries (Egypt, Jordan, Lebanon and Syria), the Maghreb countries (Algeria, Morocco and Tunisia), Israel and the Palestinian Authority. Cyprus and Malta, which are going to be full member of the EU in May 2004, and Turkey, which already has a CU with the EC and is a candidate for full membership, were also adopted the Barcelona Declaration establishing the Euro-Mediterranean Partnership and envisaging the creation of Euro-Med free trade area.

<sup>113</sup> These bilateral association agreements foreseeing the establishment of a free trade area between each country and the EU have replaced the non-reciprocal Co-operation Agreements that were in force between the EU and its Mediterranean partners dating from the 1970s.

<sup>114</sup> Stabilisation and Association agreements were concluded with the Former Yugoslav Republic of Macedonia (FYROM) and Croatia. These agreements aim at creating a free trade area on goods over a transitional period of ten years for FYROM and six years for Croatia. The three other Western Balkan countries (Bosnia-Herzegovina, Albania and Federal Republic of Yugoslavia) remain under the regime of Autonomous Trade Measures (ATMs), which were introduced by the EU in September 2000 to be applied until 31 December 2005 in order to strengthen the political stabilisation and economic development of the region. These countries will be eligible for such Agreements as soon as they meet the relevant political and economic criteria. In other words, ATMs are the forerunner to the conclusion of Stabilisation and Association Agreements. (WTO, 2002)

<sup>115</sup> The FTA covers trade in goods to be fully completed for the most part by 2003 with limited longer transitional periods for Mexican industrial products until 2007 and for agricultural products until 2010.

<sup>116</sup> It envisages a free trade area in goods, services and government procurement.

<sup>117</sup> The Last (fourth) Lome Convention expired in February 2000. Instead the fifth one, a Partnership Agreement between ACP countries and the EU was signed in June 2000 and its trade provisions took effect from 1 August 2000. It provides for the negotiation of new WTO-compatible trading arrangements, which progressively remove barriers to trade (duty-free treatment for all industrial and a large part of agricultural and processed agricultural products on a non-reciprocal basis) and enhance co-operation in all trade-related areas. These arrangements will be concluded and put into effect by the end of 2007. In the mean time, and in order to facilitate the transition, the non-reciprocal trade preferences applied under the Fourth Lome Convention have been maintained. (WTO, 2002)

<sup>118</sup> The present regulation governing the EU scheme for GSP entered into force in January 2002 and covers the period until the end of 2004. It is based on the guidelines the EU adopted for the period 1995 to 2004. The EU GSP now covers virtually all sectors and fully incorporates the new "Everything-but-arms" (EBA) initiative, which was adopted in March 2001 and grants duty free access to all products from least-developed countries. The GSP-plus treatment is available to least-developed countries under the EBA, as well as to

Considering the above “pyramid of preferences”, the imminent further enlargement of the EU<sup>119</sup> and the multiplicity of regional and other preferential trade arrangements raise certain important questions: Are the possible adverse effects -trade diversion effects- of such arrangements and accessions on third parties’ welfare interests sufficiently taken into consideration? Are the WTO rules in question adequate to deal with these adverse affects of the proliferation of preferential trade arrangements? Are they supporting or hindering the move towards multilateral liberalisation? As for the second question, the answer of the thesis in general terms is already given in the previous chapter which is “no”. The EU-centred preferential trade arrangements constitute no exception. In respect of the last question, it is more appropriate to take up it in the following section since it is directly related to the issue of EU’s implications on multilateral trade negotiations. Therefore, the first question is the main focus of the following analysis.

For historical and political reasons of a very different nature, preferentialism was extended to all kinds of trading partners in different levels. This proliferation of PTAs has led to the comment that the EU has built a “pyramid of preferences” which reflects the multiple levels of preferences or has surrounded itself with “concentric circles of discrimination”. What has irritated the GATT partners in different degrees is the very emergence and persistence of this pyramid of preferences itself. A hierarchy of friends, lesser friends and foes is surely not in keeping with the spirit of Article 24. Countries near the base of the “pyramid of privilege” are continually worried that they might lose out to the EU’s more preferred suppliers. It is inevitable that any change in the preferential status accorded one country (for example through enlargement of the Community) alters the position of everyone else in the hierarchy. For the preferred, the privileged access depends on *ex gratia*<sup>120</sup> favours, which can easily be reversed. Given the hierarchical nature of the EU preferentialism –that is unequal preferential treatment of the EU towards its preferential partners-, it is evident that each country or country grouping in the hierarchy is actually non-member, in some respects, of the other PTAs at the higher level. (Matthews 1991, pp. 132, 133)

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countries that combat drug production and trafficking, and to encourage adherence to core labour standards or to environmental standards. (WTO, 2002)

<sup>119</sup> Of ten CEECs countries each having “Europe Agreement” with the EC and each being a candidate for full membership, eight have concluded accession negotiations and are qualified to become full member of the EU on 1 May 2004. Accession negotiations with Bulgaria and Romania are currently under way.

<sup>120</sup> Given as a gift or favour rather than because of any legal requirement.

The EU's PTAs are generally with countries or country groups having high tariffs like Mediterranean countries. Therefore, the trade diversion is high as a result of such PTAs with high tariff countries. Furthermore, in such countries, the reliance on customs tariffs for government revenue is high. The higher the share of tariffs in total government revenues, the more difficult it may be to mobilise the alternative resources needed to allow a reduction in MFN tariffs. This means that EU's PTAs with high tariff countries bear an important risk for the multilateral trade liberalisation efforts, too. In the light of these facts, one may come to a conclusion that most of the PTAs concluded by the EU lead to considerable detrimental effects on the welfare of both the non-members -through trade diversion effect- and members -through trade diversion effect and government revenue losses-, and to the future of the multilateral trade liberalisation in general.

Many argued that MFN reduction or elimination of trade barriers should have reduced the detriments arising from trade diversion. Discrimination in terms of tariffs may have been eroded by the UR negotiations, but meanwhile trade policy has expanded its scope of instruments (with AD measures, rules of origin, technical barriers to trade, etc.). These new instruments can easily offset what has been achieved in terms of tariff reductions.

### *The Accession Treaties Leading to the Enlargement*

Any countries accessed to the EU actually accessed to the EU's customs union. So, there is not much difference between the welfare effects of EU enlargements and those of its PTAs with the potential members on non-members provided that average tariffs of the acceding countries, which previously had an FTA with the EU, do not increase as a result of the adoption of the Common Customs Tariff (CCT). In other words, existing situation regarding non-members' welfare does not change considerably with the enlargement of the EU since the EU already has a preferential relation generally at the level of FTA with the potential members having generally higher tariffs during the pre-accession period. For example, the previous enlargement realised in 1995 towards North to include Sweden, Finland and Austria have not had much adverse welfare effects on the rest of the world. Important amount of trade diversion had already come about through former free trade



agreements with the EFTA countries<sup>121</sup>, and average tariffs of these countries did not increase with the adoption of the CCT when the enlargement realised. Therefore, any additional trade diversion resulting from the EFTA membership did not occur.

The fact that existing situation regarding non-members' welfare does not change considerably with the enlargement of the EU is particularly true for the countries like Cyprus, Malta and Turkey with which the EU has a CU since the CCT of the EU has already adopted by these countries. But unfortunately, the EU has a CU with just these three candidate countries. With respect to the eastward enlargement, the Europe Agreements, as a part of pre-accession strategy, established bilateral FTAs for non-agricultural products by 2002 with all 10 CEECs. Therefore, considerable amount of trade diversion in industrial goods is already taking place before the realisation of enlargement in May this year for eight of these countries. Additionally, since the CEECs are still considerably more protectionist than the EU in industrial products, their accession to the EU, which necessitates the adoption of the much more liberal CCT, is not likely to lead to any additional trade diversion in those products. Messerlin (1996) found that the highest tariffs in these countries are often 20 percentage points higher than the corresponding EU tariffs.

However, since the existing Europe Agreements do not include agricultural goods -that is they do not provide for liberalisation in agricultural protection between the EU and the CEECs-, substantial amount of trade diversion in these products -when the enlargement is realised- is being expected. Additionally, agricultural protection is considerably higher in the EU than in the CEECs. In 1999, whereas average value of market support was 49 per cent of the value of production for the EU as a whole, this contrasts with much lower levels of protection of 25 per cent in the Czech Republic and Poland and 20 per cent in Hungary (OECD, 2000, p. 90). This fact increases the scope for trade diversion after the enlargement. However, Rollo (1994, p. 56) pointed out that any losses of non-members arising from trade diversion effects will need to be set against a fall in the external tariff as a result of the EU membership.

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<sup>121</sup> When Denmark and the UK, which are the former members of the EFTA, became a member of the EC in 1973, the Community concluded FTAs with the other EFTA countries individually in order not to disrupt existing free trade between the newcomers and other EFTA countries. While the EC tended to run a balance of payments surplus in its trade with EFTA, the existing trade deficits of the EFTA countries with the EC increased due to trade diversion from third countries in favour of the EC. (Harrop, 1990, p. 172)



*In conclusion*, it is evident that the enlargement of the Community and the expansion of the EU's preferential network of FTAs are bound to give main concern to the countries outside the EU preferential agreements in relation to "trade diversion".<sup>122</sup> The risk of trade diversion is real in the context of preferential trade agreements of the EU as in the case of any PTAs elsewhere. Given the fact that EU is highly responsible for the recent proliferation of regionalism in the world trading system, it could be argued that its contribution to the harm given by PTAs to third countries' welfare is considerable. As argued in the previous chapter, the relevant GATT rules on free trade agreements and CUs (Article 24) is not adequate to ensure that third country interests are respected and that these arrangements are compatible with a rules-based and progressively more open world trading system. In order to make its own PTAs respectful to third country interests and, therefore, to legitimise them in rule-based GATT terms, and in order to not to suffer, as a non-member, from trade distortions resulting from PTAs elsewhere<sup>123</sup>, the EU should push for reform of the direct and indirect rules of the WTO. Accordingly, the fourth TPR (WTO, 1997) notes that the EU has shown the willingness to reassess in depth both the pattern of its FTA relationships and their relationships with the WTO Agreements, and with MFN partners.

## **5. 2. DYNAMIC TIME-PATH EFFECTS OF THE EU ON THE MULTILATERAL TRADE LIBERALISATION**

In the following analysis, implications of the EU on multilateral trading system are examined in a dynamic time-path sense. Accordingly, the analysis is focused on whether or not the EU contributes to the multilateral freeing of trade either by progressively adding new members in its integration or by prompting accelerated multilateral trade liberalisation efforts. In other words, whether the EU is *building block* toward the multilateral freeing of trade, or *stumbling block* to the goal of worldwide freeing of trade is scrutinised in the

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<sup>122</sup> Christoforou (1997, p. 767) stated that negotiations in the framework of the sixth paragraph of Article 24, which regulates the compensation of trading partners for changes in access conditions, have been figuring prominently on the EC's trade policy agenda on a continuous basis for decades. This is due to the successive enlargements of the EC, the large number of PTAs concluded by it and, of course, the inadequacy of the Article 24 itself to prevent harm to the third countries. Compensatory adjustment negotiations have always put the EC on the defensive vis-à-vis its principal trading partners and frequently spoiled the trade relations of its constituent member states.

<sup>123</sup> Similarly, European Commission (1996) points to trade diversion in the context of NAFTA. Yeats (1997) came to a similar conclusion for the Mercosur.

framework of, firstly, “enlargement of its membership” and, secondly, “its possible effects on the multilateral trade negotiations under the auspices of GATT/WTO” in accordance with analytical questions I and II respectively.

### **5. 2. 1. Can the EU Lead to Global Free Trade Through its Continued Expansion?**

In view of the fifth enlargement of the EU and its possible future enlargements, one may wonder whether the EU stops expanding its membership after its fifth enlargement; or there will be expanding membership, with this even turning eventually into worldwide membership as in the WTO, hence reaching non-discriminatory free trade for all. In other words, it could be asked that whether the expansion of the EU can continue until a global free trade is achieved.

It is possible that trade liberalising effects of the EU would expand to an increasing number of countries and at some point it would give up its regional character by covering, eventually, the entire world as long as the EU membership continues to be found highly attractive by the non-members. However, under the present debate concerning the ultimate borders of the EU, different circles in the EU are seriously questioning where the EU will end and which countries should be given the prospect of eventual membership, and which should not. Romano Prodi, President of the European Commission, launched this debate after the proclamation of Turkish candidacy for the EU membership in the 1999 Helsinki European Council Summit by pointing out that the ultimate borders of the EU should be circumscribed after the Turkish membership. Even the Turkish membership is seriously debated and there is important resistance inside the EU. It seems unlikely in this conjuncture for countries in South Asia and Africa to be accepted to the EU as full members.

The EU has faced the “widening versus deepening” choice at three times in its history. At each point in time, it chose to deepen first and broaden later: Completing the CAP before accepting the UK, Ireland and Denmark in the early 1970s, completing the Single Market before adding Sweden, Finland and Austria to EU membership in the early 1990s, and forming Economic and Monetary Union before expanding to CEECs in the early 21<sup>st</sup> century. This is because expansion of EU membership inherently complicates and retards

the process of deepening of its integration. Therefore, whenever the EU was at the stage of deepening, it rejected or delayed applications for membership made by non-members. For example, Turkey, as a timing mistake, applied for full membership to the EC in 1987 when the EC was at the stage of completing its internal market. The EC rejected Turkish application on this ground. It is quite doubtful whether the EU as an ever-deepening regional integration scheme does not resist strongly to further enlargements towards countries, which do not pose important political considerations for the EU.

Additionally, full membership in the EU is anything but open access. The UK had to ask three times before it was allowed to join and Turkey has been struggling to be a member of the EU for more than 40 years. It has taken the EU about 50 years to expand from 6 members to 25. Negotiations are tortuous once accession is agreed in principle. Each of the ten CEECs faced a formidable list of demands and requirements prior to membership. In several cases they were required to adopt policies like the Social Charter from which some existing members -like the UK- negotiated exemptions. Evidently, this hard membership is related to the depth of European integration. Since the more complex aspects of PTAs have to be negotiated, access cannot be expected to become fast and easy. In accordance with its deep integration scheme, the EU determined, for candidate countries, membership (Copenhagen) criteria which are very comprehensive in economic, political and legal terms and difficult to comply with in the short run.

Regarding its enlargement through “full membership”, it can be concluded that the EU is unlikely to serve as a building block of, rather than stumbling block to, GATT-wide free trade in dynamic time-path sense. However, the EU also has been realising some degree of integration with non-members and, therefore, expanding its trade liberalising effects to an increasing number of countries through its PTAs. Considering the fact that it has not concluded any PTAs with just nine WTO members, one may argue that it is “going global” to a degree with negotiated PTAs with Mercosur and others in Latin America, with South Africa and with its Asia-Europe Meetings (ASEM) that attempt to counter APEC in the Pacific. In other words, it may be claimed that the EU has chosen the “expanded membership” option as a partial method for opening itself and serving as building block of, rather than stumbling block to, multilateral free trade. The analysis regarding whether the EU serves as building block or stumbling block to global free trade in the respect of

analytical question of dynamic time-path analysis is a matter of definition: “full membership” or “expanded membership”. For this thesis, it is unambiguously “full membership” since the EU stands ready to conclude PTAs only on its own terms covering issues such as rules of origin, excluded sectors like agriculture, the use of anti-dumping duties and technical barriers to trade, and so on.

### **5. 2. 2. Does the EU Serve as a Building Block or a Stumbling Block for the Multilateral Trade Liberalisation?**

Considering its weight and leverage in international trade as the most developed “preferential trade arrangement”, it is evident that the impacts of the EU’s trade policies on multilateral trade liberalisation under the auspices of the GATT/WTO have always been substantial. Following analysis questions whether the EU serves as a building block or a stumbling block for multilateral trading system with reference to the third chapter. However, in view of its uniqueness compared to the other PTA elsewhere in the world, to reach a definite judgement regarding whether the EU serves as a building block or a stumbling block for multilateral trading system is very difficult if not impossible. In some respects the EU has had negative effects undermining multilateral trade liberalisation while in some others it has had favourable effects supporting this process. Which case is the dominant one depends on the approach adopted.

#### **5. 2. 2. 1. Favourable Effects of the EU on the Multilateral Trade Liberalisation**

*Firstly*, some claimed that it has been easier for the members of the EU to make trade concessions along with other partners in such a customs union than unilaterally. In other words, regional arrangements might be more willing to agree to liberalisation than individual countries. Of the eight Rounds, the four have led to far-reaching trade liberalisation with the participation of the EC since its inception. Hufbauer (1990, p. 5) stated that without the prior formation of the EC, the Kennedy Round would not have taken place. He argues that France and Italy would have strongly resisted making any concessions in the 1960s, and Germany would not have made trade concessions in isolation from its continental partners. By making France and Italy part of the Community

the EC played a key role in their participation in the tariff reductions in those years (while it probably constrained Benelux countries and Germany from being more liberal).

