CHAPTER II
REGIONAL AND GLOBAL INTEGRATION: EUROPEAN UNION AND THE WORLD TRADE ORGANISATION

In this chapter the experience of EU as a regional trading bloc and World Trade Organisation (WTO) as a multilateral trading system are discussed. Regional Trading Arrangements (RTAs) can be viewed as a strategy to enlarge trade, markets and economic growth. Regionalism is on the rise since the 1990, in spite of the fact that at the end of the Uruguay Round the multilateral trading system emerged stronger. Another objective of this chapter is to examine the debate between 'Regionalism versus Multilateralism' in general. In this chapter we are not so much concerned about regional and global integration of Hungary and Poland and it's effect on the developing countries. The transition economies Hungary and Poland desire speedy and full entry into the world market as market economies through regional integration as well as global integration. The chapter therefore examines, the eastern enlargement of the EU, and the commitment of Hungary and Poland towards implementing the WTO agreements.

Section 2.1 through Section 2.3 of the chapter traces the history of EU since its inception in 1957 with the signing of the Treaty of Rome and the formation of the European Economic Community (EEC), till the Single European Act (SEA) of 1985 which provided the legal framework for the transformation of the EEC to the EU. The sub-sections examine the economic performance of the EEC during this period and its enlargement from six members into fifteen members in 1995. Section 2.4 examines the Eastern European enlargement as Hungary and Poland seek regional integration through the 'Europe
Agreements.’ Having gained an overview of the EU, Section 2.5 examines the impact of the EU on total and intra-EU trade. Section 2.6 presents a brief summary of the complex web of trade preferences woven by EU over time, indicating that EU is an important trading partner of the developing countries. However, the ‘Europe Agreements’, Lomé conventions and the Generalised System of Preferences (GSP), which will be discussed in detail in Chapters III and V are excluded here. Section 2.7 traces briefly the journey of the General Agreement of Trade and Tariff (GATT) from its inception in 1948 to the 1986-1993 Uruguay Round and the establishment of the WTO in 1995. The sub-sections examine the achievements of the Uruguay Round in terms of overall reduction in tariffs, increase in bindings and reduction in tariff escalation. The section also draws on examples of Hungary, Poland and EU with respect to tariff reduction and non-tariff barriers used. This will give us an idea about Hungary’s and Poland’s commitment to multilateralism, at a time when they are also seeking regional integration. The Uruguay Round broke new ground by succeeding in negotiations involving agriculture, textiles, Intellectual Property Rights and non-tariff barriers, which were outside the GATT purview in the previous rounds. Inspite of the fact that the multilateral trading system emerged stronger after the Uruguay Round, the proliferation of RTAs is a cause for concern. Section 2.8 examines the debate on whether the RTAs are ‘Building blocs’ or ‘Stumbling blocs’ for the multilateral trading system. These issues have no easy answers, as countries seek regional cooperation for a number of reasons which have to the factored in while analyzing RTAs. Section 2.9 analyses intra and interregional trade
flow of some important regional trading blocs. Section 2.10 discusses integration of Hungary and Poland into EU and WTO.

2.1  THE FOUNDATIONS OF EUROPEAN UNION

The EU is the largest and is frequently cited as the most successful regional economic integration scheme in the world. The factors, which promoted economic integration in Western Europe, were both political as well as economic in nature. The primary objective was to promote security and welfare of its people. Western Europe emerged virtually bankrupt after the war. The idea of economic integration gained momentum among the West European countries. Sections 2.1.1 and 2.1.2 discuss the Marshall plan for rebuilding the European economy and the Schuman plan which established the European Coal and Steel Community, Section 2.1.3 discusses the Treaty of Rome which led to the establishment of EEC and Section 2.1.4 examines the Northern and Southern enlargement of EEC and the reasons as to why countries seek membership in a RTA.

2.1.1  THE MARSHALL PLAN

The Second World War left the European economy in ruins. Europe had to be reconstructed and the foundation of regional economic cooperation was laid during the reconstruction period. The initiation and the money came from the Americans, in the form of the Marshall Plan. The Organization for European Economic Cooperation (OEEC) was set up in 1947 in order to divide up among the member’s states the flow of U.S aid under the Marshall Plan. The OEEC later widened its membership to include all the advanced industrial nations of the non-communist world, and changed its name in 1961
to the Organization for Economic Cooperation and Development (OECD). The granting of Marshall Aid and the creation of OEEC meant that U.S, committed to multilateralism in the post-war period, was at least ready in principle to have it put in cold storage. The U.S supported plans for European integration for three reasons³.

i) It was thought only a strong ally is a good ally. Economic integration would strengthen the United States European partners and thereby improve the overall military position of the west vis-à-vis the Soviet bloc.

ii) It was assumed that integration would produce economic growth in Europe and thus increase the demand for American products and investments.

iii) The U.S.A hoped that a prosperous and United Western Europe would accept a larger share of the common defence spending, increase its aid to developing countries and take more active role in solving international currency and commodity problems.

2.1.2 THE SCHUMAN PLAN

The next step was taken with the Schuman Plan of May 1950, which led to the signing of the treaty of Paris one year later and the establishment of the European Coal and Steel Community (E.C.S.C)⁴. The Schuman plan was a French initiative intended to deal with ‘German Problem’.

³ Mattli (1999), p 71
⁴ Tsoukalis (1993), p 16
It was essential to link Germany with its neighbors and this link should appear in the self-interest of both countries. Such a step would also prevent another war between Germany and France. Jean Monnet, the original architect of the plan with James Schuman, put forward the Schuman plan. Under the plan, Coal and Steel industries of Germany and France was planned under a single high authority, which would supervise their development - an example of limited sectoral integration. The Schuman plan laid the foundation for regional integration.

By 1955, investigations were made for establishing a common market. Intensive negotiations followed and two treaties, one to create the European Economic Community (EEC) and the other to establish the European Atomic Energy Community (Euratom) were signed in 1957. The three communities – the ECSC, Euratom and the EEC were formally amalgamated on July 1st 1967. They become jointly known as the European Community (EC), or the sometimes the European Communities.

2.1.3 THE TREATY OF ROME

The treaty of Rome, signed in 1957, led to the establishment of EEC consisting of six members – France, Germany, Italy, Belgium, Luxembourg and the Netherlands. The central pillar of the new construction was to be the creation of a common market, an economic area within which there would be free movement of goods, services, persons and capital. The main emphasis was on:

i) Progressive elimination of tariffs and quantitative restriction
ii) Establishment of a common external tariff and a common commercial policy vis-à-vis Third countries

iii) Formulate a common policy on agriculture

iv) The European Investment Bank and the European Social Fund were designed to work in favour of the least developed area of the EEC

In keeping with the above objectives, a timetable for removing all internal tariffs and quota restrictions was set and was intended to be completed in successive stages by December 1969. The process was completed 18 months ahead of schedule, on 1st July 1968. Simultaneously with the removal of internal tariffs, a common external tariff was erected based on an average of duties previously levied by the member states, with some downward adjustment. This was also completed 18 months ahead of schedule5.

The signing of the treaty of Rome created a division within Western Europe. This was because, countries like U.K., refused to accept the supernational aspects of the treaty. In response, the European Free Trade Association (EFTA) was found in 1960 with seven members - Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the UK. EFTA countries retained their independence in the conduct of external trade policies. EFTA was a much less ambitious initiative than the EEC.

---

5 Leonard (1997), p 9
2.1.4 ENLARGEMENT AND INTEGRATION OF THE EEC FROM SIX TO FIFTEEN MEMBERS

The first enlargement of the community in 1973 enhanced its northern bias, bringing in the United Kingdom, Ireland and Denmark. Ireland and Denmark benefited significantly agriculturally. The second enlargement in the 1980s shifted the balance of influence towards Southern Europe after the entry of Greece in 1981. The third enlargement involved the accession of Spain and Portugal in 1986. The reunification of Germany in 1990 was simply one of absorption of Eastern Germany. The Fourth enlargement, the entry of Austria, Finland and Sweden in 1995, was less problematic in bringing in richer countries with fewer problems. The critical test for the EU is in absorbing the former communist countries of Eastern Europe in the coming years.⁶

A question, which arises, is when do countries (non-members of a neighboring RTA) seek integration? Analytical framework suggests that a country seeks to integrate its economy only when there is significant positive cost of maintaining its present governance structure in terms of forgone growth as measured by a continuing performance gap between it and a more integrated rival governance structure.⁷

Table 2.1 compares the timing of applications for membership in the EC with the evolution of growth rates for countries inside and outside the EC. The empirical analysis shows that there is no integration sought when there is no performance gap, and that a sustained performance gap always eventually

---

⁶ Harrop (2000), p 284
⁷ Mattli (1999), pp 80-85
triggers demands for integration. Countries that fail to experience such a gap see no reason to pay the price of integration and thus stay out. The growth rates in the countries seeking accession with exception of Portugal were below EC-6 before they sought integration with EC. Countries seeking accession stand to gain from the EC’s Regional Development and Structural Readjustment Funds and are likely to attract foreign private capital as members of EC.

On the other hand, a Union will have an interest in accepting poor peripheral economies only when the net cost of excluding them is bigger than the cost of accepting them i.e. when negative externalities originating in these outside countries threaten to disrupt the union’s stability, security and prosperity. The sources of these externalities may be due to economic mismanagement, political instability or social unrest. Economic inclusion through integration, goods rather than people, trade instead of migration may be a quick formula for diffusing the threat of social disruption caused by such illegal immigrants. Trade and investment may raise living standards and increase employment opportunities, thus easing the pressure to migrate.⁸ Next, we examine the effect of integration on growth and employment and also the factors responsible for it.

