Can intraregional trade agreements bring greater prosperity and peace?

Regional trade agreements (both intra- and interregional) are an essential feature of today's global economy. The process of establishing new regional agreements has continued unabated since the beginning of the 1990s. By December 2002, around 250 such agreements had been notified to the GATT/WTO; over 170 of them currently remain in force, with a further 70 in preparation and therefore yet to be notified. It is estimated that, by 2005, the number of notified agreements could reach 300.

Professor Dr Rasul Shams
Hamburg Institute of International Economics (HWWA)
Hamburg, Germany
Shams@hwwa.de

From as early as the 1950s, trade agreements were concluded in many parts of the world based on the model of the European Economic Community. One characteristic of this «old regionalism» of the 1960s and 1970s was the principle of boosting industrialization by switching to the domestic production of previously imported goods (import-substituting industrialization). Only poor results were obtained, however, owing to the failure to remove restrictions on trade or to attract any marked influx of foreign capital.

The «new regionalism» of the 1990s is unmistakeably bound up with the process of economic reform. It is characterized by structural reforms, the creation of an enlarged market and more attractive conditions for direct foreign investment, and closer cooperation in the economic, social and political spheres.

Forms of regional integration

The simplest form is an economic preference zone. In this scenario, at least two countries undertake to grant one another preferential conditions (lower tariffs) for trade in particular products. In a free-trade zone restrictions on trade between the countries concerned are lifted for all products. There is no common policy governing trade with non-member countries. Such a policy is adopted by a customs union where common tariffs are agreed for non-member countries, whilst internal duties and non-tariff restrictions on trade (import quotas, voluntary export restrictions) are lifted.

A common market is a customs union in which movements of the production factors of labour and capital between member countries are completely liberalized. An economic union goes further by harmonizing and jointly formulating national economic policies. On the next level, a monetary union either takes the form of fixed exchange rates or a single currency. In a political union the participating states give up their political sovereignty and delegate their decision-making powers to supranational institutions.

Economic implications

Intraregional trade agreements are primarily expected to stimulate processes of development and growth in the participating countries. This expectation derives from the accrued advantages anticipated from setting up such regional integration zones. Lifting customs and border formalities, directly reduces transaction and information costs, for example. Following the removal of protection, there is increasing specialization to capitalize on comparative cost advantages. Since there is now access to larger markets, the volume of production can be stepped up, reducing unit costs and improving the international competitiveness of member countries over non-members. Competition also increases within the enlarged market, resulting in the elimination of operational inefficiencies and intensifying the search for innovative techniques and products. More efficient production is the result.

The enlarged market also becomes attractive for direct investment from abroad, since the higher tariffs applicable to imports make it more profitable to produce inside the integration zone than to export to it. When countries are linked by regional trade agreements, it also becomes easier to carry out joint projects on issues affecting several countries – e.g. river regulation, fisheries in shared waters, hydroelectric power stations or rail networks. All these factors lead to increased production within the integrated zone, and hence to higher growth rates.

Political implications

Political motives also play a prominent role in the establishment of intraregional trade agreements. One major political motive is the prospect of guaranteeing regional security. Trade alliances enhance the economic integration of the member countries. This also strengthens political

Photo: Global Aware

Developing countries do not view regionalism as any sort of substitute for the multilateral system. Their active participation in WTO negotiations bears this out.

bonds, as trust and mutual understanding grow between the economic partners. A regional alliance can reduce conflict between neighbouring countries, and their intensified cooperation enables them to respond more effectively to external security threats. The significant role that security can play in the process of regional integration is clearly illustrated by the EU. Indeed, from its inception, economic means were used to achieve security policy goals. The European Coal and Steel Community, set up in 1951, used sectoral cooperation as a means of bringing Europe together politically. Similarly, security factors played a critical role in the founding of the Mercado Común del Sur (MERCOSUR) in Latin America and the Association of Southeast Asian Nations (ASEAN).

A further political motivation is the prospect of strengthening the member countries' international negotiating power as a group. Admittedly, even a grouping of developing countries is unlikely to have sufficient clout to force an issue in negotiations. Nevertheless, by presenting themselves as a group, they make more of an impact at international negotiations and must at least be listened to. Membership in a trade agreement can also be advantageous for domestic policy purposes, since treaty obligations can be invoked in order to implement reforms.

Disadvantages of intraregional trade agreements

Intraregional trade agreements also have drawbacks, however. In many developing countries, especially in Africa, public revenue is heavily dependent on tariff revenues (accounting for more than 50 percent in some cases). A trade agreement causes direct losses of revenue as soon as tariffs on trade between member countries are abolished. The diversion of trade, i.e. the decline in tariff-laden imports from non-member countries in favour of duty-free imports from member countries, has a similar impact. In such cases, the conclusion of an agreement must go hand in hand with the search for alternative sources of income, making tax reform policies like the introduction of value-added tax essential.