However, there is a strong counter view to this argument: The EU is not genuinely unified in their approach to trade negotiations although it is the most developed integration model. As long as its number of members has increased, trade policymaking process has become more complex and slower in view of different interests and perceptions of its members. As a result, its capability regarding reaching and maintaining a common approach in trade policy has decreased. Although the EU members, along with the EU *per se*, are also members of the WTO, the Community negotiates as a single entity through the European Commission, which is the chief negotiator. The European Commission participates in the multilateral negotiations with a negotiating position that has already been shaped by intra-EU negotiation and it might be reluctant to make concessions that will upset the intra-EC compromise, which has been painfully reached after a very clumsy and slow negotiating process. Thus, the Commission tends to be inflexible in the multilateral trade negotiations. This problem was particularly clear in the UR negotiations on agriculture and textiles, where the inflexibility of the Commission's position was surely linked to the difficulty of achieving and maintaining internal cohesion on the desired direction of reform. (Smith, 1994, p. 28) This inflexibility led to the postponement of the conclusion of the Uruguay Round. It is obvious that due to scant flexibility that has decreased with the increase in the number of the members, the Community has led to difficulties for liberalisation initiatives in the GATT regarding its policies like the CAP, the MFA and the others, which undercut multilateral objectives or violate GATT principles.

*Secondly*, as a favourable effect of the EU on the multilateral trade liberalisation, it might be argued that the EU has helped prompt and consolidate economic and political reforms in potential members. The candidate countries have locked in their trade reforms and induce trade and investment flows from large countries through imminent membership to the EU. The EU has led to locking-in of the reforms in transition economies in a manner that would be difficult to reverse this liberalisation by future governments and provided credibility and permanence of liberalisation measures. It is seen in this respect as an important complement to an outward-oriented policy. Therefore, the EU might be perceived from this



perspective as a symptom of the success of the open multilateral system and is compatible with further multilateral liberalisation.

*A third argument* in favour of its constructive effects on multilateral trade liberalisation is that the EU and its PTAs with the third countries accustomed officials, governments and nations to the liberalisation process and increase the probability that they will subsequently take similar actions at the multilateral level (“learning by doing”). As the most integrated PTA, the EU permits its members and participant countries of its PTAs to liberalise beyond the extent that can take place multilaterally. Particularly “its pyramid of preferences” has eventually induced many developing countries to liberalise more than, *ceteris paribus*, one might have expected. When negotiations on further multilateral liberalisation are blocked in the WTO, countries may use intra-EU liberalisation or the PTAs with the EU to go further and provide a demonstration of the benefits, which may in turn induce other countries to soften their resistance to multilateral liberalisation.

Additionally, the experience and expertise gained via the intra-EC liberalisation process have been used in wider multilateral negotiations. For example, as stated by the OECD (1995a) and Cable (1994, p. 13), the negotiations in the EU regarding the liberalisation of public procurement gave the interest groups and decision makers valuable experience of the issues and possible solutions, which then found expression in the UR Agreement on liberalising public procurement. Therefore, the EU has a positive effect on multilateral process by helping to equip the interested parties with the models and skills needed to reach agreements.

*Fourthly*, it can also be argued that the EU is a useful laboratory for new approaches to deeper integration which can be applied multilaterally in relation, for example, to technical standards, services, public procurement, state subsidies, competition policy, dispute settlement and enforcement. For example, the European (EEC) method of reducing customs duties served as an example for the Kennedy Round. Again, provisions of several agreements (the Agreement on Technical Standards, the Agreement on Subsidies, the Agreement on Government Procurement, and the GATS) concluded as part of the UR reflect the influence of the EU experience in regional integration. The EU was also influential in the drafting of the TRIPs Agreement (Demaret, 1997, p. 835). Additionally,



mutual recognition approach by the EU as an alternative to the complex and slow process of harmonisation has stimulated new thinking on how to deal with technical barriers to trade on a multilateral level more effectively.

However, Demaret (1997, p. 833) and Woolcock (1993, p. 557) pointed out that the European experiences in trade liberalisation as laboratories are not relevant for multilateral application since the loss of sovereignty (supranationality) involved in the EU approach makes it an unlikely model for future multilateral agreements. This does not mean that multilateralism cannot learn much from experience in European integration as this is the case until now, but the European *acquis* is not about to be adopted at a multilateral level.

*Fifthly*, another favourable effect of the EU that has been observed by many is that high levels of interdependence in the EU have contributed to a broad acceptance and awareness of the need for international agreements by industries, trade unions, environmentalists and national regulatory agencies and, therefore, have indirectly strengthened multilateralism. Competition policy was given as just one example by the OECD (1995, p. 62) in this respect: When markets were Europe-wide, European industry came to accept that there was a need for an international (European) policy to regulate market structure after many years of opposing anything more than national merger control. Regulatory authorities were also obliged to accept that national approaches were inadequate when the market was European or international. Therefore, the EU has highlighted awareness that trade liberalisation has immediate implications for national policies and national sovereignty.

#### **5. 2. 2. 2. Adverse Effects of the EU on the Multilateral Trade Liberalisation**

*Firstly*, it should be stated that some of the WTO members frequently voiced their concern about whether the EU's impressive network of PTAs with non-members and its enlargements as well as its deepening process were distracting the Community's concentration from its multilateral objectives. In other words, the most convincing concerns about the EU's unfavourable effects on the multilateral trade negotiations is that the concentration of its scarce political capital and energy on promoting PTAs with the third countries, on enlarging its membership and on its deepening process will divert its attention from multilateral liberalisation. It is the most likely bloc to withdraw support for

multilateralism in view of its widening and deepening that are its primary consideration. As Hufbauer (1994, p. 119) stated, the SEA and Europe 1992 substantially drained EU energies from GATT talks. The unification of Germany and the strategic errors in packaging Maastricht Treaty led to more of the same distraction. The UR negotiations could have been concluded on more satisfactory terms if the demands that the widening and deepening of the EU puts on Brussels would not have been so distracting. However, after the UR and particularly on the eve of the new multilateral trade round, the leading forces in the EU have tended to work more in support of multilateralism as taken up in the following section.

*A second issue* to be considered is whether the massive amount of EU's preferential relations with non-members contributes to undermining the GATT system with its emphasis on non-discrimination. Whether the EU's system of PTAs could be more widely emulated should be considered seriously since it might lead to the further disintegration of the multilateral trade liberalisation. On the part of pro-multilateralists, there is a serious concern regarding the considerable potential for the contribution of the EU's system of PTAs to a tendency for trade blocs to be formed around major developed countries or country groups instead of a predominantly MFN relationship among all of the WTO members without discrimination.

*Thirdly*, from the perspective of the political economy analysis, the EU -as a considerably trade diverting union- undermines multilateral trade liberalisation since it is preferred to multilateral liberalisation by beneficiary producers of trade diversion effect. Even as a trade creating union, it is still unsupportive for further multilateral liberalisation as contrary to some claims. Beneficiary producers of both trade diversion effect and trade creation effect do not want to lose their newly-obtained markets in favour of third country producers through multilateral trade liberalisation. Hence, they form influential protectionist lobbies both in the regional and in the multilateral level as effective obstacles against multilateral liberalisation. In this respect, the EU can easily lead to retrogression rather than being a step towards further multilateral free trade. Further multilateral liberalisation may be preferred to the intra-EU liberalisation by the producer interest groups having considerable influence on the EU trade policy making, only if the increased

access to outside markets, which would come with further multilateral liberalisation, generates sufficient rents to offset the elimination of preferences.

Furthermore, in spite of the “substantially all trade” requirement of Article 24, the EU has tended to exclude from its PTAs precisely trade-sensitive industries like agriculture that would be most threatened by welfare enhancing trade creation. The possibility of such industry exclusions increases the probability of EU’s preference in favour of the conclusion of PTAs with the third countries and, therefore, of undermining multilateral liberalisation.

### **5. 3. THE EU AS AN “EMERGING LEADER” IN SUPPORT OF MULTILATERALISM**

The adverse effects of regionalism in the form of FTAs and CUs on the world trading system seem unlikely to be contained in the short-term particularly taking into account the fact that a radical reform regarding redesigning disciplines so as to avoid harmful welfare effects of PTAs on non-members as proposed in the fourth chapter has been not included in the DDA. However, considering the importance and the weight of the EU in the multilateral trading system, its attitude towards multilateralism and its effects on the system certainly will considerably affect the tendency towards regionalism and, therefore, the future of the multilateral trade liberalisation.

The EU as one of the key players in the multilateral trading system should take initiative to reform the relevant GATT/WTO disciplines so as to prevent the adverse welfare effects of PTAs on non-members. In spite of its multitude of PTAs with non-member countries and its protectionist practices, its recently rising trade liberalising outlook and its interests as a non-member of the other PTAs elsewhere in the world would help the EU to take this initiative. The new round of multilateral trade negotiations could have been an opportunity to reform the relevant disciplines, which failed to contain the formation and proliferation of PTAs and, therefore, to prevent them from harming non-members. But, this opportunity has been missed since the DDA includes redefining of Article 24 so as to make its wording more precise in the light of interpretation concerns, rather than its redesigning so as to efficiently prevent harmful effects of PTAs on non-members’ welfare. The EU should lead

to incorporate a more radical reform of Article 24 and other relevant GATT/WTO disciplines into the agenda of the future reform and liberalisation efforts.

More urgently, the last (Cancun) Ministerial Conference of the WTO in September 2003 failed to proceed the DDR of multilateral trade negotiations. This failure poses an immediate necessity for the EU to assume leadership in the absence of effective American leadership. In the following it is proposed that considering its increased absolute economic size through several enlargements and its relative economic size vis-à-vis all partners individually and, even vis-à-vis groups of them, the EU has the capacity to provide effective exercise of the WTO leadership particularly after the completion of the Single Market and the switch to a more liberal trade policy. In view of the leadership vacuum arising from American retreat, the EU is emerging as the sole alternative to the strong need of leadership for the successful conclusion of the MTNs.

### **5. 3. 1. Why Should the EU Lead the MTNs Towards a Successful Conclusion?**

#### **5. 3. 1. 1. Endogenous Factors: Importance of the MTNs for the EU**

The EU is a major beneficiary of the 40 years of the GATT-based world trade system and, thus, of the liberalisation of world trade. As the world's largest exporter of goods<sup>124</sup> and services<sup>125</sup>, it stands to gain substantially from a further opening of foreign markets. Exports to markets outside the EU account for 9 per cent of EU GDP and 10 per cent of EU employment, which means around 11 million jobs. (Cunningham *et al.*, 2000, p. 9) As long as exports increase, the number of jobs will grow. Given the fact that the unemployment rate in the EU has reached its highest level so far, increase in exports is essential for the future stability of the European economy regarding the macro-economic indicators. The trading system embodied in the WTO is a key factor in the EU's economic growth and well-being. The self-interest of the EU in having open multilateral trade is illustrated by the central position that the EU has in the network of world trade: Table 5. 1. illustrates that the EU is the only region in the world economy of the eight regions, which has trade relations of some importance with all the other regions.

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<sup>124</sup> See Annex V.

<sup>125</sup> Exports of services outside the EU reached 26 per cent of the world total in 1996. In the same year, it was 20 and 5 per cent respectively for the US and Japan. (European Commission, 1998)

**Table 5. 1. Network of World Trade, 1995 (percentage distribution)**

Region of destination									
Region of origin	WE	JPN	NA	CEE	AFR	ASIA	LA	RoW	World
WE	31	1	3	2	1	3	1	2	45
JPN	2	-	3	•	•	4	•	•	9
NA	3	1	6	•	•	3	2	•	16
CEE	2	•	•	1	•	•	•	•	3
AFR	2	•	•	•	•	•	•	•	2
ASIA	3	3	4	•	•	7	•	1	18
LA	1	•	2	•	•	•	1	•	4
RoW	1	1	•	•	•	1	•	•	3
World	43	6	18	3	2	19	5	4	100
Total World Exports: US\$ 4890 billion									

Notes: • indicates trade flow is less than 0.5 per cent of world exports.

WE = Western Europe; JPN = Japan; NA = North America; CEE = Central and Eastern Europe; AFR = Africa; ASIA = Asia; LA = Latin America; RoW = the Rest of the World.

*Source: Calculations by the authors of "Memedovic et al. (1999)" from WTO (1996b).*

Further trade liberalisation will also increase imports of foreign goods. This is a benefit, which is often underestimated by politicians. Imports serve domestic consumers by enhancing individual choice. Preserving external competition has extreme importance for encouraging economic adjustment and restructuring as well as constraining monopoly power at the regional level. The acknowledgement of this fact by the Europeans has

provided the development of the EU's internal market. Imports of raw materials are also important for many European producers, which rely on products from outside the EU for the efficient production of their goods.

It is obvious that multilateral trade negotiations under the umbrella of the GATT have also played an important role in accelerating some forms of economic reform within the EU and other major trading areas. The need to meet the WTO commitments has often encouraged governments to tackle established domestic interests. The 1992 MacSharry reforms of the CAP<sup>126</sup> provide an example of the benefits brought by multilateral trade negotiations<sup>127</sup>. As a helping way to push difficult internal reforms, the value of the new Round may be even greater for the EU than it was in the early 1990s. In 1990 the EC funded the CAP by almost 26.5 billion euro while the EU's 2000 budget allocates over 40.5 billion euro to the CAP. This represents an increase in nominal terms of over 52 per cent. (Cunningham *et al.*, 2000, p. 10)

Moreover, the eastward enlargement of the EU will have much more severe effect on the agricultural budget than the earlier accessions of Spain and Portugal since economies of the CEECs are more rural than even the poorest of the current members. With the awareness of these problems the EU acknowledges that it will be impossible to maintain CAP funding at present levels. In accordance with this awareness, the Agenda 2000 document that includes the aim of reform of the CAP was prepared by the Commission in 1997. However, translating Agenda 2000 objectives into meaningful and actual reform measures remains an intimidating political challenge that may not be achieved without the external pressure of the new Round. The new Round will also help the EU to achieve economic reforms in other areas, for example industrial subsidies and technical barriers to trade on the grounds of health and safety.

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<sup>126</sup> Devised by the Commissioner, Ray MacSharry.

<sup>127</sup> The CAP is maintained at great expense to EC consumers and at a devastating cost to the EC's budget. In spite of these costs, the EC failed to introduce necessary reforms until 1992 due to opposition by established agricultural interests in certain major member states like France. As the UR approached its conclusion in 1990 there were massive demonstrations by European farmers opposed to even minimal reform of agricultural support programmes. Opposition from farmers delayed the completion of the Round. However, at the end the pressure of multilateral negotiations allowed the European Commission to assume a considerable package of new agricultural measures. (Cunningham *et al.*, 2000, pp. 9, 10)



### **5. 3. 1. 2. Exogenous Factors: Necessity Arising from the Leadership Vacuum in the International Trading System**

There is a serious concern that the trust of the countries in the GATT/WTO multilateral trading system will be critically damaged and the tendency towards regionalism will be strengthened in the case of the unsuccessful conclusion of the DDR. Given the impetus to form FTAs also in America (Free Trade Area of the Americas) and Asia<sup>128</sup>, the trading world could fragment into a tri-bloc configuration. Annex 7 illustrates the extent to which this 'triad' of regional trading blocs dominate trade in the world economy. In 2002, intra-regional trade accounted for more than 48 per cent of the world's merchandise exports. Intra-EU trade alone represents 28.5 per cent of all such trade. By comparison, inter-bloc trade is quite modest. It is interesting to note that in the UR of trade talks, negotiations were dominated by the EU-US relationship which accounts for only less than 4 per cent of world merchandise exports. It is unfortunate that the tendency towards tri-bloc configuration regarding concentration of world trade has increased recently: In 1991, intra-regional trade accounted for 38 per cent of the world's merchandise exports and imports (Michalak and Gibb, 1997, p. 266).

Recent theoretical research about the optimal number of trading blocs<sup>129</sup> shows that tri-bloc configuration could result in a globally welfare-minimising situation and that the momentum for the trading blocs to pursue multilateral liberalisation could disappear. Even in a more optimistic scenario, it is conceivable that the consolidation of the inclination to regionalism leads to the reduction of the number of independent middle-sized and small countries, which have strongest interest in maintaining an open world trading system, and this could sow the seeds for more protectionist policies. An open and strong multilateral trading system with adequate rules to contain adverse welfare effects of the regionalism on the non-members is the best guarantee against the threat of proliferation of regionalism, which is considered in this thesis as harmful both in static (trade diversionary) and dynamic time path senses (stumbling blocs).