---

⁸ Mattli (1999), p 95
TABLE 2.1  THE TIMING OF APPLICATION FOR MEMBERSHIP IN THE EUROPEAN COMMUNITY

<table>
<thead>
<tr>
<th>Country</th>
<th>Application number</th>
<th>Year of Application</th>
<th>Growth rate differential with EC (year prior to application)</th>
<th>No. of years of below EC–6 growth rates (prior to application)</th>
<th>Growth rate differential of country with EC–6 a year after membership</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>Third</td>
<td>1970</td>
<td>Below (7.1%)</td>
<td>6</td>
<td>Above EC</td>
</tr>
<tr>
<td>Ireland</td>
<td>Third</td>
<td>1970</td>
<td>Below (2.3%)</td>
<td>1</td>
<td>Above EC</td>
</tr>
<tr>
<td>Denmark</td>
<td>Third</td>
<td>1970</td>
<td>Below (1.9%)</td>
<td>2</td>
<td>Below EC</td>
</tr>
<tr>
<td>Greece</td>
<td>First</td>
<td>1975</td>
<td>Below (7.5%)</td>
<td>1</td>
<td>Same as EC</td>
</tr>
<tr>
<td>Portugal</td>
<td>First</td>
<td>1977</td>
<td>Above (2.0%)</td>
<td>0</td>
<td>Above EC</td>
</tr>
<tr>
<td>Spain</td>
<td>First</td>
<td>1977</td>
<td>Below (1.9%)</td>
<td>1</td>
<td>Below EC</td>
</tr>
<tr>
<td>Austria</td>
<td>First</td>
<td>1989</td>
<td>Below (0.2%)</td>
<td>3</td>
<td>Same as EC</td>
</tr>
<tr>
<td>Finland</td>
<td>First</td>
<td>1992</td>
<td>Below (8.1%)</td>
<td>2</td>
<td>Above EC</td>
</tr>
<tr>
<td>Sweden</td>
<td>First</td>
<td>1992</td>
<td>Below (2.7%)</td>
<td>3</td>
<td>Above EC</td>
</tr>
<tr>
<td>Norway</td>
<td>Fourth</td>
<td>1992</td>
<td>Below (0.2%)</td>
<td>5</td>
<td>Above EC</td>
</tr>
</tbody>
</table>

Source: Mattli (1999)
2.2 ECONOMIC ENVIRONMENT IN THE EC

The EC experienced higher growth rates, increased levels of intra regional trade and employment in the 1960 and the 1970. Section 2.2.1 analyses the effect of EEC enlargement on growth, employment, and investment comparing them with Europe, United States and Japan.

The use of fiscal and monetary policy to influence aggregate demand, the promotion of ‘National Champions’ in the field of technology and the close link between EC integration and the growth of trade are some factors responsible for higher growth rates and employment in the EC.

2.2.1 EFFECTS ON GROWTH, EMPLOYMENT AND INVESTMENT

The twelve-year transitional period was a period of higher and steady growth and unprecedented levels of employment. The average rate of growth of six countries was slightly higher than the average for OECD Europe. Tables 2.2 and 2.3 show the growth rates and unemployment rates between 1960 and 1990.

Average growth rates in Ireland, after it become member was higher than the average EC 12 rates, while Britain and Denmark continued to lag behind.

Similarly, Portugal and Spain experienced higher growth rates compared to EC average of 3.1 percent.
### TABLE 2.2  GROWTH RATES IN THE DEVELOPED COUNTRIES (1960 – 1990)
(Average annual percentage change of real GDP at constant prices)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>4.6</td>
<td>5.3</td>
<td>2.2</td>
<td>1.3</td>
<td>3.2</td>
</tr>
<tr>
<td>France</td>
<td>5.5</td>
<td>5.2</td>
<td>2.8</td>
<td>1.5</td>
<td>2.9</td>
</tr>
<tr>
<td>Germany</td>
<td>3.8</td>
<td>5.0</td>
<td>2.3</td>
<td>1.1</td>
<td>3.1</td>
</tr>
<tr>
<td>Italy</td>
<td>5.6</td>
<td>4.9</td>
<td>3.7</td>
<td>1.9</td>
<td>3.0</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>2.8</td>
<td>5.5</td>
<td>1.3</td>
<td>2.2</td>
<td>4.3</td>
</tr>
<tr>
<td>Netherlands</td>
<td>4.6</td>
<td>5.1</td>
<td>2.7</td>
<td>1.0</td>
<td>2.7</td>
</tr>
<tr>
<td>Denmark</td>
<td>4.6</td>
<td>4.0</td>
<td>1.9</td>
<td>2.1</td>
<td>1.5</td>
</tr>
<tr>
<td>Ireland</td>
<td>3.6</td>
<td>5.2</td>
<td>4.9</td>
<td>2.6</td>
<td>4.4</td>
</tr>
<tr>
<td>UK</td>
<td>2.9</td>
<td>3.5</td>
<td>1.5</td>
<td>1.2</td>
<td>3.2</td>
</tr>
<tr>
<td>Greece</td>
<td>7.4</td>
<td>8.0</td>
<td>3.7</td>
<td>1.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Portugal</td>
<td>6.2</td>
<td>7.6</td>
<td>2.9</td>
<td>1.5</td>
<td>4.6</td>
</tr>
<tr>
<td>Spain</td>
<td>7.7</td>
<td>6.7</td>
<td>2.2</td>
<td>1.4</td>
<td>4.5</td>
</tr>
<tr>
<td>EC- 12</td>
<td>4.5</td>
<td>4.9</td>
<td>2.5</td>
<td>1.4</td>
<td>3.1</td>
</tr>
<tr>
<td>Austria</td>
<td>4.2</td>
<td>5.7</td>
<td>2.9</td>
<td>1.6</td>
<td>3.1</td>
</tr>
<tr>
<td>Sweden</td>
<td>4.5</td>
<td>3.7</td>
<td>1.8</td>
<td>1.8</td>
<td>2.1</td>
</tr>
<tr>
<td>Switzerland</td>
<td>4.5</td>
<td>4.3</td>
<td>-0.4</td>
<td>1.9</td>
<td>2.8</td>
</tr>
<tr>
<td>OECD-Europe</td>
<td>4.5</td>
<td>4.8</td>
<td>2.5</td>
<td>1.5</td>
<td>3.1</td>
</tr>
<tr>
<td>United states</td>
<td>4.5</td>
<td>3.3</td>
<td>2.4</td>
<td>2.4</td>
<td>3.0</td>
</tr>
<tr>
<td>Japan</td>
<td>9.8</td>
<td>9.3</td>
<td>3.6</td>
<td>3.7</td>
<td>4.6</td>
</tr>
<tr>
<td>Total OECD</td>
<td>5.0</td>
<td>4.7</td>
<td>2.7</td>
<td>2.8</td>
<td>2.7</td>
</tr>
</tbody>
</table>

Source: Tsoukalis (1993)
TABLE 2.3 UNEMPLOYMENT RATES IN THE DEVELOPED COUNTRIES (1960 – 1990)
(As percentage of labour force: average of annual unemployment rates)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>EC – 12</td>
<td>2.2</td>
<td>2.7</td>
<td>4.8</td>
<td>9.2</td>
<td>9.9</td>
</tr>
<tr>
<td>OECD – Europe</td>
<td>2.8</td>
<td>3.4</td>
<td>5.1</td>
<td>8.8</td>
<td>9.2</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>5.0</td>
<td>4.6</td>
<td>6.7</td>
<td>8.0</td>
<td>5.8</td>
</tr>
<tr>
<td>Japan</td>
<td>1.3</td>
<td>1.2</td>
<td>1.9</td>
<td>2.4</td>
<td>2.5</td>
</tr>
<tr>
<td>Total OECD</td>
<td>3.1</td>
<td>3.4</td>
<td>5.1</td>
<td>7.5</td>
<td>7.1</td>
</tr>
</tbody>
</table>

Source: Tsoukalis (1993)

Table 2.3 shows that unemployment levels remain low and below that of OECD for EC-12 till 1979. After this period, the next decade was marked by an increase in the levels of unemployment throughout the period under observation, unemployment rates were lower in Japan.

To foreign investors, the EC was more attractive than EFTA. The percentage of U.S.A. direct investment in EC rose from 40.5 percent in 1957 to 44.7 percent in 1964. Yannopoulos (1990) relates this increases to a diversion of the flow of US investment from the non-EC countries of Western Europe, to a member of the community. Numerous other studies have likewise concluded that EC attracted significantly more of the growth in total US foreign direct investment than EFTA countries. Table 2.4 reflects this trend.
TABLE 2.4  FLOWS OF US DIRECT INVESTMENT TO WESTERN EUROPE (percentage)

<table>
<thead>
<tr>
<th></th>
<th>1950</th>
<th>1957</th>
<th>1964</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western Europe</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>EC Countries</td>
<td>45.6</td>
<td>36.5</td>
<td>50.5</td>
</tr>
<tr>
<td>EFTA</td>
<td>48.9</td>
<td>59.7</td>
<td>44.1</td>
</tr>
</tbody>
</table>

Source: Yannopoulos (1990)

The exceptionally long period of high and stable growth, combined with unprecedented levels of employment, gradually came to an end. After 1973 it gave way to a new situation characterized by a deceleration of economic growth (Tables 2.2&2.3) declining rates of investment and productivity, inflation, loss of international competitiveness and a dramatic rise in unemployment.

Large increases in oil prices between 1973 and 1974 and again in 1978-1979, escalating labour costs, resurgence of protectionist measures in the west and increasing burden of Common Agriculture Policy (CAP) are some factors responsible for the end of the golden age in the EC.

The beginning of the 1980 found the Western Europe in the midst of a deep economic crisis - stagnating output and growth, rising unemployment, declining export shares in the world markets. 'Euro sclerosis', a term, which become quite popular, was used to describe this state of the EC.⁹

⁹ Tsoukalis (1993) pp 46-47
And then things slowly began to change. In the course of the 1980s, the transformation of the economic and political climate was absolutely remarkable. European economies slowly discovered their old dynamism; growth rates and investment increased, many new jobs were created. Meanwhile, regional integration gained momentum. There was an urgent need to restore confidence and competitiveness.

2.3 THE 1992 PROGRAMME

In 1985 at the Milan summit, progress was made on two issue, a seven year timetable was agreed for removing 300 barriers to the internal market, movements to alter the Treaty of Rome and democratising the decision making process. This led to the Single European Act (SEA) paving the way for establishing the Single European Market (SEM). The SEA was culmination of many years of difficult negotiations intended to provide the legal framework for the transformation of the European communities into a ‘European Union’.

