

There has been a proliferation of regional trade agreements around the world since the early 1990s. In a survey of the latest theoretical and empirical research on regionalism, **Caroline Freund** and **Emanuel Ornelas** ask whether we should celebrate or be concerned about this trend.

Regional trade agreements: blessing or burden?



In December 2009, a Ministerial meeting was concluded at the World Trade Organisation (WTO). The headlines typically read something like 'Ministers reaffirm the need and their desire to conclude the Doha Round by the end of next year'. For many observers, this was a case of déjà vu: since the current round of multilateral trade negotiations began in 2001, there have been numerous promises that it would be concluded in the 'near term'

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and time and again, those expectations have been frustrated.

The main concern with the seemingly endless delay in achieving a new agreement is that such a failure could

lead to a protectionist backlash. Like riding a bike, the argument goes, if you don't move forward, you fall over.

Fears of a retreat to protectionism became particularly intense after the onset of the financial crisis – if the road gets bumpier, then you really have to push forward to avoid falling. As it turns out, there has been only a very limited retreat towards protectionism, even though the WTO bike has not been moving forward.

Still, even if the lack of progress in multilateral talks does not imply a retreat, many observers remain worried. After all, if there are gains to be shared with further liberalisation, we should make sure we don't waste the opportunity.

While this view is correct, it must be noted that lack of progress in the multilateral arena does not imply that the world is not becoming more integrated. In fact, governments across the globe are as active as ever in negotiating new trade agreements. The difference is that the agreements are not multilateral but 'regional'.

In 2009, for example, 25 new regional trade agreements (RTAs) were notified to the WTO. The agreements include developed as well as developing countries, and involve countries from most parts of the world. In fact, they are not always regional, increasingly encompassing members from different continents.

The new agreements bring the total number of RTAs in force to nearly 300. In the same period, the WTO also received notification of 14 other RTAs that are currently being negotiated or about to enter into force. The WTO estimates that there are around 100 other agreements currently at this stage (WTO, 2009).

Should we celebrate the expansion of RTAs, or should we be concerned with this trend, which seems to be only accelerating since it took off in the early 1990s? In a survey of the theoretical and empirical literature on regionalism, we conclude that although countries should approach regionalism with care, to date RTAs have been more of a blessing than a burden for the multilateral trading system.

Assessing the impact of RTAs

To understand the impact of RTAs, it is important first to recognise that they are intrinsically different from both multilateral liberalisation (under the aegis of the WTO) and unilateral liberalisation. In both of those cases, countries lower trade barriers on all sources of imports of a good by exactly the same extent.



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In contrast, under an RTA, tariffs fall on imports from the other members of the agreement, but they need not change on imports from non-members. As a result, RTAs imply both trade liberalisation and trade discrimination. Whereas there is a near-consensus among economists that the former is desirable, that is not true for the latter.

Trade liberalisation within a trading bloc tends to be beneficial when it promotes a shift of resources from inefficient domestic suppliers to more efficient producers within the region. Economists call this phenomenon 'trade creation'.

Conversely, a trading bloc is likely to be harmful if it generates a shift of resources from efficient external producers to inefficient producers within the region. This is a consequence of trade discrimination, which economists call 'trade diversion'.

In principle, either trade creation or trade diversion can prevail within an RTA. There are theoretical arguments that support the primacy of each effect under similar circumstances. Thus, in the end, which effect dominates is an empirical matter.

Unfortunately, estimating trade creation and trade diversion is no easy task. It requires knowledge of the counterfactual: what would have happened to trade if there were no trade agreement? As this is unknown, assumptions must be made.

A variety of approaches have been employed. While results inevitably vary depending on the methodology employed (as well as the time period, the trading bloc in question and the level of aggregation in the data), at least two general messages arise from the large set of studies investigating trade creation and trade diversion in RTAs around the world:

- First, trade creation tends to be the norm in RTAs – and trade diversion is the exception.
- Second, when trade diversion is observed, its magnitudes are normally relatively small.

Trade creation versus trade diversion

Why is there such a dominance of trade creation over trade diversion? The answer is in two parts. First, governments seem to be choosing their RTA partners well. For example, variables that suggest greater gains from a bilateral RTA (such as proximity between the members, a similarity in their GDPs and a large difference in their factor endowments) are also sharp predictors of whether the two countries actually have a common RTA (Baier and Bergstrand, 2004).

Second, when countries form an RTA, their governments not only lower tariffs vis-à-vis their RTA partners, as they are supposed to do; they also bring down the trade barriers on imports from countries outside the bloc. This is not part of the agreement, so governments liberalise externally because they choose to do so – and without any type of reciprocity from the favoured non-members of the bloc.

There is increasing evidence of external trade liberalisation following an RTA, especially in developing countries. (See, for example, Estevadeordal et al, 2008, for an analysis of how Latin American countries changed their import tariffs on non-members after forming or expanding their trade ties during the 1990s.) The lower external tariffs provide a double blessing: they imply that RTAs are responsible for more trade liberalisation than they mandate (amplifying trade creation) and for less trade discrimination than might be expected (limiting trade diversion).