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<sup>128</sup> The multitude of subregional trade agreements is now being busily negotiated by Japan, South Korea, Singapore and other countries in East Asia. So, East Asian countries are getting together to make their own trade arrangements. (The Economist, 2000a, p. 19)

<sup>129</sup> By Krugman (1991a, 1991b, 1993)

The danger of regionalism -rather than multilateralism- dominating the world trading system at the expense of the latter has become more evident in the absence of a strong and credible multilateral trading system. A strong and effective multilateral trading system is critical to cope with the increased worldwide leaning towards regionalism, which is, in spite of its second-best nature, perceived as a more “functional” way of trade liberalisation compared to the recently weak multilateral regime. In order to decrease the need to fill the void being created by an increasingly dysfunctional multilateral framework, successful conclusion of the Doha Round is indispensable. In the case of the failure of this Round to provide a more liberal and institutionally stronger (and therefore more credible multilateral trading system), the alternative will most probably be a fragmented world via discriminatory trade blocs, with greater conflict and uncertainty in the international trade relations; and the multilateral trading system might get even more jeopardised.

The success of the Doha Round is in danger since the last (Cancun) Ministerial Conference of the WTO in September 2003 -whose objective was to review progress on the Doha Round- failed to proceed the negotiations due to the “lack of agreement” between developed and developing countries on the issue of market access. Ministers were unable to reach agreement on an agreed text which would serve as a framework for guiding the negotiations to a conclusion by the mandated deadline of 1 January 2005. It is evident that the maintenance of the ongoing disagreement and the hindrance for the conclusion of the Round will consolidate the trend towards regionalism and bilateralism unless the WTO members seek to take the trade talks forward and conclude the Doha Round successfully. Hence, the Doha Round is a very important turning point for the future viability of multilateralism; and the recent setback, which it is suffering, cannot be allowed to let the trading system lapse into regionalism that most probably will ultimately be destructive to the multilateral trade liberalisation. In that point, the “hegemonic stability theory” gives us some important clues to ensure the successful conclusion of the DDR in particular and a more liberal and stronger multilateral trading system in general.

The international trading system does not have an overarching authority -an international government- that lays the ground rules for the system to function effectively. Sovereign states recognise no higher authority. If states are assumed to be rational actors, then they will act in their own perceived interest. This can form what is known as a collective action

problem, where efforts in the long-term co-operation are undermined by the incentives to cheat on any agreement. In the absence of co-operation, the most likely trading system is one that is closed and protectionist. One way in such a system that a relatively stable and liberal order can exist is when there exists a single power, or a leader, or a hegemon, which both establishes and maintains an open trading regime.

Hegemonic Stability Theory<sup>130</sup> states that an international system characterised by a hegemon would result in an open trading system since the hegemon would be both able and willing to create and to maintain an open trading system, and to facilitate international co-operation to reap the benefits of exchange. The reverse also follows that without such a hegemon there can only be disorder and protectionism, which would be detrimental to states. The recent crisis in the multilateral trade negotiations for providing and maintaining co-operation poses an emergency for one of the key players to take the control and ensure co-operation in the absence of an influential (American) leadership. Otherwise, an agreement concluding the negotiations successfully cannot be produced.

Therefore, the future of the system heavily depends on how the key players in the WTO decide to respond to the last breakdown in the DDR negotiations. It should be stressed that the leadership of one of the key players is indispensable for the success of the negotiations and, thus, the world trading system considering the concern that the most likely alternative to the Doha Round is a fragmented world through discriminatory trading blocs. There is a vacuum in the international trading system in terms of a leading powerful actor supporting multilateralism in such a situation that the multilateral trading system is experiencing a quite vulnerable period. The multilateral trading system needs either a “revival” of American support or a “new” leader backing multilateral trade liberalisation through multilateral trade negotiations.

The concerns with respect to the vacuum in multilateral trading system arise from the change in the US trade policy: The commitment of the US as the key defender and the leader of the multilateral trade liberalisation in the post-World War II era has considerably weakened in favour of regionalism (preferential bilateralism) and, even worse than that, unilateralism. This shift has been apparent for fifteen years starting from the “father” Bush

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<sup>130</sup> For detailed analysis, please see Krasner (1997), Walter (1996), Lake (1993), Krasner and Webb (1989), Snidal (1985), Keohane (1984), Stein (1984), McKeown (1983).

administration. During the UR negotiations, it became clear that the US was no longer prepared to play its traditional role of GATT custodian. All features of US's liberal trade policy until the early 1980's -that is the view of trade as an opportunity for all traders, the focus on unilateral trade liberalisation, and the restraint of the use of market power- have increasingly been challenged by views concentrating on unfair trade issues, the prerequisite of reciprocity, regionalism and aggressive unilateral trade actions.

Recently, under the "junior" Bush administration, the same trend is still dominant even by gaining strength at the expense of "multilateralism" in all aspects<sup>131</sup>. The US retreat from the WTO custodian is best evidenced during the preparation stage of the Doha Round of multilateral trade negotiations: The US sought a more limited round, focused primarily on market access measures, compared to the EU that advocated a comprehensive negotiation that would address a broad liberalising agenda<sup>132</sup>. At the beginning, there was no great pressure for a new round of trade talks from major sectors of the US economy except agriculture. In other words, the initial American reaction to a new round was cool. It was the pressure from the EU that ultimately convinced the US that a full round would be desirable. (Cunningham *et al.*, 2000, pp. 12, 13) More evidently, the US determined after the Cancun failure that it would go in for bilateral agreements if multilateralism failed to

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<sup>131</sup> Unilateralism under the Bush administration:

Within the first six months of Bush administration, the US decided to:

1. Abrogate Kyoto Treaty on global warming, offer no replacement.
2. Break off talks with North Korea on nuclear proliferation
3. Sharply cut back American spending on Russian denuclearization
4. Break ABM treaty with Russia
5. Withdrew support for International Criminal Court
6. Withdrew support for a treaty on biological weapons

Subsequently:

7. Openly labeled Iraq, Iran, and North Korea "axis of evil", while Europe was trying to establish better trade and diplomatic relationships with them.
8. Withdrew support for international agreement on women's health because it might involve birth control
9. Single-handedly blocked an agreement to provide medicines for the world's poorest nations.
10. Violated trade agreements by giving tax breaks to U.S. exporters
11. Signaled his lack of support for multilateral free trade by imposing 30 per cent tariffs on steel imported to U.S.—undermining the World Trade Organization

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- Liberalisation of trade in services
- A framework of rules aimed at securing a stable and predictable climate for investment worldwide
- Harmonisation of competition laws around core disciplines
- Transparency and liberalisation in government procurement
- Trade facilitation by simplifying customs and border procedures
- Further industrial tariff reductions and the elimination of both peak tariffs and almost all tariffs on imports from the least-developed countries
- Limited but significant liberalisation in agriculture
- Review of the WTO Anti-dumping Agreement

work. Thus, the revival of the American leadership in support of multilateralism does not seem probable in the short run.

The process of withdrawing from leadership in the world trading system necessitates looking for alternatives to give the WTO the support it needs, and the EU seems the most appropriate alternative in this respect. Indeed, the leadership vacuum poses an urgent necessity for the EU to assume leadership in view of the failure of the Cancun Ministerial Conference to proceed the multilateral trade negotiations. In other words, considering the American retreat from the position of “the key defender and the leading pro-GATT player of multilateralism” in favour of regionalism and -even worse than this- unilateralism, the EU is emerging as the sole alternative to the strong need of leadership for the successful conclusion of the MTNs in spite of its simultaneous pursuing of preferential trade policy and therefore the lack of full concentration on multilateralism.

Taking into consideration its increased absolute economic size through several enlargements and its relative economic size vis-à-vis all partners individually and even vis-à-vis groups of them, the EU has the capacity to provide effective exercise of the WTO leadership particularly after the completion of the Single Market and the switch to a more liberal trade policy. Additionally, its awareness regarding the importance of multilateral trade liberalisation for its trade interests (particularly to increase market access for its imports) has recently risen and, accordingly, its support towards multilateral trade liberalisation efforts has increased as evidenced in the preparations for the Doha Development Round. However, assuming and exercising an effective WTO leadership necessitates a stronger will, and the Doha Round of multilateral trade negotiations, particularly after the breakdown of the Cancun Ministerial Conference, is a very good opportunity for the EU to show this will.

### **5. 3. 2. Problems for the EU Leadership of the WTO**

Although the EU is considered as the most feasible candidate for the WTO leadership, there are important issues, which constitute serious obstacle for assuming this role and should be eliminated immediately by the EU itself. Firstly, there is no doubt that the EU is experiencing a historically significant phase of its development -with improved governance



and reshaped institutions on its current agenda- and enlargement just ahead. The Doha Round of multilateral trade negotiations has competed with the attention and the concentration of the EU on its internal reform and enlargement processes. It has coincided with reinforcement process of the institutional structure through forming a “constitution” along with the most wide-embracing enlargement process so far. In this respect, it might be unavoidable sometimes that the EU, in favour of the reform and enlargement process, neglects multilateral trade negotiations.

Additionally, the mandate of the EU chief negotiator, European Commission, is restricted by diverging interests among member countries, which are the members of the WTO. An efficient mechanism for reaching and maintaining internal cohesion is still largely lacking. Consensus building among EU members is time consuming, and EU proposals frequently represent a careful balancing of country-specific benefits and costs rather than true support of a multilateral trading system. Considering the slow and clumsy feature of the intra-EC decision-making process, painfully negotiated compromises leave the Commission with scant flexibility for initiative and leadership in the WTO. This has always been the case for the CAP and the issues revolving around the safeguard clauses.

Another obstacle before its leadership for multilateral liberalisation is its protectionist trade practices. While EU trade policies towards European neighbours were liberalised significantly, high barriers against non-European exports are basically unchanged even in the case of the ACP countries and some other least-developed countries to which the EU granted non-reciprocal trade preferences<sup>133</sup>. Discrimination and selectivity remain typical features of the EU trade policy with regard to non-European competitors. First, this is because of the traditionally large differences in protection levels across sectors. Exporters of agricultural products, textiles and clothing, steel, as well as automobiles have been hit particularly hard. Second, the preferred protectionist instruments such as contingent protection measures like anti-dumping procedures and standards clearly reflect the EU’s bias towards bilateralism, selectivity and discretion.

Most importantly, as Messerlin (1999) pointed out, the EU is addicted to discrimination in view of the multitude of its PTAs with the third countries and its enlarging structure.

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<sup>133</sup> See Pennartz (1997, pp. 27-30).



Recently, the discriminatory stance of the EU trade policy has gained further momentum. The evidences of this are,

- firstly, its most comprehensive enlargement process so far;
- secondly, new PTAs, which are initiated especially on non-regional base with some remote areas like Mexico, Chile, Mercosur and South Africa, and
- thirdly, widening of the scope of -that is deepening of- the existing PTAs particularly regional ones (like the PTAs with the Mediterranean countries).

If the EU recognise that it would be in the EU's own interest to change its addiction to discrimination, then it will be possible to eliminate its anti-MFN bias. The economic benefits of such a change will be considerable since it is in the EU's own interests to get the WTO ball rolling.

### **5. 3. 3. The Recent Attitude of the EU Towards Multilateralism: A Feasible Alternative to the Leadership of the WTO?**

EU trade relations pose a big dilemma: They have contributed towards both freer world trade and increased protectionism. On the one hand, EU trade policies have contributed to more liberalisation in world trade since the EU has played a key role in reducing tariffs worldwide. On the other, the EU has pursued a discriminatory trade policy through the system of preferences under the inadequate GATT rules, and it frequently resorted to the use of protectionist tools such as VERs, MFA quotas and anti-dumping procedures along with the CAP -the most explicit form of EU protectionism- under the pressure of lobbies. The apparent paradox of increased liberalisation and more protectionism of European trade may reflect conflicting forces of trade policy formulation at work. Trade liberalisation via multilateral trade rounds under the auspices of the GATT, particularly in terms of tariffs, has always assumed high priority whereas a degree of ambivalence has been reserved for non-discrimination regarding trade policies of the EU.

This inconsistency seems to have diminished with the UR and with the completion of the Single Market. Through these factors, the EU has recently pursued a more liberal trade policy<sup>134</sup> and become a more supportive and active partner in multilateral trade

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<sup>134</sup> As an empirical evidence of this finding, please see Annex VI: extra-imports share in total EU imports has recently increased.

liberalisation. The UR has led to the elimination of VERs and quantitative restrictions on imports, phasing-out of MFA quotas, a more liberal agricultural policy and more strengthened disciplines in the other areas like contingent protection measures. According to Pelkmans (cited in Kol, 1999, p. 83) the Single Market Programme has developed into a substantial programme of deregulation and liberalisation towards competition and supply from outside the EU. Nunnenkamp (1993, p. 187) argued that initial concerns that, in the course of deepening through SEA, the EU would turn into more and more inward looking (Fortress Europe) have been overly pessimistic (except for agriculture) since there is little evidence of any recent major intensification of protective measures on the part of the EU. It would seem that the pro-market, the pro-structural adjustment view of the European economy that was at the basis of the Single Market programme has also favourably affected EU attitudes during the UR<sup>135</sup>. Experience with and confidence in the Single Market programme enabled the EU to initiate and exercise leadership in several fields like services in spite of problems regarding agriculture. (Pelkmans and Carzaniga, 1996, p. 95)

The EU has acknowledged the fact that its exports can increase due to the market access commitments and new disciplines imposed on its trading partners by further multilateral trade negotiations. Accordingly, in the mid 1990s, the EU added flanking policies to the existing trade policy. The market access strategy provides for mechanisms and instruments to act more forcefully against trade barriers elsewhere. In this respect, the EU resorts to the multilateral trade liberalisation as the most promising mechanism. It aims at strict compliance by its trading partners with the WTO rules, reductions of barriers to EU exports in the context of accessions of third countries to the WTO, and playing a main role in the Doha Round of multilateral negotiations. Similarly, in view of the trade diversion risk of FTAs elsewhere in the world, the EU itself is pushing for the reform of WTO procedures with a view to increasing the legal certainty for its own PTAs and with a view not to suffering from trade distortions from PTAs being struck elsewhere.

OECD (2000, p. 100-103) stated that the EU has reiterated its commitment to further multilateral liberalisation under the auspices of the WTO on several occasions. Indeed, it

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<sup>135</sup> Internal liberalisation gave the EC greater negotiation leverage and expertise in areas such as services, public procurement and technical standards. Similarly, the EC had to find an internal consensus in favour of a reform of the CAP before the deadlock multilateral negotiations on could not be broken. Additionally, the readiness of the EC to contribute to a settlement of remaining disputes in the UR has increased with European integration proceeding.

played a major role in the recently negotiated multilateral agreements on information technology, basic telecommunications and financial services liberalisation. Particularly the agreement on information technology products represents a significant market access improvement for foreign suppliers since the EU is the second largest importer of those products in the world. Although the EU has strongly supported the sectoral negotiations on the above-mentioned sectors, it is not in favour of a sectoral liberalisation approach but prefers a global approach, which should make it easier for all participants in trade negotiations to share in the mutual benefits from comprehensive and broad liberalisation.

After the failure to launch a new round of trade liberalisation in Seattle in late 1999, the EU pushed for the rapid preparation of another multilateral trade round and reiterated that it is still aiming for a broad agenda in the new round. The EU also supported an early start to negotiations in the WTO on multilateral basis for international investment and competition policy, which have become increasingly important in underpinning effective market access in increasingly integrated world. Moreover, the EU supported the fact that the WTO should update and improve its rules in response to challenges and developing countries would need to be better integrated into the system and have freer market access. For example, the EU participated in the confidence building package extending duty free access for essentially all the least-developed country imports in the hope of tempting developing countries to join a new round.

It is obvious that priority in the EU's near future trade agenda is two-fold: On the one hand, it is going to actively pursue multilateral liberalisation under the umbrella of the WTO considering its reiterated commitment to multilateralism and its considerable recent efforts in this regard. On the other, it is going to simultaneously follow its well-established regional policies in view of its widening policy through accession agreements and wide-ranging PTA network with the third countries. The medium-term trade agenda of the EU shows that there is currently little risk that it will start looking inwards or pursue aggressive unilateralism. The EU seems aware that its basic and long-term trade interest is not only to pursue but also strongly to support sustained multilateral liberalisation. In view of this awareness by the EU and its determined initiatives regarding strengthening of multilateralism, the EU can be considered as a feasible alternative to the withdrawing leader and might be proposed as an "emerging leader" in support of multilateralism.

In the last (sixth) TPR of the EU (WTO, 2002)<sup>136</sup>, the Chairperson concluded that members of the WTO acknowledged the leadership role of the EU in the WTO notably in securing agreement on the DDR, thus demonstrating its support for an open, rules-based multilateral trading system. Therefore, the continued commitment of the EU will be critical to the success of the DDR. Accordingly, the EU in its report stated that it will continue to work to reinforce the WTO, to enlarge and improve its system and to promote a more active participation of all its members. The EU sees as its immediate task to carry out multilateral negotiations in a way that reflects the objectives of the DDA and the EU's own goals.