The programme for the completion of the EC’s internal market came to be known as the 1992 programme. The original idea came from Jacques Delors, but credit for the detailed planning and the enthusiastic way in which the programme was launched should go to the then UK commission for internal market affairs, Lord Cockfield. It became clear that the programme would bring considerable economic benefits to all the member states. It also gave a new sense of purpose to the community.\(^\text{10}\) In this section we proceed as follows: Section 2.3.1 discusses the Single Market Programme and the action

---

\(^{10}\) Leonard (1997), pp 20-21
agenda to achieve it, Section 2.3.2 discusses the Maaschricht treaty which set the time-table for a monetary union, in Section 2.3.3 the convergence criteria which the member states were required to satisfy before they accede to European Monetary Union is briefly outlined and Section 2.3.4 discusses the road to economic and monetary union.

2.3.1 THE SINGLE MARKET

Most of the legislative measures in the SEA took the form of directions, obliging member states to achieve particular results within a stated period of time and leaving them free to choose the method of implementation. The White Paper drawn by Lord Cockfield, listed some 300 actions that were taken to achieve the objective of a single market. These were divided into three categories11.

i) Physical barriers: The white paper set as its target the total abolition of frontier controls by 1992. Beginning with the introduction in 1988 the single Administrative Document, which replaced up to 70 forms previously required by truck drivers crossing internal EC frontier – paving way for the complete removal at the end of the period of all restrictions on goods and individual travelers.

ii) Technical barriers: The second part of the white paper was intended to remove the barriers created by the different national regulations and standards. The commission proposed a system of mutual recognition of national standards, pending the adoption of European standards. Other proposals included: the liberalization of public procurements, the establishment of a common market for services such as transport,

11 Leonard (1997), pp 105-107
banking, and insurance; the free movement of capital throughout the community, the removal of legal restraints and the formation of EC wide companies

iii) Fiscal barriers: The third part of the white paper was mainly concerned with the approximation of Value added Tax (VAT) and excise duty rates throughout the community. The rates could vary by + or − 2.5 percentage of the target rate chosen.

By the target date of December 31st 1992, over 90 percent of these measures had been adopted by the Council of Ministers.

In subsequent years there was a marked acceleration in the decision making process of the European Council. The legislation, for e.g. with respect to harmonization of technical rules, mutual recognition of certain standards was quickly passed. The economic performance of the EC as a whole improved substantially. The average growth rate was 4 percent and still higher for the weaker economies like Portugal and Spain. This resulted in narrowing the intra-EC gap. Huge increases in investment, a large proportion of it in terms of foreign direct investment was responsible for growth. Major restructuring, long due was taking place in the manufacturing and service sector. There was a wave of mergers and acquisitions. European integration was thus extended to production level. During the same period, millions of new jobs were created and the labour cost declined and profits began to rise. The share of intra-EC trade sharply increased and this had a positive effect on income and growth, thus closing the door to 'Euroscelorisis' of earlier years.
2.3.2 THE MAASTRICHT TREATY

With the EC economy firmly in saddle, the EC leaders felt free to seek to revive the dormant project for economic and monetary union at the Hanover summit of June 1988, which reappointed Jacques Delors for further two years from January 1989, a committee was set up under his chairmanship with a mandate to study and report on means of preparing a monetary union. The committee proposed a three-stage process leading to a full currency union and European system of Central Bank.\(^{12}\)

The European Council met at Maastricht in December 1991, to approve of the European Union (EU). After hard bargaining and opt out clause insisted upon by UK, the treaty was signed. The Maastricht treaty represented the most important development in the EC’s history since the signing of the treaty of Rome. It set out a detailed timetable for achieving economic and monetary union latest by 1999.

2.3.3 CONVERGENCE CRITERIA

The Maastricht treaty set out five ‘Convergence criteria’ which member states had to satisfy before they could accede to European Monetary Union (EMU) in 1999. This convergence criteria fall into two categories: Inflation Criteria, which are designed to ensure that the transitional cost of joining are tolerable; and Fiscal criteria, which are intended to guarantee that the European Central Bank (ECB) will not find its commitment to price

---

\(^{12}\) Leonard (1997), pp 22-23
stability undermined by profligate government. The Convergence criteria are outline below:\(^\text{13}\)

- Successful candidates must have inflation rates no more than 1.5 percent above the average of the three EU countries with the lowest inflation rates
- Long term interest rates should be no more than 2 percent above the average of the three countries with lowest rates
- National currencies must not have been devalued and must have remained with a 1.5 percent band for the previous two years
- National budget deficits must be less than 3 percent of GDP
- The national debt must be less than 60 percent of GDP

2.3.4 THE ROAD TO ECONOMIC AND MONETARY UNION \(^\text{14}\)

At the European Council in Madrid in December 1995, the EU entered the third stage of economic and monetary union and introduced the single currency on 1\(^\text{st}\) January 1999. A ‘reference scenario’ was adopted by the European Council for the introduction of the single currency, setting clear dates and deadlines for the various stages of the changeover. It was agreed that the new currency would be called euro and that it would be of equal value to the European Currency Unit (ecu), based on a basket of national currencies.

Two principal trade-related benefits would stem from the introduction of a single currency: The elimination of transaction costs associated with currency conversion, and greater transparency within the single market of EU. Both

\(^{13}\) Healey (1999), p 110
\(^{14}\) Trade Policy Review of the EU (1997)
these consequence would benefit intra and extra community trade alike. Another benefit for intra-EU trade would stem from the elimination of exchange rate risks within the euro zone.

The treaty of Rome signed in 1957 led to the establishment of EEC and the treaty of Maaschrishit signed in 1991 paved the way for the formation of the EU. In the following section we discuss the Eastern enlargement of the EU.

2.4 THE EASTERN EUROPEAN ENLARGEMENT

Meanwhile, profound changes were taking place in Eastern Europe, which would have a deep effect on EU. By 1989, Hungary and Poland were well on the way to a peaceful transition from communism to democracy. The EU became the Forum for channelling Aid there, including that from the USA. The PHARE (Poland and Hungary Aid for Reconstruction of Economy) programme was set up by the group of seven (G7) summit in 1989 on behalf of 24 donor countries. Grant Aid was helpful in providing much needed expertise and has concentrated increasingly on improving basic infrastructure\(^\text{15}\).

The massive needs in Eastern Europe for Aid and Trade have major implications for the EU and the rest of the World. New trade arrangements were granted to Eastern Europe, along with the removal of import quotas and tariff reductions, to give imports from Eastern Europe the same entry conditions as those for developing countries. Thus, the Central Eastern European Countries (CEECs) moved steadily up the pecking order of trade

\(^{15}\) Harrop (2000), pp 294-295
relations with the EU, initially through the GSP and than the ‘Europe Agreements’ (will be discussed in Chapter III) signed in December 1991 with Poland, Hungary and Czechoslovakia. The ‘Europe Agreements’ were signed at a time when Hungary and Poland were making a transition to democracy and market economy and had experienced severe macroeconomic imbalances. Thus, we see that Hungary and Poland were seeking integration with the EU at a time when they experienced political disintegration and economic crises (Section 2.1.4 has outlined the reasons as to why countries seek integration).

Having gained an overview of the EU, we proceed to examine the effects of European integration on intra-EU trade.

2.5 IMPACT OF EUROPEAN INTEGRATION ON INTRA-EU TRADE

The share of intra-regional trade in total trade can measure the extent of regionalization. An increase in the intra-regional trade share is taken as verification of the effect of regionalization of trade flows. It may not be very strong evidence, but nevertheless can be an important indicator of the extent of regionalization.

The foundation of EEC was internal trade liberalization. The process of trade liberalization within the EEC has undergone three major phases. The first, starting in 1958, was the elimination of customs duties and quantitative restrictions. It was completed in 1968 with the creation of the customs union. The second, between 1973 and 1995, witnessed ‘widening’ with successive enlargements from six to 15 members. The last ending in 1992 was the completion of single market with free movement of goods and services, capital and labour. At the same time the EU has also progressively reduced external
tariffs. When the EEC was formed the average external tariff was reduced from 13 percent in 1958 to 10.4 percent in 1968 and 6.6 percent after the Kennedy Round. This shows that internal liberalization was accompanied with external liberalization.

Table 2.5 shows that the share of intra-EU trade in world exports increased from 8 percent in 1960 to 14.9 percent in 1972, whereas the share of intra-EU in total EU trade jumped from 34.6 percent to 50 percent during the same period (Table 2.6). Between the years 1980 and 1985, the share of intra-EU trade in world exports and total EU trade remained roughly constant. But the share of intra-EU in total EU trade increased to 60 percent in 1990 (Table 2.6). This could be an anticipation of the 1992 Single Market Programme. Thus, we can say that the share of intra-EU in total EU trade has significantly increased since the signing of the Treaty of Rome. But this effect is not only due to integration. External trade policy and competitiveness are also factors, which have contributed to increase shares in intra-trade over time.

TABLE 2.5 SHARE OF INTRA – EU TRADE IN WORLD EXPORTS
(Percentage)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>EEC (6)</td>
<td>8.0</td>
<td>13.9</td>
<td>14.9</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEC (12)</td>
<td></td>
<td></td>
<td></td>
<td>21.3</td>
<td>18.5</td>
<td>18.3</td>
<td>24.2</td>
<td>24.3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU (15)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>24.3</td>
</tr>
</tbody>
</table>

Source: UN, International Trade Statistics Year Book, Various Years

---

16 Gros and Steinher (2004), p 270
TABLE 2.6 SHARE OF INTRA – EU TRADE IN TOTAL EU TRADE

(percentage)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>EEC  (6)</td>
<td>34.6</td>
<td>48.9</td>
<td>49.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EEC  (12)</td>
<td></td>
<td></td>
<td></td>
<td>51.6</td>
<td>52.5</td>
<td>54.7</td>
<td>60.7</td>
<td>61.1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU   (15)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>62.2</td>
<td>61.0</td>
<td>61.1</td>
</tr>
</tbody>
</table>

Source: UN, International Trade Statistics Year Book, Various Years

The process of EU integration has favoured economic growth and trade. This outcome was due to internal as well as external liberalization of trade. The question is whether the EU is likely to continue support of the multilateral trading system. The concern arises because of the extensive network of regional agreement built around EU that are examined in the following section.