A further problem arises when the benefits accruing from integration are unequally distributed among the member countries. For example, this might happen when a less industrialized country within the integration zone loses jobs to a more highly developed partner country as a consequence of the sudden upsurge in competition within the integration zone. This can lead to demands for compensation mechanisms. In order to counteract such developments it will generally be necessary to curb the pace of liberalization or institute a regional structural policy, as in the EU.

Trade agreements in Latin America and the Caribbean

In Latin America and the Caribbean, numerous agreements exist whose goal is to succeed in a common market or a community. The most important are MERCOSUR, the Central American Common Market (CACM), the Andean Community (CAN) and the Caribbean Community and Common Market (CARICOM). These subregions are all at different stages of development into a customs union, and either have agreed common external tariffs or are in the process of doing so. As a consequence of regional integration, considerable advances have already been made in liberalizing trade in goods in Latin America. In contrast, in other sectors such as services, investments and intellectual property rights, liberalization still lacks depth and impetus. Moreover, non-tariff barriers are still obstructing regional trade.

Table 1 on page 48 shows the increase in intraregional exports in Latin America and in the Caribbean. With the exception of

MERCOSUR (Argentina, Brazil, Paraguay and Uruguay), where the integration of trade policy between member states has risen markedly, in the other subregions intraregional exports are tending to stagnate over time or even to decline. In the 1990s, in contrast, the flow of direct investment to Latin America increased drastically. Along with privatization and institutional reforms, regional integration is certainly one of the reasons for this. Although some institutional measures have already been undertaken, regional cooperation on monetary and macroeconomic policy is still underdeveloped. As the example of MERCOSUR shows, macroeconomic instability and severe fluctuations in exchange rates can pose a serious threat to the continuation of an agreement. To address infrastructure issues, the countries have joined forces in the Integration of Regional Infrastructure in South America (IIRSA) initiative. In matters of security, major successes have been achieved. The MERCOSUR and the Andean Community agreements contain democracy clauses which have already been invoked to safeguard democracy. Border disputes have been more or less overcome. The subregions have begun to present themselves as blocks at international trade negotiations, much improving their bargaining power.

Table 1: Latin America and the Caribbean: Intraregional exports 1970-2001*

	1970	1980	1990	1995	1996	1997	1998	1999	2000	2001
ACS	9.6	8.7	8.4	8.5	6.9	6.9	7.2	5.8	5.6	5.9
Andean Group	1.8	3.8	4.1	12.0	9.7	10.8	12.8	8.8	8.4	10.9
CACM	26.0	24.4	15.4	21.7	22.0	18.1	16.1	12.8	13.7	15.0
CARICOM	4.2	5.3	8.1	12.1	13.0	14.4	17.3	16.9	14.6	13.3
Central American Group of Four	20.1	18.1	13.7	22.0	22.0	19.9	16.3	14.0	14.8	14.8
Group of Three	1.1	1.8	2.0	3.2	2.4	2.7	2.6	1.7	1.7	2.1
LAIA	9.9	13.7	10.8	17.1	16.2	17.0	16.7	12.7	12.9	13.0
Mercosur	9.4	11.6	8.9	20.3	22.6	24.8	25.0	20.6	20.9	17.3
OECS	...	9.1	8.1	12.6	10.6	10.7	12.0	13.1	10.0	5.3

*As a percentage of total exports. Source: World Bank, World Development Indicators 2003

Table 2: Africa: Intraregional exports 1970-2001*

	1970	1980	1990	1995	1996	1997	1998	1999	2000	2001
CEMAC	4.8	1.6	2.3	2.1	2.3	2.0	2.3	1.7	1.0	1.2
CEPGL	0.4	0.1	0.5	0.5	0.5	0.4	0.6	0.7	0.8	0.8
COMESA	9.1	6.1	6.6	7.7	8.0	7.8	8.7	7.4	5.6	6.9
Cross Border Initiative	9.3	8.8	10.3	11.9	12.4	12.7	13.8	12.1	10.7	10.3
ECCAS	9.6	1.4	1.4	1.5	1.6	1.5	1.8	1.3	1.1	1.3
ECOWAS	2.9	10.1	7.9	9.0	8.5	8.6	10.6	10.9	9.6	9.7
Indian Ocean Commission	8.4	3.9	4.1	6.0	5.4	3.9	4.7	4.8	4.3	3.9
MRU	0.2	0.8	0.0	0.1	0.3	0.5	0.5	0.6	0.6	0.6
SADC	8.0	2.0	4.8	8.7	9.4	10.4	10.4	11.9	11.7	10.2
UDEAC	4.9	1.6	2.3	2.1	2.3	2.0	2.3	1.7	1.0	1.2
UEMOA	6.5	9.6	13.0	10.3	9.6	11.8	11.0	13.2	13.3	13.9

*As a percentage of the region's total exports. Source: World Bank, World Development Indicators 2003