After the failure of the Seattle Ministerial Conference in December 1999, the intensive efforts to launch an ambitious round of multilateral trade negotiations -with the acknowledgement that only a broad agenda could both reconcile different members' views and take into account of all members' essential interests- should also be mentioned here as an important sign of "emerging leadership" character of the EU. Supported by the EU's extensive consensus building efforts with other WTO members, in particular developing and least-developed countries, its modified approach to the new round<sup>137</sup> was certainly one element in securing support for the launch of a new round of trade negotiations at the fourth Ministerial Conference at Doha in November 2001. The far-reaching conclusions of the Doha Conference and resulting a broad DDA reflect very well the EU's overall objectives for the multilateral trade round<sup>138</sup> and its acknowledgement of a broad agenda for the round. This means that the EU acted as an emerging leader in support of multilateralism in general and for its interests in particular until the recent collapse of multilateral trade negotiations in Cancun conference. Now, it is more crucial than ever before for the future of multilateralism that the EU must continue to act as WTO-custodian and revive the trade talks on the basis of the DDA. Its increased absolute economic size through several enlargements and its relative economic size vis-à-vis all partners

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<sup>136</sup> The review is based on two reports that are prepared respectively by the WTO Secretariat and the government under review (in this case the EU) and which cover all aspects of the country's trade policies. A record of the discussion and the Chairperson's summing-up together with these two reports were published at the complete TPR of the EU.

<sup>137</sup> Drawing from the lessons of the Seattle Conference, which failed to launch a new round, the EU adapted its approach to the new round, in particular by recognising that the WTO needed to work in a more inclusive and transparent way vis-à-vis all members, and improve communication with the outside world. On the substance of the lessons drawn from Seattle, the EU took into consideration other members' opinions and continued bridge building efforts with trading partners in order to overcome differences. (WTO, 2002)

<sup>138</sup> A fourfold agenda to further liberalise market access, to update and improve WTO rules, to promote a development agenda and to address issues of public concern.

individually and, even vis-à-vis groups of them give the EU special responsibilities to assume leadership in the WTO to secure strengthening of the multilateral trading system.



## CONCLUSION

The most prominent and controversial feature of the international trading system is the co-existence of multilateralism and regionalism that are, by their nature, in contention with each other. While the GATT/WTO-based multilateral trading system depends on the principle of non-discrimination, regional trading arrangements are, by definition, discriminatory and, therefore, contradictory to the multilateral system since trade concessions are granted only to members. These inherently discriminatory agreements were inserted into the international trading system by the GATT itself. As a regulatory agency of multilateral trading system the GATT permits those arrangements under certain conditions through its own device -Article 24-. However, Article 24 has not been able to be successful in ensuring adequate mechanism with a view to containing this contradictory and potentially harmful process.

The existing GATT structure has very few safety valves build into the trading system, and even those that existed failed clearly to prevent efficiently PTAs from harming non-members' interests. As a result, the GATT/WTO system fell short of containing the formation and proliferation of potentially harmful regional trading agreements. Depending on these findings, the major issues of discussion in the thesis have been the contradictory existence of discriminatory regionalism along with multilateralism, inadequacy of the latter in controlling the former and, therefore, the question of regionalism as a long-standing issue in international trading system as to whether it undermines or underpins multilateralism.

In the light of the underlying reasons and the features of the current wave of regionalism, the thesis has come to the conclusion that current wave of regionalism that has been continuing since the second half of the 1980s will endure this time unlike the previous wave of regionalism that took place from the late 1950s through the 1970s since it shows many signs of strength and few points of vulnerability. Regionalism is a quite influential phenomenon of the international trading system, which should not be ignored with its far-reaching implications for multilateral trading system. Taking into consideration its political charm and spread, and acknowledging its conflicting nature with multilateralism, it is important to contain and arrange PTAs so that they become useful instead of harmful for



multilateral trading system and consistent with the objectives of arriving at multilateral free trade for all.

Effects of regionalism on the multilateral trading system have been analysed in the thesis by distinguishing between its static effects on non-members' welfare and its dynamic time-path effects toward worldwide non-discriminatory trade liberalisation. The thesis has had a strong awareness concerning the importance of the adverse effects of regionalism on multilateralism in dynamic time-path sense. Accordingly, it has examined those effects in terms of firstly whether regionalism will lead to a non-discriminatory multilateral free trade for all through continued expansion of the regional blocs until a universal free trade is reached, or it will fragment the world economy, and secondly whether the formation or enlargements of PTAs hinder or advance further multilateral trade liberalisation. However, the undesirable static effects of regionalism (trade diversion effects) on "non-members" have been focused on in the thesis with a view to finding an ideal -while feasible- solution, which is inclusive not only for members' welfare interests but also for the multilateral trading system in general.

As different from the orthodox approach as presented by Viner, this thesis has evaluated static effects of PTAs in terms of non-members' welfare instead of world welfare as a whole. This approach renders the size of any trade creation irrelevant and any trade diversion detrimental and, thus, undesirable regardless of whether the trade creation outweighs the trade diversion. Accordingly, the objective of the thesis has been to structure PTAs so as to avoid harming welfare interests of "non-members" in particular and the multilateral trading system in general. The way, which has been proposed in this thesis to reach this objective, is "redesigning international laws" -in this case the relevant GATT/WTO disciplines- with a view to containing trade diversion effect. The address for the proposal has been firstly Article 24 since its existing design -"no raising of barriers to trade" requirement as directly related to the welfare interests of non-members- is inadequate to this task.

With the purpose of eliminating the inadequacy of Article 24 in terms of avoiding trade diversion effect on non-members, the necessity of "not lowering prior trade volumes with the non-members" should be the basis of the way to redesign Article 24. Accordingly, the

proposal of the thesis to redesign Article 24 has been built in “Kemp-Vanek theorem”, which says that it is always possible for a PTA to be structured in such a way as to create gains for the member countries without harming any non-members by keeping trade volumes with the rest of the world at their pre-integration levels. In order to assure the same level of trade volumes with non-members as the pre-union levels, a “considerable” reduction in tariff barriers might be essential. Article 24 must be redesigned so as to incorporate the requirement of reducing the external tariffs -simultaneously with the progressive elimination of internal tariffs- to the extent that it secures the same level of external trade volumes as the pre-integration level. This would be the surest way among others to avoid harmful welfare effects to the rest of the world.

Even developing countries, by meeting this requirement, can form a CU that does not harm non-members’ welfare, while ensuring that they can maintain the degree of industrialisation that they had achieved through protective tariffs. The proposed solution involves a Kemp-Wan customs union complemented by *production tax-cum-subsidies* - instead of protective external tariffs- to achieve the non-economic objectives of member states as indicated by the theory of optimal intervention in the presence of non-economic objectives.

However, redesigning of just Article 24 may not be sufficient in order to avoid harming the rest of the world. The GATT disciplines governing unfair capture of fair trade measures like intensively-used AD actions and fast-raising standards relating to health and environment should also be improved. In accordance with this necessity, the solution proposed in this thesis includes redesigning not only Article 24, but also the other relevant GATT disciplines in a precise manner so as to avoid trade diversion and, therefore, detriment to non-members’ welfare.

In respect of the dynamic time-path effects of regionalism on multilateralism, the thesis has concluded that regionalism is more likely to be stumbling blocks toward a worldwide non-discriminatory trade liberalisation. By proposing reform of the relevant GATT rules in accordance with the direct purpose of containing the detrimental welfare effects of regionalism on the rest of the world, this thesis has indirectly aimed at a benign regionalism (building blocks) in terms of its dynamic time-path effects too. In other words,

this proposal, which focused on the interests of non-members, serves inclusively not only to members' interests in static welfare sense but also to the multilateral trading system in dynamic time-path sense.

In November 2001, the Fourth Ministerial Conference of the WTO in Doha (Qatar) launched a new multilateral trade round two years after the failure of the Seattle Ministerial Conference. The declaration of the Fourth Ministerial Conference sets 1 January 2005 as the latest date for concluding the Doha (Development) Round of multilateral trade negotiations, which particularly targets the "development" concerns of the less developed members. The Doha Development Agenda with both market access and rule-making objectives represents a further effort to provide a more liberal and stronger multilateral trading system<sup>139</sup>. However, its reform agenda is unsatisfactory to contain the harmful effects of regionalism on multilateralism.

Redesigning of the WTO obligations regarding PTAs with the object of protecting welfare interests of non-members as proposed by the thesis should have been a priority agenda item for the new round of multilateral trade negotiations. Since a determined global effort is needed to discipline the growing regionalism and ensure its beneficial impacts, the new GATT round could have been a good opportunity in this respect. But unfortunately, regarding PTAs the Doha Development Agenda addresses the need of clarifying the WTO obligations to avoid ambiguity and applying them more strictly rather than aiming at the elimination of inadequacy of the concerned obligations so as to avoid harmful welfare effects of PTAs to non-members. Redefining Article 24 with the purpose of making it more precise has been considered insufficient by the thesis to eliminate the damaging welfare effects of PTAs on non-members. Therefore, the recent opportunity to sufficiently reform Article 24 seems about to be missed since it is unlikely to do something at this stage to restore the existing agenda of the Doha Round. Considering the importance of redesigning the relevant GATT/WTO disciplines for the future of multilateralism, the key participants of multilateralism had better take initiative in this respect at the next opportunity.

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<sup>139</sup> Doha work programme and negotiating agenda are formed by four main components. These are the development dimension and technical assistance and capacity building issues, market access, rules related issues and dispute settlement.

More urgently than providing a sufficient reform of the related GATT/WTO disciplines, a successful conclusion of the Doha Round has to be assured. The danger of regionalism -rather than multilateralism- dominating the world trading system at the expense of the latter has become more evident in the absence of a strong and credible multilateral trading system. A strong and effective multilateral trading system is crucial to cope with the increased worldwide leaning towards regionalism, which is perceived as a more “functional” way of trade liberalisation in spite of its second-best nature. In order to decrease the need to fill the void being created by an increasingly dysfunctional multilateral framework, successful conclusion of the Doha Round is indispensable. In the case of the failure of this Round to provide a more liberal and institutionally stronger (and therefore more credible multilateral trading system), the alternative will most probably be a fragmented world via discriminatory trade blocs, with greater conflict and uncertainty in the international trade relations; and the multilateral trading system might get even more jeopardised.

The successful conclusion of the Doha Round is particularly in danger since the last (Cancun) Ministerial Conference of the WTO in September 2003, whose objective was to review progress on the Doha Round, failed to proceed the negotiations. Due to the (Cancun) collapse of the multilateral trade negotiations, the WTO members have become disappointed by the multilateral system. Therefore, in the post Cancun period, regional and bilateral trade negotiations have taken on a special importance due to the fact that the difficulty of achieving consensus among so many nations in the WTO process is one major hurdle in trade liberalization. For example, Brazilian President Luiz Inácio Lula da Silva proposed a free trade area for the developing south in the recent meet of the G-20 -the coalition of developing countries- in Brasilia. This represents an indication that multilateralism may not deliver the goods. Similarly, the US had said after Cancun it would go in for bilateral agreements if multilateralism failed to work.<sup>140</sup>

It is evident that the stalled trade negotiations due to the lack of agreement between developed and developing countries on the issue of market access at the Cancun Ministerial Conference will consolidate the trend towards regionalism and bilateralism unless the WTO members seek to take the trade talks forward and conclude the Doha

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<sup>140</sup> Business Standard Economy, December 15, 2003.

Round successfully. At the same time that multilateral trade negotiations have dragged on, regional agreements were reached with more ease and frequency than ever before. In other words, faster liberalisation through regional means was given priority particularly whenever the multilateral trade liberalisation lingered. If the recent situation is not reversed immediately in favour of multilateralism, the WTO members will look more seriously at regional options as in the cases whenever multilateral trading system stumbled.

The revival and the successful outcome of the Doha Round of multilateral negotiations can help the GATT/WTO-based multilateral trading system to re-establish its lost credibility and -hence- to regain its former leverage in international trading system. The weaknesses and resulting dysfunctionality of the multilateral trading system are seriously criticised and seen as the main reason -among the others- behind the recent proliferation of regionalism. The success of the negotiations will strengthen the multilateral trading system and -therefore- heal its recent dysfunctionality to some extent. This improvement in multilateralism could lead to vanishing of the inclination towards regionalism -fragmentation-. The Doha Development Agenda, encompassing both market access and rule making, and driven by a strong development objective, offers a major opportunity to promote global economic growth and sustainable development, and to further reinforce the rules-based multilateral trading system. However, in the case of the maintenance of the ongoing disagreement and the hindrance for the conclusion of the Round, the international trading system might experience developments at the expense of multilateralism. Multilateralism might get even more injured. Hence, the Doha Round is a very important turning point for the future viability of multilateralism; and the recent setback, which it is suffering, cannot be allowed to let the trading system lapse into regionalism that most probably will ultimately be destructive to the multilateral trade liberalisation.

The international trading system does not have an overarching authority -an international government- that lays the ground rules for the system to function effectively. Sovereign states recognise no higher authority. If states are assumed to be rational actors, then they will act in their own perceived interest. This can form what is known as a collective action problem, where efforts in the long-term co-operation are undermined by the incentives to cheat on any agreement. In the absence of co-operation, the most likely trading system is one that is closed and protectionist. One way in such a system that a relatively stable and



liberal order can exist is when there exists a single power, or a leader, or a hegemon, which both establishes and maintains an open trading regime. The recent crisis in the multilateral trade negotiations for providing and maintaining co-operation poses an emergency for one of the key players to take the control and ensure co-operation in the absence of an influential (American) leadership. Otherwise, an agreement concluding the negotiations successfully cannot be produced.

Cancun has opened a path towards more regionalism and bilateralism. Whether this trend consolidates or not depends on the reaction of the major players. In the case of lack of reaction by them to the recent developments at the expense of multilateralism, regionalism could dominate the international trading system. To guarantee the success of the Round and -therefore- of the multilateral trading system, that any of the key actors in the world trading system takes the lead in reversing the trend towards more protectionism and disintegration is especially important.

There is a vacuum in the international trading system in terms of a leading powerful actor supporting multilateralism in such a situation that the multilateral trading system is experiencing a quite vulnerable period. The multilateral trading system needs either the “revival” of American support or a “new” leader backing multilateral trade liberalisation through multilateral trade negotiations. The commitment of the US as the key defender and the leader of the multilateral trade liberalisation in the post-World War II era has considerably weakened in favour of regionalism (bilateralism) and, even worse than that, unilateralism. As a recent evidence of that situation, the US determined after the Cancun failure that it would go in for bilateral agreements if multilateralism failed to work. Thus, the revival of the American leadership in support of multilateralism does not seem probable in the short run.

The process of withdrawing from leadership in the world trading system necessitates looking for alternatives to give the WTO the support it needs, and the EU seems the most appropriate alternative in this respect. The thesis has concluded that the EU, with respect to its external trade relations, has a high degree of discrimination at the expense of the non-members through the application of trade policy tools (like measures of contingent protection and technical barriers to trade), common agricultural policy (which has traditionally been the most protected sector in the EU) and the conclusion of PTAs





(including accession treaties as the highest level of preferential trade patterns) with preferences extended to individual countries and to specific country groups. However, it is obvious that a more liberal inclination is under way both in its trade practices and, more importantly, in the minds of its leading policy makers.

It is tricky to judge whether the formation and enlargement of the EU have undermined or underpinned multilateral trade liberalisation. While, in some instances, it has facilitated and supported trade liberalisation under the GATT rounds, in others, it has undermined multilateral trade liberalisation efforts. It is difficult to say which effect was dominant over the other until the new round of multilateral trade negotiations. Therefore, the stance of the EU in the Doha Round is going to determine the final judgement regarding its effects on multilateral trade liberalisation. However, it should be noted that an awareness regarding the importance of multilateral trade liberalisation for its trade interests (particularly to increase market access for its imports) has recently risen and, accordingly, its support towards multilateral trade liberalisation efforts has increased as evidenced in the preparations for the Doha Development Round.

The EU is emerging as the single alternative having the capacity and the willingness to provide effective exercise of the WTO leadership considering the abovementioned switch to a more liberal trade understanding, an increase in European commitment to multilateralism and its increased absolute economic size through several enlargements and its relative economic size vis-à-vis all partners both individually as well as in groups. When an FTA for the developing south was proposed by Brazil after the Cancun disagreement, Pascal Lamy, EU trade commissioner, pointed out that any initiatives for free trade among countries and blocs were positive, but that the EU would still give priority to multilateral negotiations. Similarly a European commerce ministry official says: "Bilateralism cannot be a substitute for multilateralism. A multilateral set of rules, common to all, would need to be the foundation."<sup>141</sup> These statements<sup>141</sup> reflect recently-rising commitment of the EU to multilateralism very well. Through its active participation in multilateral trade negotiations after the UR and its strongly supporting and agenda-determining stance for the Doha Round, the EU demonstrates that its trade and related economic policies mostly focus on multilateralism.