2.6 THE PYRAMID OF EUROPEAN COMMUNITY PREFERENCES

The European Community has created a system of preferences with its trading partners, which varies in scope and degree of integration and the preferences granted. Some countries enjoy concessions similar to those granted to member states, others have received only restricted and sector-specific preferences. Preferential arrangements are of two kinds – reciprocal and non reciprocal. Under the reciprocal arrangements trade concessions is required both ways. Agreements with EFTA countries are of this nature. Non-reciprocal arrangements are where there is one-way trade concession –
agreements with Mediterranean countries and Lomé convention are examples of non-reciprocal agreements. Association agreements are signed with EU by countries eventually seeking membership. The European community pyramid of trade preferences can broadly be classified into:

A) Agreement on the European Economic Area
B) Association Agreements
C) Lomé conventions
D) Cooperation Agreements
E) Generalised System of Preferences.

We consider each of these below.

A) Agreement on the European Economic Area (EEA)\(^\text{17}\)

The idea to replace the bilateral framework between the European Community and EFTA countries by a free trade area was first launched in 1989. In 1994, agreement was reached to establish an EEA that included all members of European Community and the EFTA countries.

Agriculture products have been excluded from the EEA agreement. Several EFTA countries have concluded bilateral agreements with the EU concerning tariff concessions for certain fruits and vegetables produced by EU southern member states in order to give them better access to their markets and thus contribute to the development of the poorer EU region. The main features of the EEA are:

- The free movement of goods, services, capital and person;

\(^\text{17}\) Economic Commission for Europe, Trade Division (1997), p 32
• Contribution to cohesion fund to help reduce the social and economic disparities;
• Adoption of EU rules on company law and Consumer Protection;

As compared to full EU membership, EEA does not cover:
• The Common Commercial policy;
• The Common Transport policy;
• Direct and indirect taxation;
• Monetary and political integration;
• European Community international agreements.

The EEA shrank in number in 1995 when, Austria, Finland and Sweden were admitted as members of EU.

B) Association Agreements

Association Agreements were concluded between the EU and non-member states to establish special links in areas such as trade, close economic cooperation and financial assistance. They take two forms.\(^{18}\)

• To accommodate the special economic links that existed with former colonies, where in customs duties were reduced or lifted and financial assistance was granted through the European Development Fund for former colonies, mainly in Africa.

• The second type of Association Agreements is intended to prepare non-member countries for possible accession. The ‘Europe Agreements’ and Association Agreements with European

\(^{18}\) Economic commission for Europe,Trade Division (1997), pp33-34
Mediterranean countries fall in this category. These agreements will be discussed in detail in Chapters III and V respectively.

C) Lomé Conventions

The Lomé conventions (signed consecutively in 1975, 1979, 1984, 1989) apply to 70 African, Caribbean and Pacific (ACP) countries, most of them former overseas territories or colonies. The ACP will be examined in detail Chapter V of the study.

D) Cooperation Agreements

Cooperation Agreements are less comprehensive than Association Agreements or the Lomé conventions. Their primary aim is to promote economic relations. The Cooperative Agreements have been signed with non-Mediterranean countries, the newly independent states of Central Asia, some Asian countries and with Southern Common Markets (MERCOSUR).

(i) Cooperative Agreements with non-European Mediterranean countries cover trade issues, industrial cooperation and financial and technical assistance.

(ii) Partnership and Cooperation Agreements with the newly independent states of Central Asia. Non- Preferential partnership and Cooperation Agreement were signed with newly independent states of Central Asia in 1994 and 1995, to strengthen political links and promote trade and investment. The Agreements contain provisions, subject to safeguard for most favoured nation (MFN) treatment, removal of quotas and

19Economic commission for Europe,Trade Division (1997), pp 38-39
other quantitative restrictions, with the exception of the textiles and steel sectors. Special provisions also apply to foreign direct investment by EU countries in the Russian Federation.

(iii) Cooperation Agreements with Asian Countries

A Cooperation Agreement was signed with the Association of South East Asian Nations (ASEAN) in 1980. In 1986 and 1990 it was renewed and extended to cover more sectors, shifting emphasis from aid to trade and mutual beneficial economic cooperation. Furthermore, the EU is committed under the Agreement to foster trade development and export promotion in ASEAN countries. The EU also participates in the ASEAN regional forum meetings.

(iv) Cooperation Agreements with other countries.

The EU network of cooperation agreements has lately been expanded to MERCOSUR. In 1994, the EU and MERCOSUR agreed on the conclusion of an interregional frame for cooperation in trade and economic matters as a first step toward interregional association. This Agreement is expected to bring about trade liberalization and eventually lead to the establishment of a free trade area for manufactured goods and services.

E) Generalised System of Preferences

GSP is an autonomous instrument in that preferences are granted by the EU under a special GATT enabling clause designed to ensure that the system is non-discriminatory. The GSP will be discussed in detail in Chapter V of this study.
Thus, EU is an important destination for exports of developed as well as developing countries. A substantial part of extra-EU trade is accounted for by trade with regional partners: EFTA, Eastern Europe and Mediterranean and ACP countries. As such it has played an important part in international trade negotiations under the auspices of GATT and its successor, WTO.

The Uruguay Round was formerly concluded in March 1994 and the Agreements came into force on 1st January 1995. The EU ratified the final Act of the Uruguay Round, adopted the necessary legislation to implement its commitments and became a founding member of WTO. It thus significantly contributed to the coming into force of WTO on 1st January 1995, as scheduled\textsuperscript{20}.

The Uruguay Round final agreements includes wide ranging reductions of MFN tariffs to be effected between 1 July 1995 and 1 July 2000. The EU committed itself to widespread tariff reductions on manufactured goods. Thus, EU unweighted average tariff on industrial goods declined from the 1995 rate of 6 to 3.7 percent in 2000. In addition, tariffs were eliminated on products such as pharmaceuticals, construction equipment, medical equipment, most steel items, paper products, furniture, selected toys, soaps and detergents\textsuperscript{21}. The EU agreed to cut its agricultural export subsidies by 36 percent over a period of six years from 1994. Thus, the active participation of the EU in the Uruguay Round trade negotiation underlines its commitment to further open world markets. Thus, the EU is not only the largest and the most successful

\textsuperscript{20} Economic commission for Europe, Trade Division (1997), p 49
\textsuperscript{21} Economic commission for Europe, Trade Division (1997), p 49
RTA, but also an important trade partner of the developing countries through its web of preferential trading arrangements, is also at same time committed to multilateralism. Next, in the following section we examine the GATT and WTO as multilateral trading system.

2.7 THE WORLD TRADE ORGANISATION

In the post war period, support for liberal trade was boosted by the view that free trade was essential to world peace and prosperity. Multilateral negotiations on promoting liberal trade began in 1946. At the final negotiating conference, 56 countries were represented and they agreed to establish an International Trade Organization (ITO). The ITO was to be a rule oriented institution that would strictly enforce trade liberalization. It was intensely criticized in U.S. because of its extensive power bordering on infringement of national sovereignty. Instead, a more limited document, the GATT was signed by 23 nations in 1948 to initiate reduction in trade barriers. The GATT evolved into an effective institution that greatly influenced world trade policy for nearly half a century. The late 1960s and the early 1970s saw the mushrooming of RTAs. Section 2.7.1 examines the principles of GATT, Section 2.7.2 presents the trade liberalization achievements of the GATT that have come from eight multilateral tariff negotiating rounds, at the end of the Uruguay Round the GATT secretariat was replaced by WTO. In Section 2.7.3 we bring out the basic differences between GATT and WTO, Section 2.7.4 highlights the achievements of the Uruguay Round.
2.7.1 GATT FOUNDING PRINCIPLES

This section briefly examines the founding principles of the GATT. The principles of MFN, national treatment and reciprocity govern trade policy relation. Another important GATT principle is maintaining a balance of benefit among signatories. These fundamental principles of the GATT that underlie its philosophy are discussed briefly.

A) The principle of MFN (GATT Article I) means that contracting parties must treat each other equally in their trade policy relations. It required that where bilateral negotiation and agreements lowered tariff between two countries, the reduced rates should be multilateralised and available to all exporters of the product. The MFN claim had three exceptions: 22

1) Pre-existing preferential trading arrangements were excluded from the MFN clause. The GATT also allowed for new preferences to be granted to developing countries, such as GSP privileges granted by developed countries.

2) Customs Union and Free Trade Areas were exempted from the MFN clause. The reason behind this exemption was that free trade areas would gradually expand and facilitate the establishment of global free trade.

3) A new contracting party to the GATT could also be denied the MFN privileges by existing parties.

22 Maswood (2000) p 31
There are several economic motivations for MFN: i) Non-discrimination across countries can minimize economic distortions and lead to a more efficient allocation of resources. ii) MFN can reduce trade liberalization search and negotiation costs. A country pursuing multilateral liberalization does not need to negotiate a series of bilateral trade barriers reduction because one reduction automatically spreads to all other trading partner. iii) MFN can help reduce customs administration costs because the same duty applies to products independent of their point of origin.

B) National treatment (GATT Article III) requires that once an import has been received into a customs territory, government cannot discriminate against imports through taxes and other regulation. National treatment is a logical and necessary extension of trade liberalization. If trading partners could administer polices that differentiated domestic from foreign produced goods, liberalization at the customs border could be offset by domestic policies.

C) The Principle of reciprocity governs the process of trade liberalization. Countries are reluctant to reduce trade barriers unilaterally because of the intense economic and political pressure from the import competing sector, which is hit hard by such liberalization. But if trading partners simultaneously liberalize, then export producers in each country will gain from the other country's liberalization. Consequently, the export producers may carry enough weight to offset the protectionist lobbying.

