
Regional Trade Agreements (RTAs): A Controversial Issue

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ABSTRACT

Regional trade agreement (RTAs) since 1990s changed the world trade landscape. We know that when two countries or region become member of any regional trading bloc, they are more likely to gain from it. There has been consistent rise in the number of RTAs since 1990s. Initially these agreements are taken as compliment to WTO but with the passage of time these became substitute of it. Diversion of trade through this route has become a controversial issue among economists. In this context, the present study attempt to provide an assessment of the welfare effect of these blocs i.e. whether these blocs create trade or divert by compilation of some of the studies related to this issue. The extensive theoretical and empirical studies show that RTAs lead to increase trade than decrease. Some concluded that regional trading blocs are trade diverting. There always remain controversy among economists regarding these blocs but after these studies it is cleared that these blocs are trade creating rather than trade diverting.

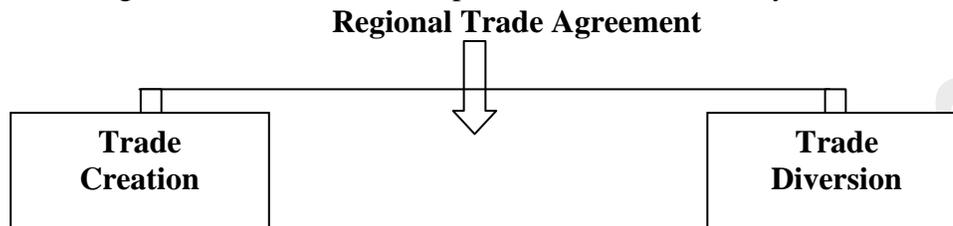
INTRODUCTION

One of the most striking developments in the world trading system since mid 1990s is a surge in regional trade agreements (RTAsⁱ). Every country is member of at least one regional bloc. Commenting on this trend, WTO Annual Report (2003) notes that: “The rapid growth in regional trade initiatives began a decade or so ago and seems to have developed into a headlong race; virtually every WTO member is today further on the RTA track as part of its trade strategy, increasingly for defensive sense, to protect market access.... The proliferation of RTAs, especially as their scope broadens to include policy areas not regulated multilaterally, increase the risks of inconsistency in the rules and procedures among RTAs themselves, and between RTAs and multilateral framework. This is likely to give rise to regulatory confusion, distortion of regional markets, and severe implementation problems, especially where there are overlapping RTA”ⁱⁱ.

When a country becomes a member of any regional bloc, it strengthens its ties among the members by granting tariff concessions for and elimination of protectionist barriers that lead to increase movements of goods and services among members at the cost of non-members. In other words, it is diversion of trade and also diversion from Most Favoured Nation (MFNⁱⁱⁱ) clause the soul of the whole philosophy of WTO. However, initially WTO encouraged the growth of RTA as a complement to it. But, the high proliferation of RTAs in global environment and diversion of trade through this route is increasingly become a cause of concern for WTO. The WTO annual report 2003 expressed a deep concern about this latest development and comments:

“RTAs can complement the multilateral trading system, help to build and strengthen it. But by their very nature RTAs are discriminatory; they are a departure from the MFN principle, a cornerstone of the multilateral trading system. Their effects on general trade liberalisation and

economic growth are not clear given that the regional economic impact of RTAs is ex-ante inherently ambiguous”.^{iv} No doubt, these blocs are beneficial for underdeveloped and developing countries more than developed, but diversion of trade^v through this route is increasingly become a cause of concern for WTO and a controversial issue among economists i.e. whether these blocs are trade creating or trade diverting. In this context, the present paper attempt to analyse this issue by reviewing some theoretical and empirical studies that already exists.



THEORETICAL AND EMPIRICAL LITERATURE

TRADE CREATION

It is trade creation when a member country starts importing some products from another member country instead of producing it domestically and because of difference in cost (after the formation of bloc), what it previously produced at home, new trade is created and increases welfare of the economy as whole.

Theoretical and Empirical Studies Related to Trade Creation

The traditional theory of gains from trade suggests that reduction/elimination of trade barriers between or among countries allows consumers and producers to purchase from the cheapest and most competitive source of supply. This enhances efficiency and increases welfare. Following this logic, it was traditionally believed that regional trade agreements should generate gains from trade when member countries reduce/remove trade barriers among themselves. This view was firstly challenged by **Viner (1950)** in his book entitled “The Customs Union Issues”. He introduced the concepts of trade creation and trade diversion to measure the effect of RTAs. He showed that the net effect of trade liberalisation at regional level is not necessarily positive. In Viner’s own words-“...where the trade diverting effect is predominant, one at least of the member countries is bound to be injured, the two combined will suffer a new injury, and there will be injury to theoretical world and to the world at large” (Viner, 1950, p.44). Viner’s analysis showed that the net welfare effect of these trading blocs entirely depends upon which of these two (trade creation and trade diversion) effects dominate.^{vi}