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<sup>141</sup> Business Standard Economy, December 15, 2003.

In the light of the fact that the “junior” Bush administration has already decided to pursue and applied a regional –even unilateral–, approach, but not multilateral one, it has been concluded that the EU is “emerging” as the sole alternative to the strong need of leadership for the successful conclusion of the MTNs in spite of its simultaneous pursuing of a preferential trade policy and, therefore, the lack of full concentration on multilateralism. Accordingly, the thesis has proposed that the EU should be a “leader” replacing the US in support of a more strengthened and a more liberal multilateral trading system particularly in such a period undergoing a bumpy multilateral trade round. Assuming and exercising an effective WTO leadership necessitates a strong will, and the Doha Round of multilateral trade negotiations, particularly after the breakdown of the Cancun Ministerial Conference, is a very good opportunity for the EU to show this will.

Achievement of the Doha Round is indispensable for not only a reinforced and a more liberal world trading system but also “a more even” expansion of world trade and sustained global economic growth since development-related issues have been placed at the centre of the Doha Declaration<sup>142</sup>. At the Doha Ministerial Meeting, the name coined for the entire work programme was the ‘Doha Development Agenda’ reflecting the pervasiveness of the focus on development in the Declaration and associated decisions and texts. The Doha Development Agenda is mainly interested in responding the development needs of developing countries. In the case of the collapse of the Round, multilateralism will lose its reliability not only in terms of its objectives of more liberal and strengthened world trading system for all its participants, but also in terms of its development objectives for its less developed members. This can easily pave the way for increase in the existing tendency of its disappointed developing members to the other means of trade liberalisation and of economic development as in the case that Brazilian President proposed a FTA for the developing south after the Cancun breakdown. Thus, the current stalemate in the multilateral negotiations led by the Cancun disagreement necessitates an immediate action

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<sup>142</sup> Most, if not all, work programmes and negotiating mandates in the Doha Declaration refer to such matters

as the importance of the development dimension, special and differential treatment, the priorities of developing countries, and the need for technical assistance and capacity building. In addition, specific sections of the Doha Declaration deal with technical co-operation and capacity building, least-developed countries and special and differential treatment. Work programmes have also been launched on small economies, trade, debt and finance, and trade and transfer of technology. One of the key principles of the Doha Development Round is that the negotiations and other aspects of the work programme are to take fully into account the principle of special and differential treatment for developing and least-developed countries.

to revive and conclude the negotiations in order not to endanger the future of the multilateral trading system. In order to prevent the world from getting even more fragmented through regional blocs, the conclusion of the Doha multilateral trade talks is standing as the urgent policy choice before the WTO members.

However, this does not mean that the increase in regionalism will be totally taken under the control through the successful conclusion of the Doha Round. A more liberal, reformed and -thus- more credible multilateral trading system can prevent a sharp increase in regionalism as a substitute for multilateralism and preclude to consolidate the process towards more regionalised and -hence- discriminated world trading system. But, it cannot totally contain the adverse effects of regionalism in the absence of effective and adequate mechanisms. Even if the Doha Round can be concluded successfully, it cannot be the direct and the exact solution to the issue of regionalism since the way of reform of the WTO obligations regarding PTAs included in the agenda of the Doha Round is insufficient. While the accomplishment of the Doha Round is a necessary criterion that poses emergency to deal with, it is most probably insufficient -with its unsatisfactory reform agenda- to contain the unfavourable effects of regionalism on the multilateral trading system.

Although the conclusion of multilateral negotiations is necessary to weaken the tendency towards regionalism and decrease the possibility of a fragmented world, just to rely on it in order to contain the detrimental effects of regionalism is risky. Considering the strong motivations of regionalism and its quite appropriate nature to endure, a more direct way to deal with regionalism is needed. International laws, which ensure regional arrangements are structured so as to avoid harming the international trade, must be resorted as direct mechanisms. However, the existing form of the GATT/WTO rules (Article 24) has proved to be ineffective and insufficient to ensure that third country interests are respected and that these arrangements are compatible with a rules-based and progressively more open world trading system. The new round of multilateral trade negotiations could have been an opportunity to reform the relevant disciplines in this respect. Nevertheless, the Doha Development Agenda includes redefining of Article 24 so as to make its wording more precise in the light of interpretation concerns. To eliminate the problem of “being inadequate”, this way of reform of Article 24 cannot be enough. Instead, Article 24 must

be redesigned so as to incorporate the requirement of reducing the external tariffs to the extent that it secures the same level of external trade volumes as the pre-integration level.

The EU as the “emerging leader” in support of the multilateral trading system should take necessary initiative to redesign the relevant GATT/WTO disciplines in this respect. In spite of its multitude of PTAs with non-member countries and its protectionist practices, its recently rising trade liberalising outlook and its interests as a non-member of the other PTAs elsewhere in the world will help the EU to take this initiative. The EU should lead to incorporate a more radical reform of Article 24 and other relevant GATT/WTO disciplines into the agenda of the future reform and liberalisation efforts. An open and strong multilateral trading system along with “adequate rules” to contain adverse welfare effects of regionalism on the non-members is the best guarantee against the threat of proliferation of regionalism, which is considered in this thesis as harmful for multilateral trading system both in static welfare sense and dynamic time-path sense.

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**ANNEX I.**

**Regional Trade Agreements Notified to the GATT/WTO and in Force**

**By date of entry into force**

**As of 1 May 2004**

Agreement	Date of entry into force	Date	GATT/WTO notification			Examination process	
			Related provisions	Type of agreement	Document series	Status	Ref.
<u>EC (Treaty of Rome)</u>	1-Oca-58	10-Kas-95	GATS Art. V	Services agreement	WT/REG39 S/C/N/6	Under factual examination	...
<u>EC (Treaty of Rome)</u>	1-Oca-58	24-Nis-57	GATT Art. XXIV	Customs union	L/626	Report adopted	6S/70 & 109 29.11.57
<u>EFTA (Stockholm Convention)</u>	3-May-60	14-Kas-59	GATT Art. XXIV	Free trade agreement	WT/REG85	Report adopted	9S/70 04.06.60
<u>CACM</u>	12-Eki-61	24-Şub-61	GATT Art. XXIV	Customs union	WT/REG93	Report adopted	10S/98 23.11.61
<u>TRIPARTITE</u>	1-Nis-68	23-Şub-68	Enabling Clause	Preferential arrangement	L/2980 L/2980/Add.1	Report adopted	16S/83 14.11.68
<u>EFTA accession of Iceland</u>	1-Mar-70	30-Oca-70	GATT Art. XXIV	Accession to free trade agreement	L/3328 L/3328/Add.1	Report adopted	18S/174 29.09.70
<u>EC — OCTs</u>	1-Oca-71	14-Ara-70	GATT Art. XXIV	Free trade agreement	WT/REG106	Report adopted	18S/143 09.11.71
<u>EC — Malta</u>	1-Nis-71	24-Mar-71	GATT Art. XXIV	Customs union	WT/REG102	Report adopted	19S/90 29.05.72
<u>EC — Switzerland and Liechtenstein</u>	1-Oca-73	27-Eki-72	GATT Art. XXIV	Free trade agreement	WT/REG94	Report adopted	20S/196 19.10.73
<u>EC accession of Denmark, Ireland and United Kingdom</u>	1-Oca-73	7-Mar-72	GATT Art. XXIV	Accession to customs union	L/3677	Report adopted	C/M/107 11.07.75
<u>PTN</u>	11-Şub-73	9-Kas-71	Enabling Clause	Preferential arrangement	L/3598 18S/11	Examination not requested	...
<u>EC — Iceland</u>	1-Nis-73	24-Kas-72	GATT Art. XXIV	Free trade agreement	WT/REG95	Report adopted	20S/158 19.10.73
<u>EC — Cyprus</u>	1-Haz-73	13-Haz-73	GATT Art. XXIV	Customs union	WT/REG97	Report adopted	21S/94 21.06.74
<u>EC — Norway</u>	1-Tem-73	13-Tem-73	GATT Art. XXIV	Free trade agreement	WT/REG137	Report adopted	21S/83 28.03.74
<u>CARICOM</u>	1-Ağu-73	14-Eki-74	GATT Art. XXIV	Customs union	WT/REG92	Report adopted	24S/68 02.03.77
<u>Bangkok Agreement</u>	17-Haz-76	2-Kas-76	Enabling Clause	Preferential arrangement	L/4418 L/4418/Corr.1	Report adopted	25S/109 14.03.78
<u>EC — Algeria</u>	1-Tem-76	28-Tem-76	GATT Art. XXIV	Free trade agreement	WT/REG105	Report adopted	24S/80 11.11.77

<b>PATCRA</b>	1-Sub-77	20-Ara-76	GATT Art. XXIV	Free trade agreement	L/4451 L/4451/Add.1	Report adopted	24S/63 11.11.77
<b>EC — Egypt</b>	1-Tem-77	15-Tem-77	GATT Art. XXIV	Free trade agreement	WT/REG98	Report adopted	25S/114 17.05.78
<b>EC — Syria</b>	1-Tem-77	15-Tem-77	GATT Art. XXIV	Free trade agreement	WT/REG104	Report adopted	25S/123 17.05.78
<b>SPARTECA</b>	1-Oca-81	20-Şub-81	Enabling Clause	Preferential arrangement	L/5100	Examination not requested	...
<b>EC accession of Greece</b>	1-Oca-81	24-Eki-79	GATT Art. XXIV	Accession to customs union	L4845	Report adopted	30S/168 09.03.83
<b>LAIA</b>	18-Mar-81	1-Tem-82	Enabling Clause	Preferential arrangement	L/5342	Examination not requested	...
<b>CER</b>	1-Oca-83	14-Nis-83	GATT Art. XXIV	Free trade agreement	WT/REG111	Report adopted	31S/170 02.10.84
<b>United States — Israel</b>	19-Ağu-85	13-Eyl-85	GATT Art. XXIV	Free trade agreement	L/5862 L/5862/Add.1	Report adopted	34S/58 14.05.87
<b>EC accession of Portugal and Spain</b>	1-Oca-86	11-Ara-85	GATT Art. XXIV	Accession to customs union	L/5936	Report adopted	35S/293 19.10.88
<b>CAN</b>	25-May-88	12-Eki-92	Enabling Clause	Preferential arrangement	L/6737	Examination not requested	...
<b>CER</b>	1-Oca-89	22-Kas-95	GATS Art. V	Services agreement	WT/REG40 S/C/N/7	Consultations on draft report	...
<b>GSTP</b>	19-Nis-89	25-Eyl-89	Enabling Clause	Preferential arrangement	L/6564/Add.1	Examination not requested	...
<b>Laos — Thailand</b>	20-Haz-91	29-Kas-91	Enabling Clause	Preferential arrangement	L/6947	Examination not requested	...
<b>EC — Andorra</b>	1-Tem-91	25-Şub-98	GATT Art. XXIV	Customs union	WT/REG53	Factual examination concluded	...
<b>MERCOSUR</b>	29-Kas-91	5-Mar-92	Enabling Clause	Customs union	WT/COMTD/1	Under factual examination	...
<b>AFTA</b>	28-Oca-92	30-Eki-92	Enabling Clause	Preferential arrangement	L/4581	Examination not requested	...
<b>EC — Czech Republic</b>	1-Mar-92	13-May-96	GATT Art. XXIV	Free trade agreement	WT/REG18	Factual examination concluded	...
<b>EC — Slovak Republic</b>	1-Mar-92	13-May-96	GATT Art. XXIV	Free trade agreement	WT/REG18	Factual examination concluded	...
<b>EC — Hungary</b>	1-Mar-92	3-Nis-92	GATT Art. XXIV	Free trade agreement	WT/REG18	Consultations on draft report	...
<b>EC — Poland</b>	1-Mar-92	3-Nis-92	GATT Art. XXIV	Free trade agreement	WT/REG18	Factual examination concluded	...
<b>EFTA — Turkey</b>	1-Nis-92	6-Mar-92	GATT Art. XXIV	Free trade agreement	WT/REG86	Report adopted	40S/48 17.12.93
<b>EFTA — Czech Republic</b>	1-Tem-92	3-Tem-92	GATT Art. XXIV	Free trade agreement	WT/REG87	Report adopted	41S/116 08.12.94
<b>EFTA — Slovak Republic</b>	1-Tem-92	3-Tem-92	GATT Art. XXIV	Free trade agreement	WT/REG88	Report adopted	41S/116 08.12.94
<b>Czech Republic — Slovak Republic</b>	1-Oca-93	30-Nis-93	GATT Art. XXIV	Customs union	WT/REG89	Report adopted	41S/112 04.10.94
<b>EFTA — Israel</b>	1-Oca-93	1-Ara-92	GATT Art. XXIV	Free trade agreement	WT/REG14	Factual examination concluded	...



<u>CEFTA</u>	1-Mar-93	30-Haz-94	GATT Art. XXIV	Free trade agreement	WT/REG11	Consultations on draft report	...
<b>Kyrgyz Republic — Russian Federation</b>	24-Nis-93	15-Haz-99	GATT Art. XXIV	Free trade agreement	WT/REG73	Under factual examination	...
<u>EC — Romania</u>	1-May-93	23-Ara-94	GATT Art. XXIV	Free trade agreement	WT/REG2	Factual examination concluded	...
<u>EFTA — Romania</u>	1-May-93	24-May-93	GATT Art. XXIV	Free trade agreement	WT/REG16	Factual examination concluded	...
<b>Faroe Islands — Norway</b>	1-Tem-93	13-Mar-96	GATT Art. XXIV	Free trade agreement	WT/REG25	Factual examination concluded	...
<b>Faroe Islands — Iceland</b>	1-Tem-93	23-Oca-96	GATT Art. XXIV	Free trade agreement	WT/REG23	Factual examination concluded	...
<u>EFTA — Bulgaria</u>	1-Tem-93	30-Haz-93	GATT Art. XXIV	Free trade agreement	WT/REG12	Factual examination concluded	...
<b>MSG</b>	22-Tem-93	7-Eki-99	Enabling Clause	Preferential arrangement	WT/COMTD/N/9 WT/COMTD/21	Examination not requested	...
<u>EFTA — Hungary</u>	1-Eki-93	23-Ara-93	GATT Art. XXIV	Free trade agreement	WT/REG13	Consultations on draft report	...
<u>EFTA — Poland</u>	15-Kas-93	20-Eki-93	GATT Art. XXIV	Free trade agreement	WT/REG15	Factual examination concluded	...
<u>EC — Bulgaria</u>	31-Ara-93	23-Ara-94	GATT Art. XXIV	Free trade agreement	WT/REG1	Factual examination concluded	...
<u>EEA</u>	1-Oca-94	10-Eki-96	GATS Art. V	Services agreement	WT/REG138 S/C/N/28	Under factual examination	...
<u>NAFTA</u>	1-Oca-94	1-Şub-93	GATT Art. XXIV	Free trade agreement	WT/REG4	Consultations on draft report	...
<u>EC — Hungary</u>	1-Şub-94	27-Ağu-96	GATS Art. V	Services agreement	WT/REG50 S/C/N/24	Consultations on draft report	...
<u>EC — Poland</u>	1-Şub-94	27-Ağu-96	GATS Art. V	Services agreement	WT/REG51 S/C/N/25	Factual examination concluded	...
<b>BAFTA</b>	1-Nis-94	15-Haz-99	GATT Art. XXIV	Free trade agreement	WT/REG77	Factual examination concluded	...
<u>NAFTA</u>	1-Nis-94	1-Mar-95	GATS Art. V	Services agreement	WT/REG4 S/C/N/4	Consultations on draft report	...
<b>Georgia — Russian Federation</b>	10-May-94	21-Şub-01	GATT Art. XXIV	Free trade agreement	WT/REG118	Under factual examination	...
<u>COMESA</u>	8-Ara-94	29-Haz-95	Enabling Clause	Preferential arrangement	WT/COMTD/N/3	Examination not requested	...
<b>CIS</b>	30-Ara-94	1-Eki-99	GATT Art. XXIV	Free trade agreement	WT/REG82	Under factual examination	...
<b>Romania — Moldova</b>	1-Oca-95	24-Eyl-97	GATT Art. XXIV	Free trade agreement	WT/REG44	Factual examination concluded	...
<u>EC — Lithuania</u>	1-Oca-95	26-Eyl-95	GATT Art. XXIV	Free trade agreement	WT/REG9	Factual examination concluded	...
<u>EC — Estonia</u>	1-Oca-95	30-Haz-95	GATT Art. XXIV	Free trade agreement	WT/REG8	Factual examination concluded	...
<u>EC — Latvia</u>	1-Oca-95	30-Haz-95	GATT Art. XXIV	Free trade agreement	WT/REG7	Factual examination concluded	...
<b>EC accession of Austria, Finland and Sweden</b>	1-Oca-95	20-Oca-95	GATT Art. XXIV	Accession to customs union	WT/REG3 L/7614/Add.1	Consultations on draft report	...