23 Armstrong (1998), p 3
24 Armstrong (1998), p 4
pressure from the import competing sector.

D) The balance of benefits principle embodied in GATT Article XXIII is the well-known nullification and impairment of benefit clause. It authorises countries to raise dispute when their benefits are substantially reduced. The logic behind it is: i) laws and trade agreements contracts are imperfect and cannot explicitly address every possible situation that might constitute a violation of liberalization. There are a variety of non-tariff barriers that a country can impose which may not be explicitly covered by the GATT but they might result in the nullification and impairment of benefits to a trading partner, ii) Enforcement of international trade law is ultimately voluntary. Therefore, countries must continue to reap a sufficiently large stream of benefits to ensure their self-interested compliance. A balance of benefits is a necessary component of enforcement.25

These principles embodied in the GATT are important as they induce countries to lower and bind tariffs over time. The trade liberalization achievements of the GATT are discussed in the following section.

2.7.2 TRADE LIBERALIZING ACHIEVEMENTS OF THE GATT

The GATT's liberal achievements have come from eight multilateral tariff-negotiating rounds. When GATT came into being in 1947 the level of tariff for industrialized countries averaged 40 percentage or more. After the

25 Armstrong (1998), p 3
Tokyo Round this fell to an average of 6.3 percentage and as a result of the Uruguay Round it fell to 3.8 percentage.

The period from the late 1970s to the end of the 1980s was marked by a resurgence of protectionist sentiment in some Western industrialized countries. To stem the tide of protectionism, in September 1980, trade ministers from 90 countries, meeting at Punta del Este, Uruguay issued a declaration launching the Uruguay Round of trade negotiations.

The developing countries played a marginal role in the early years of the GATT's operation, because it failed to promote liberalization in areas of greatest interest to them such as textiles. The debt crisis of the early 1980s and the IMF structural adjustment programs, which had forced them to liberalize their trade policies, encouraged them to try and secure a better deal through the GATT for their export commodities. The developing countries played a much active role in the Uruguay Round.

The final outcome of the Uruguay Round was to replace the GATT secretariat with the World Trade Organization (WTO), which has more wide reaching powers than the GATT. The WTO administers multilateral agreements pertaining to trade in goods, trade in services (GATS), Trade Related Intellectual Property Rights (TRIPS) and Trade Related Investment Measures (TRIMS).
2.7.3 THE BASIC DIFFERENCES BETWEEN GATT AND WTO

There are many similarities between GATT and the WTO. The basic principles remain the same. The WTO deals predominantly with the actions of governments, establishing disciplines on trade policy instruments such as tariffs, quotas, subsidies and state trading. Thus, the WTO is a regulator of regulatory actions taken by governments that affect trade and the conditions of competition facing imported products on domestic markets. In this it is no different from the old GATT.

GATT 1947 states that its objectives are to raise the standard of living ensure full employment, better utilization of world resources and expanding production and exchange of goods. Reciprocal and mutually advantageous arrangements involving substantial reduction in tariffs and non-tariff barriers will contribute to the realization of these objectives. This also continues to be the case of WTO. There are some basic differences between GATT and WTO that are discussed in Hoekman and Kostecki (2001) and are presented below:

• GATT was not formally an international organization, but an inter governmental treaty. As a result, GATT had contracting parties. This has changed with establishment of WTO, which is an international organization and has member states.

• The coverage of WTO is much greater. For the first time trade in services and intellectual property rights were included within the multilateral trading system. Environment is also becoming an agenda item.

• The WTO agreement is a ‘Single undertaking’ - all its provisions apply
to all members. Whereas the GATT framework allowed for the existence of a number of important side agreements negotiated and concluded by certain GATT contracting parties in the framework of various GATT rounds.

- In the dispute settlement area under GATT it became much more difficult to block the formation of panels and the adoption of panel reports.
- Much greater transparency and surveillance functions were granted to the secretariat through the creation of Trade Policy Review Mechanism.
- GATT trade opt-out arrangements such as those governing the clothing and textiles and agriculture sector are to be gradually overturned. Virtually all trade in goods would from now on be subject to WTO rules.

2.7.4 THE ACHIEVEMENTS OF URUGUAY ROUND

The GATT laid out the framework for dealing with trade barriers, many of which had become opaque and tended to impede trade and growth. The instruments of commercial protection can take many forms. The most common being tariffs. Other barriers are called non-tariff barriers, which include anti-dumping, safeguard measures, subsidies and countervailing duties.

The protection given to domestic produces comes from the fact that the measures are designed to favour them at the expense of importers. While the GATT sought to eliminate barriers to trade it allowed certain exceptions so as
to grant temporary protection to troubled industries in order to allow them to charter through troubled water.

This section examines the results of Uruguay Round in assessing how successfully it has been concluded in terms of overall reduction in tariffs, increase in bindings and reduction in tariff escalation. In view of increasing recourse to NTB by member countries, the Uruguay Round has laid down additional rules, so that countries use them only sparingly. For the first time intellectual property rights, trade in services was introduced. The dispute settlement mechanism was strengthened. These are discussed below:

A) Tariffs

GATT’s primary focus in the years was on the reduction of tariffs, initially on a request offer basis and then, starting with the Dillon Round by a percentage amount. When the negotiation is complete the concessions made are bound at a certain level and the benefit from them is extended to all members of the GATT. This is known as MFN. Judging whether a negotiating round has been successful depends on a number of factors. Some criteria for assessing a round are discussed below:

i) Reduction of tariffs.

ii) Tariffication

iii) Distribution of tariffs

iv) Bindings

v) Tariff escalation.
i) Reduction in Tariffs

The final reduction of tariffs on industrial goods amounted to an overall average of 37.38 percentage and an average of 40 percentage among developed countries. For the developed countries as whole industrial imports benefiting from zero duty will jump from 20 percentage to 44 percentage of trade. The overall reduction was improved by important offers made by developing countries.

Members of GATT / WTO receive benefits from the relatively low protection levels that existed and were further reduced under the Uruguay Round. According to Krueger (1998), the transition economies benefited from tariff reduction resulting from the Uruguay Round, which led to substantial increase in their volume of exports especially to the EU.

ii) Tariffication

This technique was used for the first time in the Uruguay Round. The idea was to convert non-tariff barriers into tariffs, which are more transparent and less restrictive.

iii) Distribution of tariffs

In Developed countries about 91 percentage of the imports will now enter at a tariff of less than 10 percentage. The Developing countries have made substantial efforts with reduction in the no.of tariffs above 35 percentage and more binding of tariff in the 15 to 35 percentage category (GATT,1994).
iv) Bindings

The bindings represent the international agreed tariff levels, not necessarily what is applied in practice. In practice, applied rates may be different. The degree of bindings among industrialized countries was already high before the Uruguay Rounds. But among developing countries many had few or zero bindings.

In Hungary, 83.3 percent of all tariff lines were bound in 1991. Post Uruguay Round, 95.7 percent of all national tariff lines are bound. Most of the 4.3 percent of unbound tariff lines pertain to live animal products, chemical products, transport equipment, precision instruments and works of art. The lack of binding in these areas, allows higher application of tariffs.\(^6\) Poland increased its coverage of binding after the Uruguay Round from zero to 93.5 percent of tariff lines.

V) Tariff escalation

Many tariff structures, such as low tariffs on the raw materials used by domestic producers, but higher tariffs on the product that is processed, depending on the degree of processing is known as tariff escalation. This creates problems for developing countries that are trying to diversify out of the production and exports of raw materials into processed goods. In the Uruguay Round tariff escalation according to level of processing has remained almost the same.

Poland’s tariff structure exhibits significant tariff escalation that favours domestic processors of mainly food, beverages & tobacco, textile and leather; of wood and wooden furniture.  

Tariff Preferences in Hungary and Poland

Hungary provides substantial tariff preferences (Table 2.7) to various trading partners, which include EU, EFTA, Poland, Czech Republic and developing countries. Hungary has also concluded free-trade agreements with Israel and Turkey. Preferential tariff cover 70 to 80 percentage of Hungary’s import. Under the GSP, preferential tariff rates are applied to products originating from developing countries that provide MFN treatment for Hungarian goods.

### TABLE 2.7 TARIFF PREFERENCES IN HUNGARY (1997) (percentage)

<table>
<thead>
<tr>
<th></th>
<th>MFN</th>
<th>GSP</th>
<th>EU</th>
<th>EFTA</th>
<th>Poland</th>
<th>Czech</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>37.1</td>
<td>16.6</td>
<td>37.1</td>
<td>36.3</td>
<td>17.6</td>
<td>18.9</td>
</tr>
<tr>
<td>Industry</td>
<td>8.2</td>
<td>3.4</td>
<td>2.0</td>
<td>2.0</td>
<td>0.9</td>
<td>0.9</td>
</tr>
</tbody>
</table>


### TABLE 2.8 TARIFF PREFERENCES IN POLAND (1999) (percentage)

<table>
<thead>
<tr>
<th></th>
<th>MFN</th>
<th>GSP</th>
<th>EU</th>
<th>EFTA</th>
<th>Poland</th>
<th>Czech</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>17</td>
<td>12.4</td>
<td>15.3</td>
<td>13.2</td>
<td>5.5</td>
<td>3</td>
</tr>
<tr>
<td>Industry</td>
<td>16</td>
<td>14.4</td>
<td>5.9</td>
<td>6.7</td>
<td>4.9</td>
<td>3.9</td>
</tr>
</tbody>
</table>

Poland provides substantial tariff preferences to various trading partners under regional agreements and free trade agreements. These include tariff preferences for imports from the EU, EFTA and Central Eastern European Agreement (CEFTA) members, and bilaterally on imports from countries like Estonia, Croatia and Turkey. Most of Poland’s trade is conducted under these preferential arrangements. The GSP rates on agriculture products and industrial products are much lower than MFN rates. It covers mainly three quarters of Poland's trade. Again preferential tariffs are lower than MFN rates (Table 2.8).

Substantial difference between MFN and preferential tariffs imply that Hungary’s and Poland’s tariff structure is likely to divert imports away from MFN sources. The Republic of Korea, India and United States have voiced concern over the wide gap existing between MFN and preferential tariffs. The response of Poland and Hungary in this respect was once they get accession, they would have to adopt EU's common external MFN tariff, which will reduce its MFN rates by almost two thirds. This will decrease considerably the gap between Poland and Hungary's preferential and MFN rates.