According to **Lipsey (1957) and Summers (1991)**, the chances of trade diversion is minimal if the member countries are geographically proximate and have very high trade dependence upon each other. **Aitken’s (1973)** study was the first to include a dummy variable to estimate the effect of a PTA, which takes a value of one if the two trading countries are members of the same agreement and zero otherwise. A positive coefficient on this variable indicated that the PTA tended to generate more trade among its members i.e. trade creating. **Kemp and Wan (1976)** stated that if external tariffs are adjusted then the formation of a CU does not affect trade with outsiders, the union is surely welfare improving.

Bergstrand (1985), Thursby and Thursby (1987), Brada and Mendez (1988) and De (1998) showed that European bloc's trade increased during the 1960s and 1970s. **Wonnacott and Lutz (1989)** showed that, other things remain constant, since proximity between PTA members tended to increase trade among them; it will lead to reduce the extent of trade diversion and increase the benefits of PTAs. **Summers (1991)** is of the opinion that RTAs are likely to be welfare augmenting because trade diversion is only likely to have a benign impact on the non-member countries. **Frankel (1997) and Frankel and Wei (1993, 1997)** found evidence of trade creation in Asian and North American trading blocs from 1970s to 1992. **Foroutan and Pritchett (1993)** in their study showed that as number of RTAs tended to increase in Sub Saharan African, there was very limited scope of intra-trade that means less trade was created. **Krugman (1993)** also expressed the similar views, that the welfare effects of these are enough inherent in the transport costs between the member countries of the RTAs. **Robinson et al. (1993)** stated that the impact of RTA on TC and TD depends on the export capacity of the partner country and whether the partner country faces constant costs.

Jacquemin and Spair (1991), Wonnacott and Lutz (1989), Langhammer (1992) also concluded in their studies that RTAs are trade creating. **Park (1995)** in his study stated that the smaller the intra-regional shares in total trade; more will be the chance of trade diversion through RTA. **Bayoumi and Eichengreen (1997)** used augmented model and included another dummy variable to represent extra-bloc trade, which takes the value of one for bilateral trade between a PTA member and a non-member country. Results showed that PTAs tended to increase trade between members and the rest of the world and thereby foster greater trade worldwide. **De Rosa (1998)** suggested that in order to prevent trade diversion, RTA member countries should reduce trade barriers with non-member countries as they do for members. **Baldwin (1997) and Panagariya (1996)** in his study revealed that RTAs may be beneficial or harmful but it depends upon the particular countries involved and the extent of the trade creation relative to that of trade diversion.

Garman et al. (1998) and Soloaga and Winters (2001) examined regional trading agreements in Latin America and found evidences of trade creation. **Burfisher et al. (2001)** showed that the effect of RTA (trade creation and trade diversion) depends on parameter values and initial economic structure of related countries. **Cernat (2001)** assessed regional trade arrangement in South-South RTAs (AFTA, CARICOM, COMESA, ECOWAS, MERCOSUR and SADC) and showed that contrary to the feared negative impacts RTAs are not more trade diverting than other RTAs. **Clausing (2001)** examined the impact of Canada-United States (US) Free Trade Agreement (CUSFTA) on pattern of trade and also growth of trade both with member and non-member countries. Results indicated that CUSFTA has substantial trade creation effect and little trade diversion is occurred. **Feenstra et al. (2001), Frankel and Rose (2002), Frankel et al. (1995) and Frankel (1997)** showed that regional trading blocs are trade creating.

Chang and Alan (2002) studied the effects of Southern Common Market (Mercosur) a trading regional bloc on export prices of Brazil. They found that Argentina's export prices continued to increase, whereas the export prices of countries outside Mercosur fell. These price effects indicated that Mercosur has hurt outsiders while helping Argentina (the Mercosur partner). **Lee and Shin (2006)** revealed that preferential regional trading blocs involving natural trading partners located. **Koo et al. (2006)** used dummy variables in gravity model to examine the impact of regional preferential trade agreements (RPTAs) (ASEAN FTA, CAN, EU and

NAFTA) on agricultural trade i.e. trade creation and trade diversion (non-member countries). Results of the study showed that regional trading blocs are trade creating, increased trade volume through both inter and intra-industry trade. RPTAs are not harmful for non-member countries. **Jayasinghe and Sarker (2008)** analysed the trade creation and trade diversion effects of NAFTA on trade in six important agri-food products. For this, they used extended gravity model and generalised least square (GLS) methods. It showed that the share of intraregional trade is growing within NAFTA and that NAFTA has displaced trade with the rest of the world. While NAFTA has served to boost trade among its members, it reduced the degree of openness to trade with non-members. **Oh and Selmier (2008)** showed that RTAs are trade creating.