<b>EC accession of Austria, Finland and Sweden</b>	1-Oca-95	20-Oca-95	GATS Art. V	Accession to services agreement	WT/REG3 S/C/N/6	Consultations on draft report	...
<b>EC — Bulgaria</b>	1-Şub-95	25-Nis-97	GATS Art. V	Services agreement	WT/REG1 S/C/N/55	Under factual examination	...
<b>EC — Czech Republic</b>	1-Şub-95	9-Eki-96	GATS Art. V	Services agreement	WT/REG139 S/C/N/26	Under factual examination	...
<b>EC — Romania</b>	1-Şub-95	9-Eki-96	GATS Art. V	Services agreement	WT/REG2 S/C/N/27	Under factual examination	...
<b>EC — Slovak Republic</b>	1-Şub-95	27-Ağu-96	GATS Art. V	Services agreement	WT/REG52 S/C/N/23	Factual examination concluded	...
<b>Faroe Islands — Switzerland</b>	1-Mar-95	8-Mar-96	GATT Art. XXIV	Free trade agreement	WT/REG24	Factual examination concluded	...
<b>EFTA — Slovenia</b>	1-Tem-95	18-Eki-95	GATT Art. XXIV	Free trade agreement	WT/REG20	Factual examination concluded	...
<b>Kyrgyz Republic — Armenia</b>	27-Eki-95	4-Oca-01	GATT Art. XXIV	Free trade agreement	WT/REG114	Under factual examination	...
<b>Kyrgyz Republic — Kazakhstan</b>	11-Kas-95	29-Eyl-99	GATT Art. XXIV	Free trade agreement	WT/REG81	Under factual examination	...
<b>SAPTA</b>	7-Ara-95	22-Eyl-93	Enabling Clause	Preferential arrangement	WT/COMTD/10	Examination not requested	...
<b>CEFTA accession of Slovenia</b>	1-Oca-96	8-Oca-98	GATT Art. XXIV	Accession to free trade agreement	WT/REG11	Consultations on draft report	...
<b>EC — Turkey</b>	1-Oca-96	22-Ara-95	GATT Art. XXIV	Customs union	WT/REG22	Under factual examination	...
<b>Estonia — Ukraine</b>	14-Mar-96	25-Tem-00	GATT Art. XXIV	Free trade agreement	WT/REG108	Factual examination concluded	...
<b>EFTA — Estonia</b>	1-Haz-96	25-Tem-96	GATT Art. XXIV	Free trade agreement	WT/REG28	Factual examination concluded	...
<b>EFTA — Latvia</b>	1-Haz-96	25-Tem-96	GATT Art. XXIV	Free trade agreement	WT/REG29	Factual examination concluded	...
<b>Georgia — Ukraine</b>	4-Haz-96	21-Şub-01	GATT Art. XXIV	Free trade agreement	WT/REG121	Under factual examination	...
<b>Georgia — Azerbaijan</b>	10-Tem-96	21-Şub-01	GATT Art. XXIV	Free trade agreement	WT/REG120	Under factual examination	...
<b>Slovenia — Latvia</b>	1-Ağu-96	20-Şub-97	GATT Art. XXIV	Free trade agreement	WT/REG34	Factual examination concluded	...
<b>EFTA — Lithuania</b>	1-Ağu-96	25-Tem-96	GATT Art. XXIV	Free trade agreement	WT/REG30	Factual examination concluded	...
<b>Slovenia — Former Yugoslav Republic of Macedonia</b>	1-Eyl-96	20-Şub-97	GATT Art. XXIV	Free trade agreement	WT/REG36	Factual examination concluded	...
<b>Kyrgyz Republic — Moldova</b>	21-Kas-96	15-Haz-99	GATT Art. XXIV	Free trade agreement	WT/REG76	Factual examination concluded	...
<b>Slovak Republic — Israel</b>	1-Oca-97	30-Mar-98	GATT Art. XXIV	Free trade agreement	WT/REG57	Factual examination concluded	...
<b>Poland — Lithuania</b>	1-Oca-97	30-Ara-97	GATT Art. XXIV	Free trade agreement	WT/REG49	Factual examination concluded	...
<b>Slovenia — Estonia</b>	1-Oca-97	20-Şub-97	GATT Art. XXIV	Free trade agreement	WT/REG37	Factual examination	...

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<b>EC — Faroe Islands</b>	1-Oca-97	19-Şub-97	GATT Art. XXIV	Free trade agreement	WT/REG21	Under factual examination	...
<b>Canada — Israel</b>	1-Oca-97	23-Oca-97	GATT Art. XXIV	Free trade agreement	WT/REG31	Factual examination concluded	...
<b>EC — Slovenia</b>	1-Oca-97	11-Kas-96	GATT Art. XXIV	Free trade agreement	WT/REG32	Factual examination concluded	...
<b>Slovenia — Lithuania</b>	1-Mar-97	20-Şub-97	GATT Art. XXIV	Free trade agreement	WT/REG35	Factual examination concluded	...
<b>Israel — Turkey</b>	1-May-97	18-May-98	GATT Art. XXIV	Free trade agreement	WT/REG60	Factual examination concluded	...
<b>CARICOM</b>	1-Tem-97	19-Şub-03	GATS Art. V	Services agreement	WT/REG155 S/C/N/229	Factual examination not started	...
<b>CEFTA accession of Romania</b>	1-Tem-97	8-Oca-98	GATT Art. XXIV	Accession to free trade agreement	WT/REG11	Consultations on draft report	...
<b>Slovak Republic — Latvia</b>	1-Tem-97	14-Kas-97	GATT Art. XXIV	Free trade agreement	WT/REG47	Factual examination concluded	...
<b>Slovak Republic — Lithuania</b>	1-Tem-97	14-Kas-97	GATT Art. XXIV	Free trade agreement	WT/REG48	Factual examination concluded	...
<b>Czech Republic — Latvia</b>	1-Tem-97	13-Kas-97	GATT Art. XXIV	Free trade agreement	WT/REG45	Factual examination concluded	...
<b>EC — Palestinian Authority</b>	1-Tem-97	30-Haz-97	GATT Art. XXIV	Free trade agreement	WT/REG43	Factual examination not started	...
<b>Canada — Chile</b>	5-Tem-97	13-Kas-97	GATS Art. V	Services agreement	WT/REG38 S/C/N/65	Factual examination concluded	...
<b>Canada — Chile</b>	5-Tem-97	26-Ađu-97	GATT Art. XXIV	Free trade agreement	WT/REG38	Factual examination concluded	...
<b>Czech Republic — Lithuania</b>	1-Eyl-97	13-Kas-97	GATT Art. XXIV	Free trade agreement	WT/REG46	Factual examination concluded	...
<b>EAEC</b>	8-Eki-97	6-Nis-99	GATT Art. XXIV	Customs union	WT/REG71	Under factual examination	...
<b>Czech Republic — Israel</b>	1-Ara-97	30-Mar-98	GATT Art. XXIV	Free trade agreement	WT/REG56	Factual examination concluded	...
<b>Slovenia — Croatia</b>	1-Oca-98	25-Mar-98	GATT Art. XXIV	Free trade agreement	WT/REG55	Factual examination concluded	...
<b>Kyrgyz Republic — Ukraine</b>	19-Oca-98	15-Haz-99	GATT Art. XXIV	Free trade agreement	WT/REG74	Under factual examination	...
<b>EC — Lithuania</b>	1-Şub-98	11-Şub-02	GATS Art. V	Services agreement	WT/REG145 S/C/N/189	Under factual examination	...
<b>EC — Estonia</b>	1-Şub-98	11-Şub-02	GATS Art. V	Services agreement	WT/REG144 S/C/N/188	Under factual examination	...
<b>Romania — Turkey</b>	1-Şub-98	18-May-98	GATT Art. XXIV	Free trade agreement	WT/REG59	Factual examination concluded	...
<b>Hungary — Israel</b>	1-Şub-98	24-Mar-98	GATT Art. XXIV	Free trade agreement	WT/REG54	Factual examination concluded	...
<b>Czech Republic — Estonia</b>	12-Şub-98	3-Ađu-98	GATT Art. XXIV	Free trade agreement	WT/REG62	Factual examination concluded	...

<b>Slovak Republic — Estonia</b>	12-Şub-98	3-Ađu-98	GATT Art. XXIV	Free trade agreement	WT/REG63	Factual examination concluded	...
<b>EC — Tunisia</b>	1-Mar-98	23-Mar-99	GATT Art. XXIV	Free trade agreement	WT/REG69	Factual examination concluded	...
<b>Poland — Israel</b>	1-Mar-98	25-Şub-99	GATT Art. XXIV	Free trade agreement	WT/REG65	Factual examination concluded	...
<b>Lithuania — Turkey</b>	1-Mar-98	8-Haz-98	GATT Art. XXIV	Free trade agreement	WT/REG61	Factual examination concluded	...
<b>Kyrgyz Republic — Uzbekistan</b>	20-Mar-98	15-Haz-99	GATT Art. XXIV	Free trade agreement	WT/REG75	Under factual examination	...
<b>Hungary — Turkey</b>	1-Nis-98	12-May-98	GATT Art. XXIV	Free trade agreement	WT/REG58	Factual examination concluded	...
<b>Estonia — Turkey</b>	1-Haz-98	23-Mar-99	GATT Art. XXIV	Free trade agreement	WT/REG70	Factual examination concluded	...
<b>Czech Republic — Turkey</b>	1-Eyl-98	24-Nis-99	GATT Art. XXIV	Free trade agreement	WT/REG67	Factual examination concluded	...
<b>Slovak Republic — Turkey</b>	1-Eyl-98	24-Mar-99	GATT Art. XXIV	Free trade agreement	WT/REG68	Factual examination concluded	...
<b>Slovenia — Israel</b>	1-Eyl-98	8-Mar-99	GATT Art. XXIV	Free trade agreement	WT/REG66	Factual examination concluded	...
<b>Georgia — Armenia</b>	11-Kas-98	21-Şub-01	GATT Art. XXIV	Free trade agreement	WT/REG119	Under factual examination	...
<b>Estonia — Faroe Islands</b>	1-Ara-98	26-Oca-99	GATT Art. XXIV	Free trade agreement	WT/REG64	Factual examination concluded	...
<b>Bulgaria — Turkey</b>	1-Oca-99	4-May-99	GATT Art. XXIV	Free trade agreement	WT/REG72	Factual examination concluded	...
<b>CEFTA accession of Bulgaria</b>	1-Oca-99	24-Mar-99	GATT Art. XXIV	Accession to free trade agreement	WT/REG11	Consultations on draft report	...
<b>EC — Slovenia</b>	1-Şub-99	11-Şub-02	GATS Art. V	Services agreement	WT/REG146 S/C/N/190	Under factual examination	...
<b>EC — Latvia</b>	1-Şub-99	11-Şub-02	GATS Art. V	Services agreement	WT/REG143 S/C/N/187	Under factual examination	...
<b>Poland — Latvia</b>	1-Haz-99	29-Eyl-99	GATT Art. XXIV	Free trade agreement	WT/REG80	Factual examination concluded	...
<b>Poland — Faroe Islands</b>	1-Haz-99	18-Ađu-99	GATT Art. XXIV	Free trade agreement	WT/REG78	Factual examination concluded	...
<b>CEMAC</b>	24-Haz-99	28-Eyl-00	Enabling Clause	Preferential arrangement	WT/COMTD/N/13 WT/COMTD/24	Examination not requested	...
<b>EFTA — Palestinian Authority</b>	1-Tem-99	21-Eyl-99	GATT Art. XXIV	Free trade agreement	WT/REG79	Factual examination not started	...
<b>Georgia — Kazakhstan</b>	16-Tem-99	21-Şub-01	GATT Art. XXIV	Free trade agreement	WT/REG123	Under factual examination	...
<b>Chile — Mexico</b>	1-Ađu-99	14-Mar-01	GATS Art. V	Services agreement	WT/REG125 S/C/N/142	Factual examination concluded	...
<b>Chile — Mexico</b>	1-Ađu-99	27-Şub-01	GATT Art. XXIV	Free trade agreement	WT/REG125	Factual examination concluded	...
<b>EFTA — Morocco</b>	1-Ara-99	20-Şub-00	GATT Art. XXIV	Free trade agreement	WT/REG91	Factual examination concluded	...

<b>Georgia — Turkmenistan</b>	1-Oca-00	21-Şub-01	GATT Art. XXIV	Free trade agreement	WT/REG122	Under factual examination	...
<b>EC — South Africa</b>	1-Oca-00	14-Kas-00	GATT Art. XXIV	Free trade agreement	WT/REG113	Factual examination not started	...
<b>WAEMU/UEMOA</b>	1-Oca-00	3-Şub-00	Enabling Clause	Preferential arrangement	WT/COMTD/N/11 WT/COMTD/23	Examination not requested	...
<b>Bulgaria — Former Yugoslav Republic of Macedonia</b>	1-Oca-00	21-Oca-00	GATT Art. XXIV	Free trade agreement	WT/REG90	Factual examination concluded	...
<b>Hungary — Latvia</b>	1-Oca-00	20-Ara-99	GATT Art. XXIV	Free trade agreement	WT/REG84	Factual examination concluded	...
<b>EC — Morocco</b>	1-Mar-00	8-Kas-00	GATT Art. XXIV	Free trade agreement	WT/REG112	Under factual examination	...
<b>Hungary — Lithuania</b>	1-Mar-00	20-Ara-99	GATT Art. XXIV	Free trade agreement	WT/REG83	Factual examination concluded	...
<b>Poland — Turkey</b>	1-May-00	14-May-00	GATT Art. XXIV	Free trade agreement	WT/REG107	Factual examination concluded	...
<b>Turkey — Slovenia</b>	1-Haz-00	6-Mar-02	GATT Art. XXIV	Free trade agreement	WT/REG135	Factual examination concluded	...
<b>EC — Israel</b>	1-Haz-00	7-Kas-00	GATT Art. XXIV	Free trade agreement	WT/REG110	Factual examination concluded	...
<b>Mexico — Israel</b>	1-Tem-00	27-Şub-01	GATT Art. XXIV	Free trade agreement	WT/REG124	Factual examination concluded	...
<b>Latvia — Turkey</b>	1-Tem-00	22-Oca-01	GATT Art. XXIV	Free trade agreement	WT/REG116	Factual examination concluded	...
<b>EC — Mexico</b>	1-Tem-00	1-Ağu-00	GATT Art. XXIV	Free trade agreement	WT/REG109	Under factual examination	...
<b>EAC</b>	7-Tem-00	11-Eki-00	Enabling Clause	Preferential arrangement	WT/COMTD/N/14 WT/COMTD/25	Examination not requested	...
<b>Turkey — Former Yugoslav Republic of Macedonia</b>	1-Eyl-00	22-Oca-01	GATT Art. XXIV	Free trade agreement	WT/REG115	Factual examination concluded	...
<b>Croatia - Bosnia and Herzegovina</b>	1-Oca-01	6-Eki-03	GATT Art. XXIV	Free trade agreement	WT/REG159	Factual examination not started	...
<b>New Zealand - Singapore</b>	1-Oca-01	4-Eyl-01	GATT Art. XXIV	Free trade agreement	WT/REG127	Factual examination concluded	...
<b>New Zealand - Singapore</b>	1-Oca-01	4-Eyl-01	GATS Art. V	Services agreement	WT/REG127 S/C/N/169	Under factual examination	...
<b>EFTA — Former Yugoslav Republic of Macedonia</b>	1-Oca-01	31-Oca-01	GATT Art. XXIV	Free trade agreement	WT/REG117	Factual examination concluded	...
<b>EC — Mexico</b>	1-Mar-01	21-Haz-02	GATS Art. V	Services agreement	WT/REG109 S/C/N/192	Under factual examination	...
<b>Hungary — Estonia</b>	1-Mar-01	4-Eki-01	GATT Art. XXIV	Free trade agreement	WT/REG128	Under factual examination	...
<b>EC — FYROM</b>	1-Haz-01	21-Kas-01	GATT Art. XXIV	Free trade agreement	WT/REG129	Under factual examination	...
<b>EFTA - Mexico</b>	1-Tem-01	25-Tem-01	GATT Art. XXIV	Free trade agreement	WT/REG126	Factual examination concluded	...