B) Non-Tariff Barriers

GATT also contained certain provisions to prohibit or restrict NTBs. It prohibited the use of quantitative restrictions and set down certain rates for the use of other NTBs. But as tariffs were reduced, NTBs continued to

---

flourish. In the Uruguay Round some additional conditions were added and other grey area measures were banned. Some of the non-tariff barriers are discussed below.

i) Antidumping (AD)

AD measures are permitted by GATT under its Article VI, which defines dumping as having occurred if the product of a country is sold in another country at less than its normal value. In the Uruguay Round a sunset clause was added whereby duties are to be terminated within 5 years of imposition. Moreover, if margins are less than 2 percent or market share of firm is less than 3 percent than dumping duties would not be imposed.

To a large extent the increased use of antidumping measures is due to increased liberalization around the globe, and countries in the cold wind of competition feel more secure if they have some trade weapons up their sleeves to be used as a last resort. Although, there is increase in number of AD cases, it covers only a small percentage of imports.

The EU continues to be the second most frequent user of anti-dumping procedures, after the United States. The number of measures in force, which stabilized at around 150 between 1992 and 1995, increased in 1997 and a total of 177 measures were in force. An examination of antidumping measure initiated by the EU, country-wise show that measures against China are most frequent, with 34 measures in force, followed by the Russia Federation (14), Japan (13) and Republic of Korea (12). The Asian region attracted more than half of all measures, with Central and
Eastern Europe the second most affected area Turkey and Egypt are the only two Mediterranean countries affected by antidumping measures. In Latin America, there are measures against Brazil, Venezuela and Mexico. Turning to product breakdown, three large categories of product represent two thirds of all measures: iron and steel, textiles and footwear products and consumer electronic products.  

ii) Safeguards

The main objective of GATT agreement is trade liberalization and in order to facilitate such liberalization, certain set of rules and discipline was designed so as to lower these barriers and to eliminate them progressively. But at the same time it was recognized that unexpected surges in imports would cause serious injury to a particular industry. Therefore a safety valve - Article XIX was inserted into GATT agreement. These include quantitative import restrictions, import surveillance measures etc.

Hungary has not applied any safeguard measures to WTO members since the entry into force of the Uruguay Round Agreements. Poland has used safeguard provisions under regional trading agreements to restrict preferential imports. Poland implemented safeguard measures against EU Yoghurt import from 1999. The tariff preference was withdrawn and the tariff was raised from 9 percentage to the MFN rate of 35 percentage. This was because of a substantial rise in the volume of

subsidized imports from the EU. Safeguard proceedings were also initiated in 1999 against imports of coated steel sheets.

iii) Countervailing duties and Subsidies

Governments in many countries provide subsidy to their industry and exports in order to enhance their competitiveness and in some circumstances may provide unfair advantage to them vis-à-vis the industry and trade of another country. Hence disciplines have been laid down in the WTO agreements to the grant of subsidies and also taking action against subsidies given by other countries.

C) Agriculture

Agriculture has been one of the most contentious areas of world trade. Prior to the Uruguay Round, it was effectively put outside the GATT sphere of influence. With the creation of EEC 1957, European countries also insisted on a special treatment for this sector. CAP implementation by EEC protected farmer from foreign competition.

The Uruguay Round broke new ground by including all aspects of agriculture trade & liberalization. Certain factors to which this change can be ascribed are discussed:

- In the early 1980 a constituency emerged in the EU that favoured a reduction in agricultural support. These subsidies were a heavy burden on the budget.
- Two oil shocks had led to large fiscal deficits, compounding the pressure on government finances.
- A decision by the US to engage in a subsidy war with EU in 1980s,
which raised opposition to EU export subsidization also helped to increase financial pressure.

- Agriculture disputes became more intense and provided the incentive for dealing with agriculture in GATT.

The Agreement on agriculture that emerged from the Uruguay Round has four main parts i) market access ii) domestic support iii) export competition iv) sanitary and phytosanitary measures (Armstrong, 1998). Markets for agricultural products are of considerable interest to Eastern European economies in transition. The transition economies are net exporters of agricultural products, and do not themselves have large domestic support schemes for agriculture. The countries participating in the Uruguay Round pressed hard for liberalization of agricultural trade, although only Hungary was formally a member of the Cairns Group. A simple average reduction of tariffs on agricultural commodities after the Uruguay Round was 39 percent on the exports from the economies in transition. On the negative side, tariffs on agricultural commodities in which the economies in transition seem to have a comparative advantage remain high, and there are still high domestic supports in place in many industrialized countries.30

D) Agreement on Textiles and clothing

Trade polices towards textile and clothing imports were exempted from GATT agreement. Many developing countries have a comparative advantage as textile and clothing requires less capital and is labour intensive. As domestic producers in high-income countries came under

30 Pietras (1998), pp 357-358
pressure from cheap imports especially from Asian countries, they
lobbied for protection.

During the Dillon Round a short-term arrangement on cotton textile was
introduced. This rapidly evolved into long term arrangement, which in
turn led to 4 successive multifibre arrangements (MFA). The MFA was a
system of voluntary restraints administered by exporting countries to limit
import growth rates in the receiving countries.

In the Uruguay Round agreement on Textiles and Clothing (ATC)
resulted, from a deal between the advanced economies seeking greater
intellectual property rights protection on the part of developing
economies in return for abolishing the old system of quota administered
under MFA.

The ATC differs from the other agreements in that it serves as a vehicle
for transferring MFA covered product into GATT 1994. The ATC
stipulates that the MFA will be out and trade in textiles and clothing
integrated into GATT over 10 years period.\textsuperscript{31}Integration means GATT
rules prohibiting the use of quantitative restriction. EU and U.S.
liberalized categories, where the imports were already unrestricted.
Moreover, Article 6 of the ATC authorizes transitional safeguard
measures, which were to be used sparingly.

\textsuperscript{31} Armstrong (1998), p 5
E) Agreement on TRIPS

Another breakthrough of the Uruguay Round was the Agreement on Trade Related Intellectual Property Rights (TRIPS). Counterfeiting, copying and piracy are now widespread, thus presenting barriers to fair trade. The situation becomes worse because such practices are not illegal in many developing countries. The copying of products has led to loss of revenue among the industrialized countries. TRIPS attempts to regulate and standardize international intellectual property rights in order to prevent the above-mentioned abuses and thus create a fairer trade market. Though the introduction of intellectual property (IP) rights will generate both positive and negative effects on developing countries, the net effect will very likely be negative because of the increased prices of patented products, particularly in the area of pharmaceuticals.\(^{32}\)

F) General Agreement on Trade in Service (GATS)

The Uruguay Round includes for the first time a "General Agreement on Trade in Service" which attempts to do for services what GATT has done for trading in goods by establishing a multilateral framework for the reduction and elimination of barriers to international trade in service. GATS establish the MFN principle for trade in service.

G) Trade Related Investment Measures (TRIMS)

Foreign direct investment (FDI) is a significant area of growth in the

\(^{32}\) Armstrong (1998), p 4
global economy and it is a result of the increase in FDI that TRIMS was included for the first time in the Uruguay Round. TRIMS are policies used by government with view to forcing foreign investors to put certain performance standards for e.g. the local content requirement, restriction on volume or value of imports that an enterprise can purchase etc.

H) Trade Policy Review Mechanism (TPRM)

The purpose of the TPRM is to monitor the trade policies and practices of the WTO members and to assess their impact on the multilateral and where relevant plurilateral trading system. The aim of the TPRM is to achieve a degree of transparency and understanding of members trade policies that will lead to a smoother running of the global trade system.

I) Dispute settlement mechanism

The establishment of a Dispute Settlement Mechanism was one of the major achievements of Uruguay round. The Uruguay Round brought about 2 key changes, i) The parties who were to become the WTO signatories changed the 100 percentage consensus rule to a reverse consensus rule: a panel report would automatically become official WTO law unless there was 100 percentage consensus not to adopt the report. ii) All disputes would be settled under the rules of Unified Dispute Settlement Body. This reversed the Tokyo Round Policy of subdividing disputes settlement procedures. The Tokyo Round resulted in separate codes covering different areas of trade policy each with a
separate set of dispute resolution procedure.

Two other modifications to dispute settlement were the introduction of an Appellate Body and specific time limitation. The time to complete dispute settlement under GATT had increased in several instances lasting several years. In the Uruguay round the maximum time for circulating a panel report is 9 months. The standing Appellate Body is an innovation, which gives disputants the right to appeal a panel report. This body has final authority in term of upholding or over turning the panel findings.

The Uruguay Round managed to tie up a lot of the loose ends that were not dealt with by the Tokyo Round. It introduced much strict discipline in the operation of the safeguard clause. It also brought agriculture and textile within the folds of WTO. Though the multilateral trading system emerged stronger after the Uruguay round there is a threat that regionalism may gain an upper hand, because of proliferation of RTAs in the 1990s. So, is regionalism a threat to the multilateral trading system? This issue is taken up in Section 2.8.

2.8 REGIONALISM VERSUS MULTILATERALISM

The agreements reached in the Uruguay Round therefore constitute a significant step forward in reasserting the principles of nondiscrimination and open markets. Without these agreements the WTO would have been much less credible as an organization. But over the last three decades, RTAs have proliferated; virtually all members of WTO belong to some kind of an RTA.
This development represents both a challenge and an opportunity for the WTO. In this section we examine the conflict that arises between ‘Regionalism versus Multilateralism.’

Regionalism is not new and has existed for many years, its numbers multiplying soon after the post war period and reaching its peak in the early 1970s. But this first wave of regionalism was not very successful. After being dormant in the 1980s, it revived again in the 1990s - termed as the second wave of regionalism. By Mid 1998 there were 102 regional agreements notified under Article XXIV of the GATT, compared to 40 in 1990. The RTAs have deepened and widened in scope. The Free Trade Area of the Americans (FTAA) will cover more than half a billion people. The European Union’s agreements with Central and Eastern Europe and the Mediterranean are comparable in scope to the FTA. Mexico signed a FTA with the EU in 1998, EU-MERCOSUR (Argentina, Brazil, Paraguay and Uruguay) talks are ongoing, Chile completed negotiations for setting up a FTA with the EU in 2002, and thus EU’s preferential arrangements talks with South America include block-to-block negotiations and single country negotiations.

