THE GREATEST CHALLENGE? REGIONAL TRADE ARRANGEMENTS AND THE WORLD TRADE ORGANIZATION

Regionalism is one alternative that has gained particular appeal. Indeed, many observers believe that regional trade arrangements pose the single greatest challenge to the multilateral trade system. Regional trade arrangements pose a challenge to the WTO because they offer an alternative, and often more discriminatory, way to organize world trade.

A **regional trade arrangement (RTA)** is a trade agreement between two or more countries, usually located in the same region of the world, in which each country offers preferential market access to the other. RTAs come in two basic forms: free-trade areas and customs unions. In a **free-trade area**, like the North American Free Trade Agreement, governments eliminate tariffs on other members' goods, but each member retains independent tariffs on goods entering their market from non-members. In a **customs union**, like the EU, member governments eliminate all tariffs on trade between customs union members and impose a common tariff on goods entering the union from non-members.

Because RTAs provide tariff-free market access to some countries, but not to others, they are inherently discriminatory. Though such discrimination is inconsistent with the GATT's core principle, GATT's Article XXIV allows countries to form RTAs as long as the level of protection imposed against nonmembers is no higher than the level of protection applied by the countries prior to forming the arrangement. Nevertheless, the discriminatory aspect of RTAs makes many worry about the impact they will have on the nondiscriminatory trade encouraged by the WTO.

Such worries arise because of the rapid proliferation of RTAs. According to the WTO, there are currently 279 RTAs in operation. If all RTAs now planned are created, there may be as many as 445 RTAs in effect. Free-trade agreements constitute the vast majority of these RTAs, for 86 percent of existing RTAs and for 99 percent of arrangements currently being negotiated. More than half of all RTAs are bilateral agreements. The others are "plurilateral" agreements that include at least three countries. RTAs are densely concentrated in Europe and the Mediterranean region. Agreements between countries in Western, Eastern, and Central Europe, and in the Mediterranean account for almost 50 percent of RTAs in operation. North and South America take second place, accounting for about 12 percent. Until quite recently, sub-Saharan Africa and Asia-Pacific states have joined few RTAs.

RTAs have emerged in three distinct waves (see Figure 2.1). The first wave began early in the 1950s and extended to the mid-1970s. This wave began with the construction of the original European Economic Community in 1958 and the Latin American Free Trade Area in 1960, and concluded with the formation of the Economic Community of West African States in 1975. This wave was motivated in part by a desire to promote deeper economic cooperation within particular regions in an attempt to promote peace and achieve more rapid economic development. In this regard, the contribution of the EEC to Franco-German political reconciliation after World War II and to rapid postwar economic recovery encouraged governments in other regions to emulate the approach. This early enthusiasm waned, however, as the economic gains realized in Europe did not materialize in the so-called developing world imitators.