At first, it may seem odd that governments, pressured by special interests as they are virtually everywhere, would voluntarily lower their external tariffs without any compensation from the favoured countries. But it does make sense.

Suppose that domestic special interest groups pressure the government and induce it to set relatively high tariffs, which allow the domestic industry to maintain high prices and enjoy a large market share. If subsequently the country enters into a RTA, export-oriented firms



Regional trade agreements generally seem to amplify trade creation and limit trade diversion



benefit (and support the agreement) because of the better access to foreign markets, whereas purely domestic firms suffer from the tougher competition from the RTA partners.

But this also weakens the domestic firms' stance on protection against non-members. The reason is that the free access to the domestic market enjoyed by the partners' exporters under the RTA lowers the market share of the domestic industry. As a result, the RTA makes any price increase generated by a higher tariff less valuable for the domestic industry: now whenever the government attempts to help domestic producers through higher external tariffs, the partners' producers absorb part of that surplus.

In other words, the RTA creates 'leakage' in the trade policy redistributive channel. External protection also becomes more costly, because of the trade diversion that accompanies the RTA. As a result, external tariffs tend to fall after the formation of an RTA both because the economic marginal cost of external protection rises and because the political-economy marginal gain from external protection falls.

For developing countries, empirical research supports this rationale because trade preferences tend to lead to lower external tariffs. Results for the United States and the European Union (EU), however, indicate that they are less likely to reduce external tariffs on goods where preferences are offered (see Limao, 2006). But since the tariffs of both the United States and the EU are very low to start with, and cannot be raised because of their WTO commitments, there is not much room for change anyway.

Are RTAs welcome?

The benign view that trade creation dominates trade diversion does not imply that RTAs are necessarily welcome. In fact, some commentators argue that the multilateral negotiations at the WTO are stuck because RTAs are spreading. Their basic argument suggests that governments' resources are scarce, so if officials are busy negotiating bilateral

agreements, they will be unable to focus on more evolving multilateral negotiations.

Others put forward more elaborate arguments. For example, it is possible that RTAs may create rents to some groups. Once well entrenched, these groups may be able to block further liberalisation initiatives that would destroy such rents.

On the other hand, there are arguments indicating that the opposite may be true. A simple one is that negotiating RTAs helps officials to develop the expertise and the frameworks to implement international trade agreements, and these could be useful at subsequent WTO negotiations. Moreover, RTAs also destroy rents in parts of

relevant) from bad (empirically inconsequential) theories.

Hence, to the extent that we can measure, the increasing wave of regionalism has been largely beneficial to the world trading system. Most empirical analyses indicate that trade creation, not trade diversion, is the norm, both because governments choose well when forming RTAs and because they adjust other trade policies to moderate the distortions from discrimination.

Although it is possible that regionalism could endanger multilateralism, at the moment we just do not know.

the economy. If the rent-holders who lose with RTAs were the ones slowing down multilateral talks, then RTAs can actually provide a boost to such negotiations.

These and related arguments constitute an intellectually engaging debate, but which of them dominate? When faced with opposing theoretical results, the solution is typically to scrutinise the divergent predictions empirically. The problem here is that the nature of the question – whether regionalism helps or hinders multilateralism – does not lend itself easily to testing.

Simply put, at any point in time we observe a single realisation of WTO negotiations. Would they have been any faster, or easier, had there been fewer (or more) RTAs? This is a very difficult question. Consequently, to date empirical scrutiny has not been able to help us distinguish good (that is, empirically

Since regionalism has become and will probably remain the preferred form of reciprocal liberalisation for most countries, no matter what we economists say, henceforth we should focus on ways to integrate regionalism with multilateralism more effectively.

This article summarises 'Regional Trade Agreements' by Caroline Freund and Emanuel Ornelas, CEP Discussion Paper No. 961 (<http://cep.lse.ac.uk/pubs/download/dp0961.pdf>) and forthcoming in the *Annual Review of Economics* 2: 139-67 (September 2010).

Caroline Freund is at the World Bank. **Emanuel Ornelas** is a reader in LSE's management department and a research associate in CEP's globalisation programme.

With regionalism here to stay, economists should focus on ways of integrating it more effectively with multilateralism

Further reading

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Antoni Esteveadeordal, Caroline Freund and Emanuel Ornelas (2008) 'Does Regionalism Affect Trade Liberalization towards Non-members?'. *Quarterly Journal of Economics* 123: 1531-75.

Nuno Limao (2006) 'Preferential Trade Agreements as Stumbling Blocks for Multilateral Trade Liberalization: Evidence for the US', *American Economic Review* 96: 896-914.

WTO, World Trade Organisation (2009) 'Overview of Developments in the International Trading Environment,' document WT/TPR/OV/12 (http://www.wto.org/english/news_e/news09_e/wt_tpr_ov_12_a_e.doc).