There is also an increasing web of interlocking agreements. European countries and Mexico belong to more than ten agreements. Brazil, Colombia, Venezuela, Chile and some Central American countries belong to between five and ten such agreements. Moreover, joining blocs centered on the major powers has a number of advantages for developing and transition economies. Apart from the improved access to the developed country market, such an arrangement involves considerable liberalization of the trade and trade related
policies of the developing or transition economy. Such associations may bring additional benefits, such as US support for Mexico in the financial crisis of 1994 or access to structural funds from the EU\textsuperscript{33}.

Naturally, therefore concern about rise in regionalism is justified. These issues have no easy answers. Countries seek regional cooperation for a variety of reasons and these wide ranging differences have to be taken into account in analyzing RTAs. Section 2.8.1 spells out the differences between GATT and RTAs principles emphasizing that GATT has never formally objected to RTAs, and Article XXIV of the GATT has provisions for coexistences of RTAs with the multilateral trading system if certain conditions are fulfilled. Section 2.8.2 traces the causes of failure of the first wave of regionalism, Section 2.8.3 examines the causes of rise in the number of RTAs in the 1990s and in this context in Section 2.8.4 we examine the debate on "Regionalism versus Multilateralism" investigating whether RTAs constitute "Building bloc" or "Stumbling blocs" for the multilateral trading system.

2.8.1 RTA PRINCIPLES IN GATT

The GATT has never formally objected to regional agreements. But concern about regionalism arises partly because of the differences between GATT and RTA principles that are presented in Table 2.9

One of the main underlying principles of GATT is the MFN clause that has been discussed in the earlier section of this chapter. Article XXIV of GATT departs from the MFN principle and allows RTAs to coexist with the general

\textsuperscript{33} Laird (1999) pp 1190-1191
agreement under certain conditions. The rationale behind Article XXIV is discussed below.

(i) Full integration on trade would be allowed among any subset of GATT members since it created an important element of a single-nation characteristics among these nations.

(ii) Exception would be permitted only for case where all trade barriers would need to come down, excludes the possibility of the world breaking up into many fragmented, discriminatory blocs.

(iii) Articles XXIV can also be considered a supplemental, practical route to the universal free trade that GATT favoured as the ultimate goal, with the general negotiation during the many rounds leading to a dismantling of trade barriers on a GATT wide basis while deeper integration would be achieved simultaneously within those areas where

<table>
<thead>
<tr>
<th>GATT Principles</th>
<th>RTA Principles</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Non – Discrimination</td>
<td>Discrimination</td>
</tr>
<tr>
<td>2. MFN</td>
<td>Special preference not granted to nation outside the bloc</td>
</tr>
<tr>
<td>3. Protection should be provided through tariff</td>
<td>Protection could be provided through quantitative restrictions as well as tariffs.</td>
</tr>
<tr>
<td>4. GATT / WTO is open to all who are willing to follow membership rules</td>
<td>The RTA could be an exclusive club.</td>
</tr>
</tbody>
</table>

Source: From Landau (2001)
polities permitted faster movement to free trade under a strategy of full and time bound commitment\textsuperscript{34}.

Under Article XXIV, Customs Unions and free trade area agreements are permitted because it is recognized that such agreements have the potential to further economic integration without adversely affecting the interest of third countries. There are four criteria that must be adhered to in forming a Customs Union or a free trade area. These include ‘substantially all’ criteria; the ‘Not on the whole higher’ criteria; the interim agreement plan and schedule, and the problem of notification and decision of the GATT which are discussed below:

i) ‘Substantially all’ criterion

Paragraph 8 of Article XXIV defines the characteristics of Customs Union and free trade area. It states that parties to Customs Union and free trade area must eliminate duties and other restrictive regulations of commerce with respect to substantially all the trade between their constituent customs territory\textsuperscript{35}. ‘Substantially all’ phrase allows flexibility where members of Customs Union and free trade area may where necessary exercise their rights to maintain restrictions under GATT Article XI, XII, XIII, XIV, XV and XX.\textsuperscript{36} Also ‘Substantially all trade’ would permit a quantitative or a qualitative approach as it can be interpreted as covering most of the sectors or most of the volume or value of trade. Most often, agriculture sector is excluded.

\textsuperscript{34}Bhagawati(1992 b), pp.537-538

\textsuperscript{35}WTO,\textit{International Economic Integration} (1998), p27

\textsuperscript{36}Hudec and Southwick (1999), p 63
An important rationale for the substantially all trade requirement is that it helps government to resist the inevitable political pressure to avoid or minimize tariff reductions in inefficient import competing sectors. This also ensures that RTAs have wide political support and that they are not narrow based discriminatory arrangements. A wider sectoral coverage enhances the trade creating effects of such agreements.

ii) Duties ‘not on the whole Higher or More Restrictive’

A major constraint placed on customs union under paragraph 5 of Article XXIV is the requirement that the common external tariff imposed at the time of the formation of the union not be on the whole higher or more restrictive than those imposed by the constituent territories before the formation. Another issue was the method in which the common external tariff of a Customs Union is elaborated – for example, simple averaging, trade-weighted averaging or alignment at the lowest tariff, because it has important effects on market access opportunities of third country supplies. Another issue was whether ‘The general incidence of duties’ should be examined on a product by product basis i.e. whether the general incidence of duties for each product category after the implementation of the Customs Union should be no higher than the incidence of duties applied by each of the Custom Union parties to that product category before the agreement or whether an increase in one sector could be offset by a decrease in another sector.

The Uruguay Round addresses these questions and accordingly, weighted tariffs would be used. The assessment will look at the impact of duties as a whole, allowing for the averaging of increases and decrease. This understanding has not solved the entire problem. But it has improved the review of Customs Union since 1995, including the enlargement of the EU to include Austria, Finland and Sweden.

Similar progress cannot be reported regarding the issue of rules of origin. In a free trade areas and some Custom Union’s the parties apply rules of origin to determine which products imported from another free trade area or Custom Union party have undergone sufficient processing within the free trade area or Custom Union to benefit from the agreements tariff preferences. Problems have arisen in Custom Union and free trade areas when the agreement imposes strict requirements, demanding unusually high levels of regional content, to qualify for tariff preferences. The strict rules can cause manufactures within the region to ensure that their finished products will qualify for the preferential intraregional duties\textsuperscript{38}.

iii) Interim agreements: notification, plans and schedule for completion.

A contracting party entering into a customs union or free trade area is required to promptly notify the contracting parties. Article XXIV contains requirements to ensure transparency of proposed agreements. Agreements are to be promptly notified to GATT for examination by the contracting parties. Custom union’s and free trade areas are

\textsuperscript{38}Hudec and Southwick (1999), p 55
established over a long period and Article XXIV provides explicitly for interim agreements. There needs to be a period of adjustment and transition. To avoid the danger that such interim agreements are used as a pretext for introducing discriminatory preferences, it requires that they include a ‘plan and schedule for the formation of such a customs union or free trade area within a reasonable time. If the contracting parties find that the plan and schedule in the interim agreement are not likely to lead to the formation of customs union or free trade area, or not do as within a reasonable period, the contracting parties are to make recommendation. The parties to the interim agreement shall not maintain or put into force the agreement if they are not prepared to modify it in accordance with these recommendations\(^{39}\).

The criteria discussed have their pros and cons. The ‘substantially all trade’ criterion prevents governments from forming Custom Union’s and free trade areas that promote the interest of same group at the expense of the other. Thus, preventing trade diversion. But at the same time, the criterion of ‘duties not on the whole higher’ ignores the trade diverting effects. For example, because of preferential treatment given to partners, the demand for the products from non-members may decline even if the external level of tariff is not raised. Article XXIV makes no mention of such trade diversion. Despite these drawbacks, criteria laid down in Article XXIV ensure that RTAs are more compatible with GATT than they would have been otherwise. The RTAs, which proliferated in the 1960s and 1970s, were not successful. Why did the first wave of regionalism fail? What factors were at play that has strengthened the second

wave of regionalism? These are some issues that are examined in the following section.

2.8.2 THE FIRST WAVE OF REGIONALISM

The architects of the GATT or the United States, the chief proponent of multilateralism and non-discrimination, did not see regionalism as antithetical to the GATT and its principals. According to Bhagwati (1992b) the first wave of regionalism failed because:

i) United States restrained itself from resorting to Article XXIV and remained strongly committed to multilateralism. But at the same time, United States supported the formation of the European Community in 1958 because it saw this as a political beneficial union to maintain peace in Europe.

ii) There was an outbreak of free trade area proposals in the developing countries as well. They were motivated by different rationale formulated by Cooper and Massell (1965a and 1965b), Johnson (1965) and Bhagwati (1968). This was that given any targeted level of import-substituting industrialisation, the developing countries, with their small markets, could reduce the costs of this industrialisation by exploiting economies of scale through preferential opening of market with one another. By the end of 1960s, the attempts of forming regional free trade area and Custom Union’s along these lines collapsed. This was because bureaucratic negotiations were used for allocation of industries rather than trade liberalization and hence prices to guide industry allocations. Moreover, although many of these agreements had achieved the objective of achieving free trade on a limited number of
products, these arrangements could not be used as conduit of development because there was no wide sectoral coverage, limiting the gains from trade.

Regionalism had virtually died by the end of 1960 except for the original EC and EFTA.