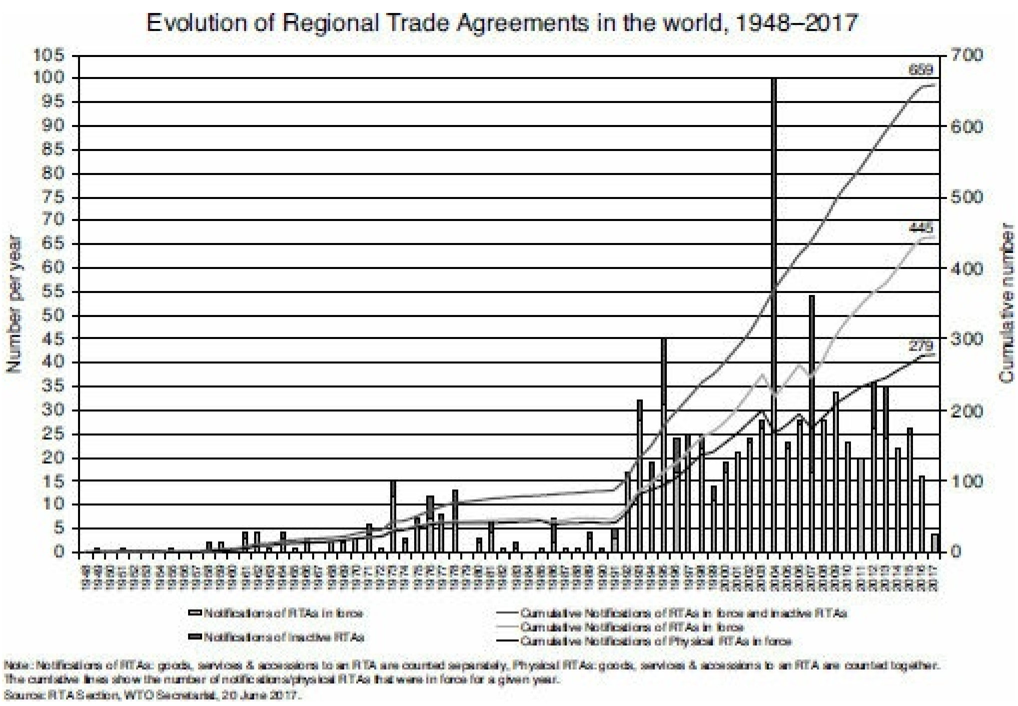

FIGURE 2.1

Regional Trade Arrangements, 1950–2016

Source: The World Trade Organization, WTO Secretariat, RTA Section, 20 June 2017.

The second wave began in the context of far-reaching trade policy reforms in Eastern and Central Europe, the former Soviet Union, and other developing countries. Governments in former members of the Soviet Bloc, for instance, sought new ways to organize their trade, and sought access to Western European markets. Consequently, a large number of agreements were reached between countries within the region and between these countries and the EU (WTO 2000). Moldova, for example, entered RTAs with eight other newly independent countries formed from the former Soviet Union between 1992 and 1996. Russia entered at least nine RTAs with this same set of countries. Ten Eastern and Central European countries reached bilateral RTAs with the European Union between 1991 and 1997. There were also substantial changes in developing-country trade policies in the late 1980s and early 1990s, which led to a greater willingness to enter RTAs (WTO 2000). Mexico, for example, negotiated RTAs not only with the United States and Canada (NAFTA), but also with Chile, Costa Rica, and Nicaragua. Chile negotiated RTAs with Colombia, Ecuador, and Peru, in addition to completing the agreement it reached with Mexico.

The third wave began in 2008 or so and has been closely associated with the so-called **mega-regional agreements**. The two most prominent of these mega-regional agreements are the Trans-Pacific Partnership (TPP), negotiated between the U.S. and the EU, and the Transatlantic Trade and Investment Partnership (TTIP), which was negotiated by 13 states in Asia and North and South America. A third mega-regional, the Regional Comprehensive Economic Partnership, ties China to 15 other economies throughout Asia and the Pacific. In contrast to previous waves, which tended to focus most heavily on trade liberalization, the mega-regional agreements seek deeper economic integration among their members. To achieve this goal, these agreements are both broader in scope and reach more deeply into domestic arrangements than prior agreements. The TTIP and the TPP were intended to promote cooperation and harmonization on technical barriers to trade, which are domestic rules, regulations, and administrative procedures that can limit trade flows. In addition, these agreements included trade in services, more ambitious rules regarding the protection of intellectual property than are present in the WTO and agreement on the treatment and protection of foreign investment. The TPP included most of these issues as well as an elaborate and enforceable code on labor standards.

Why have RTAs proliferated, especially since 1990? Scholars have advanced a number of general explanations for this trend. Some emphasize a country's desire to gain more secure access to the market of a particularly important trading partner. In the U.S.–Canada Free Trade Agreement concluded in the late 1980s, for example, Canada sought secure access to the U.S. market—the most important destination for Canada's exports. During much of the 1980s, the United States made frequent use of anti-dumping and countervailing duty investigations to protect American producers from Canadian imports. Such measures clearly interfered with the ability of Canadian producers to export to the American market. The Canadian government hoped that the U.S.–Canada Free Trade Agreement would give Canada "some degree of exemption" from these measures (Whalley 1998, 72–73).