Coulibaly (2009) showed that RTAs are trade creating not diverting by using two steps estimation approach combining the estimation of gravity equation with a kernel regression. **Vicard (2009)** used gravity model with panel data on the 1960-2000 to investigate the effect of depth of RTAs on trade. Results showed the level of integration has more effect on trade and lead to increase trade among member countries. **Buigut (2012)** estimated the trade effect of the EAC customs union on each individual member and concluded that the customs union has generated disproportionate impact of intra-bloc exports and imports for individual members.

Macphee and Sattayanuwat (2014) applied modified gravity equation to investigate the effects of 12 major RTAs on intra and extra regional trade flows in member developing countries over 1981-2008. Findings showed that not all the RTAs succeeded to generate intra-bloc trade. Several RTAs fail to generate intra bloc trade creation. Seven of the 12 RTAs generate import trade diversion while most of the extra-bloc export dummies are not statistically significant. However, three of the five African RTAs in the sample increased intra-bloc trade. The differences in RTA performances are related to their implementation policies. **Karemera (2015)** used modified gravity model to examine which factors affecting (income, population, production capacity, distance and exchange rate volatile) bovine and swine meat trade flows. Results showed that along with these factors, trade is also affected by regionalism. RTAs (NAFTA and EU) have positive effect on trade and diversion from non-members to members.

Shinyekwa (2015) applied expanded gravity model to investigate the potential impact of East African Community (EAC) RTA on trade. By using export data from 2001 to 2011 on 70 countries, findings suggested that south-south region RTA (EAC) created trade among member countries instead of trade diversion. **Sen et al. (2013)** analysed the effect of eleven PTAs on trade creation and diversion for China and India individually over the period 1984-2009, used an augmented gravity model. Results suggested that PTAs are net trade creating for China's exports and imports and opposite for India. For both countries, ASEAN+6 PTAs created intra/extra-bloc trade. The partial scope Asia-Pacific Trade Agreement (APTA) generated the strongest net export creation effect.

TRADE DIVERSION

The trade diversion occurs when a member country imports goods at high rate from another member (after the formation of bloc) that it previously imported from outside the bloc at cheaper rate. Then the trade is diverted and decreases welfare.

Theoretical and Empirical Studies Related to Trade Diversion

Bhagwati and Panagriya (1996) are of the opinion that the trade diversion is more likely to dominate trade creation in most situations. They argued that at multilateral level, when countries import from and export to union members as well as outside countries, trade diversion is inequitable. Also if members of the regional trade agreement are small in relation to the outside world, very little trade creation will take place. As a result under these conditions trade diversion is likely to be more dominant effect. **Dee and Gali (2003)** in their study controlled some unobservable factors that affect trade flows and found that 12 of the 18 recent PTAs are diverted more trade to non-members than they created among members. However, the theoretical and empirical studies on RTAs have not been able to provide a clear picture as to whether these blocs are necessarily welfare augmenting (more trade creating than trade diverting).

CONCLUSION

There exists a vast body of literature attempting to analyse the whether these blocs create or divert trade. Moreover, there intensity to divert trade depends upon the many factors as discussed in above studies. From the above discussion, it can be concluded that these blocs are trade creating to some extent. Regional cooperation especially among developing countries help to accelerate the growth level, enlarge market size, increase efficiency, stimulate competition, facilitate the level of integration and explore potential areas for further cooperation, expand intra and extra regional trade, etc. These trade agreements are considered as facilitator to achieve the ultimate goal of WTO and complement of it.

DECLARATION

I sadhna here declared that this paper is original and not elsewhere submitted for publication.

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ENDNOTES

i A regional trade agreement is an economic agreement between two or more nations to facilitate trade among member countries by reducing tariff and Non-Tariff Barriers (NTBs) on selected products. These agreements could be mutually beneficial to both countries, liberalise trade and set higher benchmarks for the multilateralism.

ii WTO Annual Report, 2003, pp.27.

iii MFN is the first article of the GATT that governs trade in goods. Under the WTO agreements, countries cannot normally discriminate between their trading partners. Grant someone a special favour (such as a lower customs duty rate for one of their products) and you have to do the same for all other WTO members.

iv WTO Annual Report 2003, pp. 27.

v When a country becomes a member of any regional bloc, it strengthens its ties among the members by granting tariff concessions for and elimination of protectionist barriers that lead to increase movements of goods and services among member at the cost of non-members.

vi http://ideaswebsite.org/pdfs/survey_paper_rta.pdf