<u>EFTA - Mexico</u>	1-Tem-01	25-Tem-01	GATS Art. V	Services agreement	WT/REG126 S/C/N/166	Under factual examination	...
<u>India — Sri Lanka</u>	15-Ara-01	26-Haz-02	Enabling Clause	Free trade agreement	WT/COMTD/N/16	Examination not requested	...
<u>United States — Jordan</u>	17-Ara-01	18-Eki-02	GATS Art. V	Services agreement	WT/REG134 S/C/N/193	Factual examination not started	...
<u>United States — Jordan</u>	17-Ara-01	5-Mar-02	GATT Art. XXIV	Free trade agreement	WT/REG134	Factual examination not started	...
<u>Bulgaria - Israel</u>	1-Oca-02	14-Nis-03	GATT Art. XXIV	Free trade agreement	WT/REG150	Factual examination not started	...
<u>Bulgaria - Estonia</u>	1-Oca-02	25-Mar-03	GATT Art. XXIV	Free trade agreement	WT/REG149	Factual examination not started	...
<u>EFTA — Jordan</u>	1-Oca-02	22-Oca-02	GATT Art. XXIV	Free trade agreement	WT/REG133	Under factual examination	...
<u>EFTA — Croatia</u>	1-Oca-02	22-Oca-02	GATT Art. XXIV	Free trade agreement	WT/REG132	Under factual examination	...
<u>Slovenia — Bosnia and Herzegovina</u>	1-Oca-02	21-Oca-02	GATT Art. XXIV	Free trade agreement	WT/REG131	Factual examination not started	...
<u>Chile — Costa Rica</u>	15-Sub-02	24-May-02	GATS Art. V	Services agreement	WT/REG136 S/C/N/191	Under factual examination	...
<u>Chile — Costa Rica</u>	15-Sub-02	14-May-02	GATT Art. XXIV	Free trade agreement	WT/REG136	Under factual examination	...
<u>Bulgaria - Lithuania</u>	1-Mar-02	30-Nis-03	GATT Art. XXIV	Free trade agreement	WT/REG152	Factual examination not started	...
<u>EC — Croatia</u>	1-Mar-02	20-Ara-02	GATT Art. XXIV	Free trade agreement	WT/REG142	Factual examination not started	...
<u>EC — Jordan</u>	1-May-02	20-Ara-02	GATT Art. XXIV	Free trade agreement	WT/REG141	Factual examination not started	...
<u>Chile - El Salvador</u>	1-Haz-02	16-Sub-04	GATT Art. XXIV	Free trade agreement	WT/REG165	Factual examination not started	...
<u>Chile - El Salvador</u>	1-Haz-02	17-Mar-04	GATS Art. V	Services agreement	WT/REG165 S/C/N/299	Factual examination not started	...
<u>EFTA</u>	1-Haz-02	3-Ara-02	GATS Art. V	Services agreement	WT/REG154 S/C/N/207	Under factual examination	...
<u>Canada — Costa Rica</u>	1-Kas-02	17-Oca-03	GATT Art. XXIV	Free trade agreement	WT/REG147	Factual examination not started	...
<u>Japan - Singapore</u>	30-Kas-02	14-Kas-02	GATS Art. V	Services agreement	WT/REG140 S/C/N/206	Under factual examination	...
<u>Japan - Singapore</u>	30-Kas-02	14-Kas-02	GATT Art. XXIV	Free trade agreement	WT/REG140	Under factual examination	...
<u>EFTA - Singapore</u>	1-Oca-03	24-Oca-03	GATS Art. V	Services agreement	WT/REG148 S/C/N/226	Factual examination not started	...
<u>EFTA - Singapore</u>	1-Oca-03	24-Oca-03	GATT Art. XXIV	Free trade agreement	WT/REG148	Factual examination not started	...
<u>EC - Chile</u>	1-Sub-03	18-Sub-04	GATT Art. XXIV	Free trade agreement	WT/REG164	Factual examination not started	...
<u>CEFTA accession of Croatia</u>	1-Mar-03	3-Mar-04	GATT Art. XXIV	Accession to free trade agreement	WT/REG11	Factual examination not started	...



<u>EC - Lebanon</u>	1-Mar-03	4-Haz-03	GATT Art. XXIV	Free trade agreement	WT/REG153	Factual examination not started	...
<u>Bulgaria - Latvia</u>	1-Nis-03	8-Nis-03	GATT Art. XXIV	Free trade agreement	WT/REG151	Factual examination not started	...
<u>Croatia - Albania</u>	1-Haz-03	31-Mar-04	GATT Art. XXIV	Free trade agreement	WT/REG166	Factual examination not started	...
<u>Turkey - Bosnia and Herzegovina</u>	1-Tem-03	8-Eyl-03	GATT Art. XXIV	Free trade agreement	WT/REG157	Factual examination not started	...
<u>Turkey - Croatia</u>	1-Tem-03	8-Eyl-03	GATT Art. XXIV	Free trade agreement	WT/REG156	Factual examination not started	...
<u>Singapore - Australia</u>	28-Tem-03	1-Eki-03	GATS Art. V	Services agreement	WT/REG158 S/C/N/233	Factual examination not started	...
<u>Singapore - Australia</u>	28-Tem-03	1-Eki-03	GATT Art. XXIV	Free trade agreement	WT/REG158	Factual examination not started	...
<u>Albania - Bulgaria</u>	1-Eyl-03	31-Mar-04	GATT Art. XXIV	Free trade agreement	WT/REG167	Factual examination not started	...
<u>Albania - UNMIK (Kosovo)</u>	1-Eki-03	8-Nis-04	GATT Art. XXIV	Free trade agreement	WT/REG168	Factual examination not started	...
<u>China - Macao, China</u>	1-Oca-04	12-Oca-04	GATT Art. XXIV	Free trade agreement	WT/REG163	Factual examination not started	...
<u>China - Macao, China</u>	1-Oca-04	12-Oca-04	GATS Art. V	Services agreement	WT/REG163 S/C/N/265	Factual examination not started	...
<u>China - Hong Kong, China</u>	1-Oca-04	12-Oca-04	GATT Art. XXIV	Free trade agreement	WT/REG162	Factual examination not started	...
<u>China - Hong Kong, China</u>	1-Oca-04	12-Oca-04	GATS Art. V	Services agreement	WT/REG162 S/C/N/264	Factual examination not started	...
<u>United States - Singapore</u>	1-Oca-04	19-Ara-03	GATT Art. XXIV	Free trade agreement	WT/REG161	Factual examination not started	...
<u>United States - Singapore</u>	1-Oca-04	19-Ara-03	GATS Art. V	Services agreement	WT/REG161 S/C/N/263	Factual examination not started	...
<u>United States — Chile</u>	1-Oca-04	19-Ara-03	GATT Art. XXIV	Free trade agreement	WT/REG160	Factual examination not started	...
<u>United States — Chile</u>	1-Oca-04	19-Ara-03	GATS Art. V	Services agreement	WT/REG160 S/C/N/262	Factual examination not started	...
<u>Republic of Korea - Chile</u>	1-Nis-04	19-Nis-04	GATT Art. XXIV	Free trade agreement	WT/REG169	Examination not requested	...
<u>Republic of Korea - Chile</u>	1-Nis-04	19-Nis-04	GATS Art. V	Services agreement	WT/REG169 S/C/N/302	Examination not requested	...
<u>EU Enlargement</u>	1-May-04	30-Nis-04	GATT Art. XXIV	Accession to customs union	WT/REG170	Examination not requested	...
<u>EU Enlargement</u>	1-May-04	28-Nis-04	GATS Art. V	Accession to services agreement	WT/REG170 S/C/N/303	Examination not requested	...
<u>ECO</u>	not available	22-Tem-92	Enabling Clause	Preferential arrangement	L/7047	Examination not requested	...
<u>GCC</u>	not available	11-Eki-84	Enabling Clause	Preferential arrangement	L/5676	Examination not requested	...



## ANNEX II. WTO MEMBERS AND OBSERVERS

*147 members on 4 April 2003, with dates of membership:*

**Albania** 8 September 2000  
**Angola** 23 November 1996  
**Antigua and Barbuda** 1 January 1995  
**Argentina** 1 January 1995  
**Armenia** 5 February 2003  
**Australia** 1 January 1995  
**Austria** 1 January 1995  
**Bahrain, Kingdom of** 1 January 1995  
**Bangladesh** 1 January 1995  
**Barbados** 1 January 1995  
**Belgium** 1 January 1995  
**Belize** 1 January 1995  
**Benin** 22 February 1996  
**Bolivia** 12 September 1995  
**Botswana** 31 May 1995  
**Brazil** 1 January 1995  
**Brunei Darussalam** 1 January 1995  
**Bulgaria** 1 December 1996  
**Burkina Faso** 3 June 1995  
**Burundi** 23 July 1995  
**Cameroon** 13 December 1995  
**Canada** 1 January 1995  
**Central African Republic** 31 May 1995  
**Chad** 19 October 1996  
**Chile** 1 January 1995  
**China** 11 December 2001  
**Colombia** 30 April 1995  
**Congo** 27 March 1997  
**Costa Rica** 1 January 1995  
**Côte d'Ivoire** 1 January 1995  
**Croatia** 30 November 2000  
**Cuba** 20 April 1995  
**Cyprus** 30 July 1995  
**Czech Republic** 1 January 1995  
**Democratic Republic of the Congo** 1 January 1997  
**Denmark** 1 January 1995  
**Djibouti** 31 May 1995  
**Dominica** 1 January 1995  
**Dominican Republic** 9 March 1995  
**Ecuador** 21 January 1996  
**Egypt** 30 June 1995  
**El Salvador** 7 May 1995  
**Estonia** 13 November 1999  
**European Communities** 1 January 1995  
**Fiji** 14 January 1996

**Finland** 1 January 1995  
**Former Yugoslav Republic of Macedonia (FYROM)** 4 April 2003  
**France** 1 January 1995  
**Gabon** 1 January 1995  
**The Gambia** 23 October 1996  
**Georgia** 14 June 2000  
**Germany** 1 January 1995  
**Ghana** 1 January 1995  
**Greece** 1 January 1995  
**Grenada** 22 February 1996  
**Guatemala** 21 July 1995  
**Guinea** 25 October 1995  
**Guinea Bissau** 31 May 1995  
**Guyana** 1 January 1995  
**Haiti** 30 January 1996  
**Honduras** 1 January 1995  
**Hong Kong, China** 1 January 1995  
**Hungary** 1 January 1995  
**Iceland** 1 January 1995  
**India** 1 January 1995  
**Indonesia** 1 January 1995  
**Ireland** 1 January 1995  
**Israel** 21 April 1995  
**Italy** 1 January 1995  
**Jamaica** 9 March 1995  
**Japan** 1 January 1995  
**Jordan** 11 April 2000  
**Kenya** 1 January 1995  
**Korea, Republic of** 1 January 1995  
**Kuwait** 1 January 1995  
**Kyrgyz Republic** 20 December 1998  
**Latvia** 10 February 1999  
**Lesotho** 31 May 1995  
**Liechtenstein** 1 September 1995  
**Lithuania** 31 May 2001  
**Luxembourg** 1 January 1995  
**Macao, China** 1 January 1995  
**Madagascar** 17 November 1995  
**Malawi** 31 May 1995  
**Malaysia** 1 January 1995  
**Maldives** 31 May 1995  
**Mali** 31 May 1995  
**Malta** 1 January 1995  
**Mauritania** 31 May 1995  
**Mauritius** 1 January 1995  
**Mexico** 1 January 1995  
**Moldova** 26 July 2001  
**Mongolia** 29 January 1997  
**Morocco** 1 January 1995

**Mozambique** 26 August 1995  
**Myanmar** 1 January 1995  
**Namibia** 1 January 1995  
**Nepal** 23 April 2004  
**Netherlands** - For the Kingdom in Europe and for the Netherlands Antilles 1 January 1995  
**New Zealand** 1 January 1995  
**Nicaragua** 3 September 1995  
**Niger** 13 December 1996  
**Nigeria** 1 January 1995  
**Norway** 1 January 1995  
**Oman** 9 November 2000  
**Pakistan** 1 January 1995  
**Panama** 6 September 1997  
**Papua New Guinea** 9 June 1996  
**Paraguay** 1 January 1995  
**Peru** 1 January 1995  
**Philippines** 1 January 1995  
**Poland** 1 July 1995  
**Portugal** 1 January 1995  
**Qatar** 13 January 1996  
**Romania** 1 January 1995  
**Rwanda** 22 May 1996  
**Saint Kitts and Nevis** 21 February 1996  
**Saint Lucia** 1 January 1995  
**Saint Vincent & the Grenadines** 1 January 1995  
**Senegal** 1 January 1995  
**Sierra Leone** 23 July 1995  
**Singapore** 1 January 1995  
**Slovak Republic** 1 January 1995  
**Slovenia** 30 July 1995  
**Solomon Islands** 26 July 1996  
**South Africa** 1 January 1995  
**Spain** 1 January 1995  
**Sri Lanka** 1 January 1995  
**Suriname** 1 January 1995  
**Swaziland** 1 January 1995  
**Sweden** 1 January 1995  
**Switzerland** 1 July 1995  
**Chinese Taipei** 1 January 2002  
**Tanzania** 1 January 1995  
**Thailand** 1 January 1995  
**Togo** 31 May 1995  
**Trinidad and Tobago** 1 March 1995  
**Tunisia** 29 March 1995  
**Turkey** 26 March 1995  
**Uganda** 1 January 1995  
**United Arab Emirates** 10 April 1996  
**United Kingdom** 1 January 1995  
**United States of America** 1 January 1995

Uruguay 1 January 1995  
Venezuela 1 January 1995  
Zambia 1 January 1995  
Zimbabwe 5 March 1995

***Observer governments***

Algeria  
Andorra  
Azerbaijan  
Bahamas  
Belarus  
Bhutan  
Bosnia and Herzegovina  
Cambodia  
Cape Verde  
Equatorial Guinea  
Ethiopia  
Holy See (Vatican)  
Kazakhstan  
Lao People's Democratic Republic  
Lebanese Republic  
Nepal  
Russian Federation  
Samoa  
Sao Tome and Principe  
Saudi Arabia  
Serbia and Montenegro  
Seychelles  
Sudan  
Tajikistan  
Tonga  
Ukraine  
Uzbekistan  
Vanuatu  
Viet Nam  
Yemen

**Note:** With the exception of the Holy See, observers must start accession negotiations within five years of becoming observers.

***International organizations observers to General Council:***

(observers in other councils and committees differ)

United Nations (UN); United Nations Conference on Trade and Development (UNCTAD); International Monetary Fund (IMF); World Bank; Food and Agricultural Organization (FAO); World Intellectual Property Organization (WIPO); Organization for Economic Co-operation and Development (OECD).

## ANNEX III. ARTICLE 24

### *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.

## **ANNEX IV. OTHER GATT/WTO PROVISIONS ON PREFERENTIAL TRADE AGREEMENTS**

While Article 24 is the principal means for GATT members to derogate from the non-discrimination obligation and to grant preferences to other countries, there are also some other provisions concerning preferential trading arrangements which constitute exceptions to the MFN principle: Firstly, as a general GATT provision *Article 25 (waivers)* allows the contracting parties acting jointly to grant waivers from obligations under the GATT. This provision has on occasion been used to authorise preferential agreements that could not satisfy the rules of GATT specifically relating to regional trading arrangements. Even if a preferential trading arrangement is not compatible with the requirements of Article 24 and, therefore, is inadmissible, Article 25 of the GATT can be resorted to grant waivers to make this arrangement GATT-legal. Since the beginning of the GATT system, 28 waivers from Article I were granted. To achieve such a waiver, the parties to the agreement have to prove that it is being formed because of “exceptional circumstances” and such a derogation must be approved by at least two-thirds of GATT contracting parties. Under the WTO, waivers are still feasible but are time-limited.

The European Coal and Steel Community (ECSC), which could not qualify as a customs union, was an important example in this respect. Although it could not meet the “substantially-all-trade” requirement because of its limited product coverage, was authorised by a waiver from the obligation of GATT in 1952. However, a majority of the 28 waivers from Article 1 have involved preferences granted by developed countries to developing ones on a non-reciprocal basis. A recent example to this is the waiver granted in December 1994 to the EC for preferential treatment on imports from African Caribbean and Pacific Group (ACP) states under the Fourth Lome Convention.

Secondly, *Part IV of the GATT on “Trade and Development”* (Articles 36, 37 and 38) establishes the principle of non-reciprocity in trade negotiations between developed and developing countries and ensures the developed countries to adopt special measures to promote the expansion of imports from developing countries. The aim of that part of which was incorporated into the GATT in 1965 is to promote trade and development of developing contracting parties. In some cases, developed country parties to agreements

with developing countries have invoked Part IV in working parties of Article 24 to justify preferential, non-reciprocal access for developing country members. For example, the EU in the context of the First, Second and Third Lome Conventions.