Other scholars emphasize a government's need to signal a strong commitment to economic reform. Governments use RTAs to convince foreign partners that they will maintain open markets and investor-friendly policies. This argument has been applied most commonly to Mexico's decision to seek a free-trade agreement with the United States. Mexico shifted from a highly protectionist to a more liberal trade policy in the mid-1980s. The success of that strategy hinged in part on Mexico's ability to attract foreign investment from the United States. The Mexican government feared, however, that American investors would not believe that the Mexican government was committed to its new strategy. What would prevent Mexico from shifting back to protectionism and nationalizing foreign investments? If American businesses didn't believe the Mexican government was committed to this liberal strategy, they would be reluctant to invest in Mexico. Absent American investment, Mexico would be deprived of foreign capital that was critical to the success of its strategy.

A free-trade agreement with the United States allowed Mexico to signal to American investors the depth of its commitment to market liberalization. It did so in part because NAFTA contained very clear and enforceable rules concerning the treatment of foreign investment located in Mexico. A similar argument might be used to understand at least part of the interest that Eastern and Central European governments had in signing free-trade agreements with the EU. These governments were also reorienting their economic policies and were trying to attract foreign investment. Like Mexico, they might have needed an external institution, such as an agreement with the EU, to signal to foreign investors their commitment to market reforms. Notice that these arguments actually place less emphasis on the trade benefits that might result from an RTA and focus more on the need to attract foreign investment.

Other scholars argue that countries enter RTAs to increase their bargaining power in multilateral trade negotiations. A small country bargaining individually in the WTO lacks power because it does not have a large market to offer. By pooling a group of small countries, the market that can be offered to trade partners in WTO negotiations increases substantially. Consequently, each member might gain larger tariff concessions in WTO negotiations. Current American enthusiasm for RTAs might also be seen as an attempt to gain bargaining power in the WTO. As it has become more difficult to reach decisions within the WTO, the United States has explicitly threatened to rely more on free-trade agreements. By doing so, the United States denies its market to countries unwilling to make concessions in the WTO. The fear of losing access to the U.S. market could induce governments to make concessions in the WTO that they would not otherwise make. The threat to rely more on RTAs and less on the WTO, therefore, enhances American power in the organization.

Finally, and clearly relevant to the emergence of the mega-regional agreements, the impasse in the Doha Round encouraged states to find other paths along which to pursue their trade policy goals. These agreements have enabled the EU, the U.S., Canada, Mexico, and South American countries with Pacific ties, as well as a few partners in Asia to pursue economic integration on issues of common interest and concern that they could not address in the WTO, given the resistance by many members to the initiation of negotiations on new issues. Digital trade, for instance, which is commerce in products that are delivered via the Internet (such as music, video, apps, e-books, etc), constitutes an important and growing share of the global economy and international trade. Current estimates indicate that its total value is $4.2 trillion worldwide (U.S. International Trade Commission 2013). Yet, in spite of its growing importance, the issue was kept out of the Doha Round. Within the mega-regionals, governments could negotiate extensive rules to govern this trade. Moreover, the growing importance of global value chains has provided multinational businesses with a strong incentive to pressure their governments to negotiate these deeper agreements in order to better protect their investments, to harmonize product standards across national markets, and to make it easier and cheaper to ship goods across national boundaries (Baldwin 2014).

The rapid growth of RTAs raises questions about whether they challenge or complement the WTO. This is not an easy question to answer. On the one hand, RTAs liberalize trade, a mission they share with the WTO. In this regard, RTAs complement the WTO. On the other hand, RTAs institutionalize discrimination within world trade. In this regard, RTAs challenge the WTO.

Economists conceptualize these competing consequences of RTAs as **trade creation** and **trade diversion**. Consider an RTA between France and Germany. Because the RTA eliminates tariffs on trade between France and Germany, more Franco-German trade takes place. This is trade creation. Because the RTA does not eliminate tariffs on trade between France and Germany on the one hand, and the United States on the other, some trade between the United States and Germany is replaced by trade between France and Germany. This is trade diversion. An RTA's net impact on trade is the difference between the trade it creates and the trade it diverts. If more trade is created than diverted, the RTA has liberalized trade. If more trade is diverted than created, the RTA has pushed the world toward protectionism.