Table 3: Asia: Intraregional exports 1970-2001*

	1970	1980	1990	1995	1996	1997	1998	1999	2000	2001
ASEAN	22.9	18.7	19.8	25.4	25.4	24.9	21.9	22.4	23.9	23.3
Bangkok Agreement	2.7	3.7	3.7	5.0	5.2	5.1	5.0	5.2	5.2	5.5
EAEC	28.9	35.6	39.7	48.1	49.0	48.0	42.2	44.0	46.8	46.9
SAARC	3.2	4.8	3.2	4.4	4.3	4.0	5.2	4.6	4.3	4.8

*As a percentage of the region's total exports. Source: World Bank, World Development Indicators 2003

Agreements in Africa

In Africa, too, many intraregional trade agreements of different forms are in existence, with varying scope and objectives. The best known are the Common Market for Eastern and Southern Africa (COMESA), the Economic Community of West African States (ECOWAS) and the Southern African Development Community (SADC). As Table 2 shows, regional integration in Africa has not led to an increase in intraregional trade, nor to diversification of exports or any intra-industrial specialization. This is because regional trade liberalization in Africa is very slow and is incomplete. Since tariffs make up the greater part of state revenues in these countries, trade liberalization causes them particular hardship. Moreover, political conflicts also make cooperation more difficult, and non-tariff barriers to trade are especially numerous in Africa.

Some of the subregions mentioned have taken steps towards macroeconomic harmonization and formulated economic and financial policy criteria to assimilate the economic policy framework conditions. But little progress has been made in implementing these policies. The degree of financial integration is also low. Exceptions are the Central African Economic and Monetary Community of Central Africa and the West African Economic and Monetary Union (CEMAC and UEMOA/WAEMU), which were planned as such from the outset under the influence of the Franc Zone. In other spheres regional cooperation has not progressed beyond a few good initiatives.

Agreements in Asia

Compared with other regions, Asia has fewer intraregional trade agreements in the form of partial economic preference zones or free-trade zones. While East Asia exhibits a very high degree of intraregional integration, it is informal in character. The best known agreement is the Association of Southeast Asian Nations (ASEAN).

Trade alliances also strengthen political bonds, as trust and mutual understanding between the economic partners grow.

Photo: Global Aware

Although ASEAN was set up back in 1967, it achieved serious levels of trade liberalization only in the 1990s. As Table 3 shows, while there is a high level of intraregional trade, there is no clear upward trend. Since the financial crisis of 1997, monetary and financial cooperation in Asia have increased. The major success areas have been the exchange and monitoring of information, regional financing instruments, stabilization funds and regional exchange rate mechanisms. While the creation of a monetary union has been discussed repeatedly, it remains a long-term objective. ASEAN demonstrates regional cooperation in a multitude of forms, ranging across the economic-political sphere, social and cultural affairs, the environment, human capital, and science and technology.

Multiple membership

Many developing countries are members of several agreements. Overlapping intraregional agreements can give rise to problems, for instance when a country in a customs union (common external tariffs for non-member countries) has a free-trade agreement with third countries. This is a particular problem in Latin America and Africa. In these cases, special conditions and exemption clauses can be necessary to solve the problem, making agreements more complicated. Uncertainties can also arise in the private sector until it is known how the problem will be resolved.

Generating and diverting trade

Intraregional trade agreements are often criticized for diverting trade rather than generating it. Generated trade is the additional trade between member states as a consequence of the abolition of tariffs between them, and is what makes the arrangement beneficial. Since these tariffs still apply to third countries, a member country can replace its past imports with imports from another member country. If supplies from third countries cost less than those from the relevant member country, the benefits decline. If generated trade is lower than diverted trade, there is a net loss of benefit to the world as a whole. Whether this is the case remains an empirical question. Studies on Latin America show that, in the 1990s, the generation of trade was higher than the diversion of trade (IBRD, *Beyond Borders, The New Regionalism in Latin America, Washington DC 2002, p41*). Empirical studies on Africa point in the same direction (Lucian Cernat, *Assessing South-South Regional Integration: Same Issues, Many Metrics, United Nations, New York and Geneva, 2003, UNTAD/ITCD/TAB/22*).

Trade agreements and multilateral liberalization

Regional trade agreements clearly contravene the non-discrimination principle of the multilateral trade system as represented by GATT/WTO. Therefore it is claimed that the proliferation of such agreements has an adverse effect on participation in the process of global trade liberalization. Dissenters take the view that regionalism will tend to support the process of multilateral liberalization. The developing countries do not consider regionalism to be any sort of substitute for the multilateral system. Thus they participate actively in the preparations for WTO rounds and in the negotiations themselves.

The multilateral trade system to date has not been at all successful in dealing with the issue of regionalism. Hence there is a need for changes to those rules of the multilateral system which affect regionalism, in such a way that the benefits of regionalism are maximized while its costs to the partners and the global economy are minimized (cf. above, IBRD, *Beyond Borders, p.51*).

A regional alliance can reduce conflict between neighbouring countries, and their intensified cooperation enables them to respond more effectively to external security threats.