The third exception to the MFN principle, which is called the Enabling Clause,<sup>1</sup> was agreed in 1979 during the Tokyo Round of negotiations. That was a significant revision of the GATT since the Enabling Clause incorporates a number of provisions into the GATT as a legal cover for preferential agreements between developing countries. This clause permits signatory developing countries to grant differential and more favourable treatment to each other's trade at the expense of imports originating in non-members despite the MFN principle.

Although the Enabling Clause is subject to some conditions<sup>2</sup>, developing countries were allowed to adopt preferential tariffs under less strict conditions than in Article 24. Developing countries may invoke the Enabling Clause allowing them to establish customs unions (like Mercosur) and free trade areas that do not meet the conditions of Article 24. Additionally, under the legal cover provided by the Enabling Clause GATT contracting parties have granted favourable treatment to the developing country members. Generalised System of Preferences (GSP), waiving the provisions of Article 1 in its application to the developing countries, is an important example to trade concessions granted to the developing countries through this clause.

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<sup>1</sup> The 1979 Decision on Differential and More Favourable Treatment of Developing Countries

<sup>2</sup> The arrangements must not contemplate the selective removal of non-tariff barriers, in which case approval by other GATT contracting parties is required. Any such arrangement must be designed to facilitate and promote the trade of developing countries and not to raise barriers to or to create undue difficulties for the trade of any other contracting parties. Furthermore, the Enabling Clause requires that those arrangements must not impede the reduction or elimination of tariffs and non-tariff barriers on an MFN basis. (Sampson, 1996b, p. 22)

**ANNEX V. LEADING EXPORTERS AND IMPORTERS IN WORLD  
MERCHANDISE TRADE (EXCLUDING INTRA-EU TRADE), 2002**

**(Billion dollars and percentage)**

Rank	Exporters	Value	Share	Annual percentage change	Rank	Importers	Value	Share	Annual percentage change
1	Extra-EU exports	939.0	19.1	6	1	United States	1202.5	23.2	2
2	United States	693.5	14.1	-5	2	Extra-EU imports	931.3	18.0	1
3	Japan	416.0	8.5	3	3	Japan	336.4	6.5	-4
4	China	325.6	6.6	22	4	China	295.2	5.7	21
5	Canada	252.5	5.1	-3	5	Canada	227.6	4.4	0
6	Hong Kong, China	200.6	4.1	5	6	Hong Kong, China	208.6	4.0	3
	domestic exports	16.7	0.3	-18		retained imports <sup>a</sup>	24.7	0.5	-21
	re-exports	183.9	3.7	8	7	Mexico	176.5	3.4	0
7	Korea, Rep. of	162.5	3.3	8	8	Korea, Rep. of	152.1	2.9	8
8	Mexico	160.8	3.3	1	9	Singapore	116.2	2.2	0
9	Chinese Taipei	130.3	2.6	6		retained imports <sup>a</sup>	9.4	0.2	-27
10	Singapore	125.6	2.6	3	10	Chinese Taipei	112.6	2.2	5
	domestic exports	67.0	1.4	1					
	re-exports	58.6	1.2	5					
11	Russian Fed.	106.9	2.2	4	11	Switzerland	83.5	1.6	-1
12	Malaysia	95.7	1.9	9	12	Malaysia	80.2	1.5	9
13	Switzerland	87.6	1.8	7	13	Australia	72.7	1.4	14
14	Saudi Arabia	73.9	1.5	1	14	Thailand	64.5	1.2	4
15	Thailand	68.6	1.4	5	15	Russian Fed.	60.0	1.2	12
16	Australia	65.0	1.3	3	16	India	56.3	1.1	12
17	Brazil	60.4	1.2	4	17	Poland	54.8	1.1	9
18	Norway	60.3	1.2	2	18	Brazil	49.5	1.0	-15
19	Indonesia	52.0	1.1	0	19	Turkey	48.8	0.9	18
20	India	50.0	1.0	15	20	Czech Rep. <sup>b</sup>	40.6	0.8	11
21	United Arab Emirates	40.4	0.8	-2	21	United Arab Emirates	40.6	0.8	4
22	Poland	40.4	0.8	12	22	Hungary	37.0	0.7	10
23	Czech Rep.	36.8	0.7	10	23	Philippines	35.5	0.7	13
24	Philippines	35.6	0.7	9	24	Israel	35.2	0.7	-1
25	Turkey	34.8	0.7	11	25	Norway	34.6	0.7	5
26	Hungary	33.7	0.7	11	26	Indonesia	31.3	0.6	1
27	South Africa	29.7	0.6	2	27	Saudi Arabia	31.2	0.6	0
28	Israel	29.5	0.6	1	28	South Africa	29.4	0.6	3
29	Venezuela	26.9	0.5	-2	29	Iran, Islamic Rep. of	21.4	0.4	20
30	Argentina	25.4	0.5	-5	30	Viet Nam	19.4	0.4	21
	Total of above <sup>c</sup>	4460.0	90.6	-		Total of above <sup>c</sup>	4536.0	90.5	-
	World (excl. intra-EU trade) <sup>c</sup>	4922.1	100.0	4		World (excl. intra-EU trade) <sup>c</sup>	5178.4	100.0	3

<sup>a</sup> Retained Imports are defined as Imports less re-exports.

<sup>b</sup> Imports are valued f.o.b.

<sup>c</sup> Includes significant re-exports or imports for re-export.

Source: WTO

## ANNEX VI.

## Merchandise trade of selected regional integration arrangements, 2002

(Billion dollars and percentage)

	Value	Share in total exports/imports				Annual percentage change		
		2002	1990	1995	2000	2002	1995-00	2001
<b>APEC (21)</b>								
Total exports	2779	100,0	100,0	100,0	100,0	6	-8	3
Intra-exports	2023	67,5	72,4	72,7	72,8	6	-9	4
Extra-exports	756	32,5	27,6	27,3	27,2	6	-5	-1
Total imports a	3068	100,0	100,0	100,0	100,0	7	-7	4
Intra-imports	2148	65,4	71,7	71,2	70,0	7	-8	4
Extra-imports	920	34,6	28,3	28,8	30,0	7	-2	3
<b>EU (15)</b>								
Total exports	2449	100,0	100,0	100,0	100,0	2	0	6
Intra-exports	1509	64,9	64,0	62,4	61,6	2	-1	5
Extra-exports	940	35,1	36,0	37,6	38,4	3	1	6
Total imports	2447	100,0	100,0	100,0	100,0	3	-2	4
Intra-imports	1514	63,0	65,2	60,3	61,9	2	-1	5
Extra-imports	933	37,0	34,8	39,7	38,1	6	-4	1
<b>NAFTA (3)</b>								
Total exports	1107	100,0	100,0	100,0	100,0	7	-6	-4
Intra-exports	626	42,6	46,0	55,7	56,5	12	-6	-2
Extra-exports	481	57,4	54,0	44,3	43,5	3	-6	-6
Total imports b	1599	100,0	100,0	100,0	100,0	11	-6	2
Intra-imports	609	34,4	37,7	39,6	38,1	12	-7	-2
Extra-imports	990	65,6	62,3	60,4	61,9	10	-6	4
<b>ASEAN (10)</b>								
Total exports	405	100,0	100,0	100,0	100,0	6	-10	5
Intra-exports	97	20,1	25,5	24,0	24,0	5	-12	8
Extra-exports	308	79,9	74,5	76,0	76,0	6	-9	4
Total imports	353	100,0	100,0	100,0	100,0	1	-8	5
Intra-imports	83	16,2	18,8	23,7	23,6	5	-12	9
Extra-imports	270	83,8	81,2	76,3	76,4	-1	-7	4
<b>CEFTA (7)</b>								
Total exports	157	-	100,0	100,0	100,0	7	11	14
Intra-exports	19	-	14,6	12,1	12,2	3	14	12
Extra-exports	138	-	85,4	87,9	87,8	8	11	14
Total imports	187	-	100,0	100,0	100,0	8	8	11
Intra-imports	19	-	11,3	9,6	10,2	5	13	13
Extra-imports	168	-	88,7	90,4	89,8	9	7	11
<b>MERCOSUR (4)</b>								
Total exports	89	100,0	100,0	100,0	100,0	4	4	1
Intra-exports	10	8,9	20,5	21,0	11,5	4	-14	-33
Extra-exports	78	91,1	79,5	79,0	88,5	4	9	8
Total imports	62	100,0	100,0	100,0	100,0	2	-6	-26
Intra-imports	11	14,5	18,1	19,8	17,0	4	-11	-33
Extra-imports	52	85,5	81,9	80,2	83,0	2	-5	-24
<b>ANDEAN (5)</b>								
Total exports	53	100,0	100,0	100,0	100,0	8	-9	0
Intra-exports	5	4,2	12,3	8,9	10,2	1	12	-7
Extra-exports	48	95,8	87,7	91,1	89,8	9	-11	1
Total imports c	39	100,0	100,0	100,0	100,0	1	12	-10
Intra-imports	5	7,7	12,9	13,8	13,9	2	8	-6
Extra-imports	34	92,3	87,1	86,2	86,1	0	12	-11

a Imports of Canada, Mexico and Australia are valued f.o.b.

b Imports of Canada and Mexico are valued f.o.b.

c Imports of Venezuela are valued f.o.b.

Note: The figures are not fully adjusted for differences in the way members of the arrangements in this table record their merchandise trade.

**ANNEX VII.**
**Intra- and inter-regional merchandise trade, 2002**

(Billion dollars and percentage)

Origin	Destination							World
	North America	Latin America	Western Europe	C./E. Europe/Baltic States/CIS	Africa	Middle East	Asia	
<b>Value</b>								
North America	382	152	170	7	12	20	204	946
Latin America	215	54	44	3	4	5	23	350
Western Europe	270	55	1787	168	66	68	208	2657
C./E. Europe/Baltic States/CIS	14	6	176	80	4	7	24	314
Africa	24	5	71	1	11	3	24	140
Middle East	38	3	40	2	9	17	116	244
Asia	394	39	260	21	26	48	792	1620
World	1336	315	2549	282	133	169	1391	6272
<b>Share of inter-regional trade flows in each region's total merchandise exports</b>								
North America	40,3	16,1	17,9	0,7	1,2	2,1	21,5	100,0
Latin America	61,3	15,4	12,6	1,0	1,2	1,3	6,7	100,0
Western Europe	10,2	2,1	67,3	6,3	2,5	2,6	7,8	100,0
C./E. Europe/Baltic States/CIS	4,5	1,9	56,2	25,5	1,2	2,4	7,7	100,0
Africa	17,0	3,3	50,9	0,7	8,1	2,3	16,8	100,0
Middle East	15,5	1,4	16,4	0,8	3,8	7,1	47,4	100,0
Asia	24,3	2,4	16,0	1,3	1,6	3,0	48,9	100,0
World	21,3	5,0	40,6	4,5	2,1	2,7	22,2	100,0
<b>Share of regional trade flows in world merchandise exports</b>								
North America	6,1	2,4	2,7	0,1	0,2	0,3	3,2	15,1
Latin America	3,4	0,9	0,7	0,1	0,1	0,1	0,4	5,6
Western Europe	4,3	0,9	28,5	2,7	1,1	1,1	3,3	42,4
C./E. Europe/Baltic States/CIS	0,2	0,1	2,8	1,3	0,1	0,1	0,4	5,0
Africa	0,4	0,1	1,1	0,0	0,2	0,1	0,4	2,2
Middle East	0,6	0,1	0,6	0,0	0,1	0,3	1,8	3,9
Asia	6,3	0,6	4,1	0,3	0,4	0,8	12,6	25,8
World	21,3	5,0	40,6	4,5	2,1	2,7	22,2	100,0



## ANNEX VIII.

## Merchandise trade of the European Union by region and economy, 2002

(Billion dollars and percentage)

Destination	Exports					Origin	Imports				
	Value	Share		Annual percentage change			Value	Share		Annual percentage change	
		2002	1995	2002	2001			2002	2002	1995	2002
<b>Region</b>						<b>Region</b>					
World	2449,0	100,0	100,0	0	6	World	2446,7	100,0	100,0	-2	4
Western Europe	1650,6	69,7	67,4	-1	5	Western Europe	1642,3	69,3	67,1	-1	5
North America	246,5	7,1	10,1	1	5	Asia	281,8	10,9	11,5	-8	4
Asia	188,9	9,3	7,7	-1	5	North America	178,9	7,6	7,3	-4	-6
C./E. Europe/ Baltic States/CIS	156,8	4,3	6,4	13	13	C./E. Europe/ Baltic States/CIS	154,3	4,2	6,3	7	12
Africa	62,5	2,8	2,6	4	4	Africa	71,0	3,0	2,9	-1	-2
Middle East	61,5	2,4	2,5	7	8	Latin America	49,0	2,2	2,0	-3	4
Latin America	50,8	2,2	2,1	0	-7	Middle East	37,2	1,6	1,5	-16	-6
<b>Economies</b>						<b>Economies</b>					
European Union (15)	1509,2	63,6	61,6	-1	5	European Union (15)	1513,6	63,6	61,9	-1	5
United States	223,9	6,4	9,1	0	5	United States	163,3	6,8	6,7	-4	-6
Switzerland	66,2	3,2	2,7	2	0	China	77,1	1,8	3,1	5	14
Japan	39,1	2,0	1,6	-3	-1	Japan	64,4	3,6	2,6	-15	-5
Poland	34,8	1,0	1,4	2	11	Switzerland	56,1	2,7	2,3	-1	3
Above 5	1873,2	76,2	76,5	-1	5	Above 5	1874,4	78,5	76,6	-2	4
China	31,9	0,9	1,3	15	20	Russian Federation	37,3	1,3	1,5	-1	8
Russian Federation	28,3	1,0	1,2	37	15	Norway	36,9	1,6	1,5	-8	1
Czech Republic	27,0	0,7	1,1	11	12	Poland	26,5	0,8	1,1	11	12
Norway	24,6	1,1	1,0	-1	7	Czech Republic	26,0	0,6	1,1	13	16
Hungary	23,4	0,5	1,0	1	11	Hungary	23,9	0,5	1,0	9	8
Turkey	22,4	0,8	0,9	-35	26	Korea, Republic of	21,0	0,7	0,9	-16	9
Canada	20,8	0,6	0,9	3	7	Turkey	20,8	0,6	0,8	12	15
Hong Kong, China	18,5	1,0	0,8	2	-2	Taipei, Chinese	19,9	0,8	0,8	-11	-6
Korea, Republic of	16,0	0,8	0,7	-8	17	Brazil	16,3	0,7	0,7	1	0
Australia	15,5	0,7	0,6	-4	13	Canada	14,8	0,8	0,6	-6	-8
Brazil	14,4	0,7	0,6	7	-11	South Africa	14,8	0,5	0,6	11	-7
Mexico	14,0	0,3	0,6	4	5	Malaysia	13,5	0,6	0,6	-11	9
Saudi Arabia	13,7	0,5	0,6	6	18	Singapore	12,3	0,6	0,5	-18	8
Singapore	13,3	0,7	0,5	-4	3	India	12,3	0,5	0,5	1	6
United Arab Emirates	13,2	0,4	0,5	13	8	Saudi Arabia	11,6	0,6	0,5	-20	-1
India	12,2	0,6	0,5	-10	11	Algeria	10,7	0,3	0,4	-7	1
Israel	11,7	0,6	0,5	-11	-7	Thailand	10,6	0,4	0,4	-6	-2
South Africa	11,6	0,5	0,5	3	3	Romania	9,8	0,2	0,4	19	17
Taipei, Chinese	10,8	0,6	0,4	-14	-5	Indonesia	9,7	0,4	0,4	-4	0
Romania	10,7	0,2	0,4	17	15	Slovak Republic	9,2	0,2	0,4	14	26
Slovak Republic	8,2	0,2	0,3	17	16	Hong Kong, China	9,1	0,5	0,4	-15	1
Slovenia	8,1	0,3	0,3	1	8	Libyan Arab Jamahiriya	8,9	0,4	0,4	-15	-14
Malaysia	7,6	0,5	0,3	8	-8	Australia	8,3	0,3	0,3	1	0
Algeria	7,6	0,3	0,3	19	14	Israel	7,9	0,3	0,3	-7	-7
Iran, Islamic Rep. of	7,4	0,2	0,3	24	28	Philippines	6,9	0,2	0,3	-9	22
Above 30	2265,9	91,1	92,5	-	-	Above 30	2273,4	92,9	92,9	-	-
<b>Memorandum item:</b>						<b>Memorandum item:</b>					
EU acceding countries	116,0	3,2	4,7	5	12	EU acceding countries	100,9	2,7	4,1	10	12