Which of these effects predominates in existing RTAs? Nobody really knows, in large part because it is difficult to evaluate trade creation and trade diversion empirically. It is especially difficult once we begin to think about how RTAs evolve once created. An RTA that originally diverts more trade than it creates might over time create more trade than it diverts. Or an RTA could evolve in the opposite direction. Consider the first case. Some scholars have argued that RTAs exert a kind of gravitational force on countries that are not currently members. Countries that do not belong to the EU, but that engage in lots of trade with it, have a strong incentive to join. So it is no surprise, therefore, that over the last 40 years the EU has expanded from six to 25 member countries. Some see a similar dynamic at work in the Western Hemisphere. Mexico's decision to seek a free-trade agreement with the United States was at least partially motivated by concerns about the cost of being outside a U.S.–Canada Free Trade Area that had been negotiated in the late 1980s (Gruber 2000). The interest of many Latin American countries in a Free Trade Area of the Americas (FTAA) is at least partially a consequence of Mexico's entry into NAFTA (Baldwin 1995). Over time, this gravitational pull attracts so many additional members that a regional RTA evolves into a global free-trade area. In this optimistic scenario, RTAs lead eventually to global free trade in which trade creation outweighs trade diversion and RTAs complement the WTO.

Policy Analysis and Debate

The United States and the TPP

Question

Should the United States embrace aggressive bilateralism?

Overview

The Trump administration appears committed to a strategy of aggressive bilateralism in its trade relationships with the rest of the world. In its first major outline of trade policy, submitted to Congress in March 2017, the USTR stated that the guiding principle for its policy was to “expand trade in a way that is freer and fairer for all Americans.” And it stated that this goal “can be best accomplished by focusing on bilateral trade negotiations rather than multilateral negotiations—and by renegotiating and revising trade agreements” when necessary. Consequently, one of the first steps the Trump administration took upon entering office was to withdraw the U.S. from the TPP. In April of 2017, President Trump called the WTO “another one of our disasters” and ordered the Department of Commerce to undertake an extensive review of WTO rules. One month later, the administration notified Congress of its intention to renegotiate NAFTA, and in September 2017, Trump and other administration officials began to speak publicly about scrapping the U.S.–South Korea Free Trade Agreement. At present, the administration has wavered on its orientation toward TTIP and has yet to state publicly whether it intends to withdraw from this agreement as well.

The administration’s stated rationale for these changes is twofold. First, members of the administration assert that existing trade agreements between the United States and other countries put the U.S. at an “unfair advantage in global markets” (USTR 2017). Foreign governments enact unfair trade policies and practices such as subsidies, piracy of intellectual property, and currency manipulation that “harm American workers, farmers, ranchers, services providers, and other businesses” (ibid). And the WTO and other international enforcement mechanisms do not permit the U.S. to take steps to punish such transgressions. Second, the administration asserts that it can negotiate a series of bilateral trade agreements that prevent these unfair practices. It intends to use these bilateral negotiations to “hold our trading partners to higher standards of fairness” and will use American trade law “in response to trading partners that continue to engage in unfair activities.”

Policy Options

- The United States should retain its postwar policy based on multilateral cooperation within the WTO supplemented by regional trade agreements.
- The United States should be more aggressive in its trade relationships and the shift to bilateralism is a good way to implement such an approach.

Policy Analysis

- Does the United States derive benefits from the mega-regionals and the WTO that it cannot otherwise enjoy?
- How disadvantaged are American producers by unfair trade practices?

Take a Position

- Which option do you prefer? Justify your choice.
- What criticisms of your position should you anticipate? How would you defend your recommendation against these criticisms?

Resources

Online: Visit the U.S. Trade Representative website (www.ustr.gov) for timely information about current negotiations. The fullest statement of the Trump administration's approach is in the USTR's "The President's 2017 Trade Policy Agenda," which you can find at the Resource Center at USTR.gov

In Print: See Jeffrey J. Schott, *US Trade Policy Options in the Pactific Basin: Bigger is Better, PB17-7* (Washington, DC: Peterson Institute for International Economics, 2017); Doug Irwin, 2017, "The False Promise of Protectionism," *Foreign Affairs* 96 (May/June): 45–56.

By contrast, the creation of a large RTA in one region could encourage the formation of rival and more protectionist RTAs in other regions. In this scenario, NAFTA as well as FTAA could be seen as an American response to the EU. An emerging free-trade area in Pacific Asia could be seen as a response to regionalism in Europe and the Western Hemisphere. In this view, world trade is becoming increasingly organized into three regional and rival trade blocs. Once regional trading blocs have formed, each bloc might raise tariffs to restrict trade with other regions. A tariff increase by one RTA could provoke retaliation by the others, leading to a rising spiral of protection that undermines global trade liberalization (Frankel 1997, 210). In this case, trade diversion outweighs trade creation and RTAs pose an obvious challenge to the WTO.

It is impossible to predict which of these two scenarios is the more likely. The world does seem to be moving toward three RTAs: one in Europe, one in the Western Hemisphere, and one in Asia. At the same time, governments appear to be aware of the challenges RTAs pose to the WTO, as they have created a WTO committee on RTAs that is exploring the relationship between these arrangements and the multilateral system. Only time will tell, however, whether RTAs will develop into discriminatory trade blocs that engage in tariff wars or if instead they will pave the way for global free trade.

CONCLUSION

The multilateral trade system is an international political system. It provides rules that regulate how governments can use policies to influence the cross-border flow of goods and services. It provides a decision-making process through which governments revise existing rules and create new ones. And it provides a dispute-settlement mechanism that allows governments to enforce common rules. By promoting nondiscriminatory international trade, by establishing a formal process for making and revising rules, and by allowing governments to enforce the rules they create, the WTO reduces the impact of raw power on international trade relationships. In short, the WTO brings the rule of law to bear in international trade relations.

Like all political systems, the WTO reflects the interests of the powerful. Its creation reflected the interests of a hegemonic United States; its strengthening during the Cold War era reflected the growing interest of European and Japanese governments that trade liberalization promised real gains. Although one can argue that the WTO reflects only the interests of the advanced industrialized countries, the trends over the last 20 years suggest otherwise. The rapid growth in the number of countries joining the WTO during that period suggests that most of the world's governments believe that they are better off with the WTO than without it. This doesn't mean that the system is perfect. It does suggest, however, that in the contemporary global economy, the majority of the world's governments believe that they do better when world trade is organized by a system based on nondiscrimination and market liberalism than they do in a discriminatory, protectionist, and rule-free environment. The WTO will weaken, and perhaps even crumble, when governments no longer believe this is true.

The largest contemporary challenges to the WTO emerge from the ability of its decision-making process to continue to produce outcomes in a changing world. On the one hand, the growth of WTO membership and the emergence of the G-20 as a powerful bloc within the organization has raised the stakes of trade negotiations and made it more difficult to find packages acceptable to the full membership. On the other hand, the emergence of a vocal NGO movement critical of the WTO's apparent tendency to place business interests before consumer interests has made it even more difficult to reach agreements within the organization. The full consequences of these two challenges remain uncertain. Can governments reform decision making in the system in a way that simultaneously enhances its legitimacy and efficiency? Or will continued decision-making paralysis impart additional impetus to regionalism?

KEY TERMS

Customs Union
Dispute Settlement Mechanism
The Doha Round
Free Riding
Free-Trade Area
Generalized System of Preferences
Hegemon
Hegemonic Stability Theory
Intergovernmental Bargaining
Market Liberalism
Mega-Regional Agreements
Ministerial Conference
Most-Favored Nation
National Treatment
Nondiscrimination
Non-tariff Barriers
Public Good
Regional Trade Arrangement (RTA)
Tariffs
Trade Creation
Trade Diversion