2.8.3 THE SECOND WAVE OF REGIONALISM

The surge in RTAs in the 1990s constituted a break from the previous wave of regionalism. Previous regional agreements had been neither so numerous, nor so successful, as those of recent years. Developments in four essentially independent areas seem to have come together in the late 1980s to create a movement towards regionalism. Europe integration, United States strategy, developments in Canada and changing attitude towards trade in the developing world.40

i) The influence of Europe

The European community took major steps with the single Europe market initiative that was adopted in 1987 and took effect in 1992. Although there have been set backs, but still European Community’s scope, depth and geographical area covered is a remarkable achievement. This success has had a demonstration effect, encouraging other countries to emulate in forming RTAs.

ii) The Reversal of the American position

At the GATT ministerial conference in Geneva United States showed willingness for regional initiative with interested partners. The swift

40 Frankel (1997), pp 4-7
outcome was the U.S.-Israel free trade area and the Caribbean Basin initiative. But there is a deeper historical significance to this American policy – the decline of American hegemony. In this view, a non-discriminatory global trading regime, enforced by an institution such as the WTO, is an international public good. That is, the non-discriminatory regime benefits everyone, but support to initiate and maintain it will not be provided if each country acts to maximize its self-interest under the assumption that it is too small to affect the action of others. In this view, the cooperation to support such a regime will only be forthcoming if there exists a hegemonic power – that is a power large enough to recognize the effects its action have on the global system and therefore large enough to organize the others into collective action. The United States has been the necessary hegemony since World War II but now no longer. In response, the United States have decided to abandon active support for the non-discriminatory regime in favour of pursuing its own regionalist agenda.

iii) Canada enters the picture

Canada initiated negotiations with the United States and this bilateral deal was completed in 1988. In doing so it reversed the 100 years of explicit rejection of such proposals with larger neighbors. The view among Canadian business people was that, their market was too small to exploit economies of scale.

---

41 Frankel (1997), pp 5-6
iv) Developing countries abandonment of import substitution

The developing countries have taken serious regional initiatives. Those countries have dumped the import substitution model which dominated their thinking in 1960s and 70s, are now in favour of market liberalization. As long as goal was to find regional market for favoured industries that could not compete in world markets, the arrangement was bound to fail. But when the goal is to make industries better able to compete internationally, regional arrangements are more likely to succeed.

Regionalism is now here to stay. So, then does it pose a threat to the multilateral trading system or is regionalism complementing the multilateral trading system? We take up this debate in the subsequent section.

2.8.4 CONFLICT BETWEEN REGIONALISM VERSUS MULTILATERALISM

A number of studies, for e.g. Bhagwati (1992b), are concerned about the negative effects of growing regionalism on the rule based multilateral trading system. Bhagwati gives a number of reasons for the growth of regionalism, but emphasizes the importance of multilateralism for freer trade. According to him the revival of regionalism is unfortunate, but it is important to contain and shape it in such a way that it becomes maximally useful and minimally damaging.

Krueger (1995) is of the opinion that the establishment of regional free trade areas might create beneficiaries who would form a lobby against
multilateralism. For example, the Uruguay Round showed that beneficiaries under the Lomé convention were concerned about the erosion of preferences. But on the other hand, there is no evidence that RTA members opposed multilateral liberalization.

On the other hand, Baldwin (1997) rejects the notion that the recent trend to regionalism is related to dissatisfaction with the GATT system. Participants do not see regionalism according to him as a substitute for multilateralism, and many fears about regionalism are misplaced. He points out that North-South agreements may be a way of promoting liberalization in developing countries.

The complementarity between regionalism and multilateralism is also stressed by Ethier (1998). He argues that regionalism is the means by which new countries trying to enter the multilateral system compete among themselves for direct investment and also a result of the success of multilateral liberalization.

Lawerence (1999) argues that developing countries that sign agreements such as the GATT or regional agreement may gain improved access to foreign markets for their exports and provide economies of scale. Lawerence argues that the correct comparison is not between a preferential agreement and complete multilateral liberalization. A more realistic comparison between multilateral liberalization that is only partial and preferential trade liberalization, which could be much more complete. In practice the two approaches have not been incompatible.
WTO (1995) noted that the scope for achieving tariff advantages had been reduced under the MFN tariff cutting commitments in the Uruguay Round. Attention was therefore turned to non-tariff measures. The report also noted that few regional agreements covered agriculture, services and intellectual property, whereas WTO covered them. It noted that step taken in certain regional agreements, for example, in services, had helped to lay the foundation for progress in the same areas in the Uruguay Round. The report concluded that the coexistence of RTAs and the multilateral system had been 'at least satisfactory, if not broadly positive'.

This section takes up the most debated issue of whether RTAs are 'building blocs' or 'stumbling blocs' towards a liberal multilateral trading regime.

2.8.4 A BUILDING BLOCS: POSITIVE IMPLICATIONS OF REGIONALISM FOR MULTILATERAL LIBERALIZATION

i) Integration for Lock-in to Reforms

RTAs can act as commitment mechanism to lock-in reforms, because they are built upon reciprocal preferences. The agreements reduces the likelihood of a country reversing its trade liberalization, because if it goes back on the trade preferences it has granted, it can be sure that its partners will respond by cancelling the preferential access they grant. MERCOSUR provides a good example, where Brazil had to back down on its attempts to deviate from the agreements after coming under pressure from Argentina (World Bank, 2000).
On the other hand it is argued that tariff bindings under the WTO are better devices for locking in reforms than are regional agreements. A comparison of the of the 1982 and 1994 Mexican crises illustrates the lock-in point. In the first debt crises, Mexico raised trade barriers against all partners sharply. In the second crises, with North America Free Trade Area (NAFTA) in place, Mexico raised tariffs on some products against partners outside of the Western Hemisphere but continued to cut tariffs on US trade, as called for under the agreement. This response illustrates that the regional agreements bound tariffs more strongly than did WTO membership.42

Some regional trade agreements have explicitly added a commitment to democracy to their original design. This has clearly been the case with the EU, and the granting of membership to the new democracies of Portugal, Greece and Spain, where regional group was used as a commitment mechanism.

ii) Efficiency of Negotiating with Larger Units

The idea in the 1980s was that progress towards free trade could be made more rapidly by regional negotiations than by GATT negotiations. Within the context of multilateral negotiations, it can be slow and awkward to negotiate separately with over 100 small countries. It is argued that it is easier for a smaller group of countries

42 Frankel (1997), p 217
to negotiate a Customs Union first. With common external trade policy, they can then enter multilateral negotiations as a group.\textsuperscript{43}

The EU is certainly the most important example of this. Other groups such as Association of South East Asian Nations (ASEAN), the Caribbean Common Market (caricom), can be urged to integrate regionally so they can speak in a unified voice.

On the other hand, dozens of regional trading arrangements among Western Hemisphere countries have created spaghetti like web. To negotiate with every possible group would be a herculean task, both in terms of time and capital and probably worse than negotiating with 112 or more members of WTO.

iii) Competition and Scale Effect

Many countries are too small to support activities that require large economies of scale. RTA offers one route to overcome these disadvantages as it combines markets and increases competition. This can yield three types of gain: i) because of increased competition, firms are induce to cut prices and to expand sales, benefiting the consumers, ii) because of market enlargement firms exploit economies of scale more fully, iii) because of reductions in internal inefficiencies that firms are induce to make. If the RTA increases the intensity of competition, it may induce firms to eliminate internal inefficiencies.

\textsuperscript{43} Frankel (1997), pp 217-218
iv) Foreign Direct Investment

RTAs create a large market and therefore succeed in attracting FDI. Inflow of FDI may be seen as increased confidence in the economy and as a route through which an economy can modernize. Modernization occurs through access to modern technology, modern management, marketing networks, and sources of inputs. FDI enters blocs to exploit investment opportunities and to use one member as a platform for serving the whole bloc. There is considerable evidence that RTAs with larger markets have succeeded in attracting FDI. Mexico provides the best example of this. FDI flows into Mexico more than doubled in the year following the launch of NAFTA. The EU’s share of world wide inward FDI flows increased from 28 percent to 33 percent during 1982-93 (World Bank, 2000).

v) The Pattern of Trade

Regional integration will change relative prices in member economies. Imports from partner countries will become cheaper due to the elimination of tariff, and in response demand patterns will change, causing changes in the flow of trade and in output levels in many sectors. It involves expansion of some sectors, contraction of others, and relocation of industries from country to country. If the partner country’s production displaces higher cost domestic production, than there will be gain - trade creation. But if the partner country’s production displaces lower cost imports from the rest of world than there will be loss of welfare - trade diversion.
The EU's common agricultural policy is the best-known example of trade diversion. This involves a price structure for agricultural products designed to divert consumer purchases towards EU farmer and away from non-European suppliers. Messerlin (1998) estimate the cost of this protection at, 12 percent of total EU farm income.

An example from NAFTA concerns clothing. Following the 1994 crisis, Mexico increased tariffs on non NAFTA imports, just as it was reducing tariffs on NAFTA imports. Mexican imports from the rest of the world fell by 66 percent between 1994 and 1996 while those from United States increased by 47 percent. Similarly in the U.S. markets, imports from Asia fell while imports of clothing and finished textiles from Mexico and from Canada increased by more than 90 percent (USITC 1997).44

vi) Convergence or Divergence due to Relocation

Regional integration will lead to relocation of economic activity depending on comparative advantage, clustering and knowledge flows. This forces acting together may lead to either convergence in the levels of income or divergence. Comparative advantage may lead to either convergence of income between rich partners, but may cause divergence of income between two poor countries. If the RTA is between high and low income countries, than relocation of industries will take place with respect to factor endowments and factor prices. For examples, both within the EU and also its relationship with some

44 World Bank (2000), p 42
of the transition economies, there is evidence that there is relocation of
industry with labour intensive activities moving to lower wage
economies and promoting convergence in wage rates. These are
possible economic arguments favouring regional strategy (World
Bank, 2000).

2.8.4 B STUMBLING BLOCS: NEGATIVE IMPLICATIONS OF
REGIONALISM FOR MULTILATERAL LIBERALIZATION

i) Bloc’s Market Power and Incentive to Protect.

In a world consisting of a few large blocs, each unit will have more
monopoly power and thus will be tempted to seek to shift the terms of
trade in its favour by raising tariff against the other blocs. Collectively
the blocs fail to improve their terms of trade and merely reduced
everyone’s welfare. But this does not stop them from trying.

ii) Manipulation by Special Interests

Special interest argument points out that a RTA provides abundant
opportunities for trade-sensitive industries to manipulate the process,
particularly in those sectors that might be hurt. Typically it may take
the form of excluding certain sectors altogether or introducing long
phasing out periods or through the rules of origin. The members of
ASEAN for example, have in the past exempted almost all the
important sector from the system of preference that they are suppose to
grant each other. Another example is, EU treatment of agriculture and
steel. In the ‘Europe Agreements’ EU has offered longer phase out
period for import from Poland and Hungary in precisely those products
which account for about one third of their exports and they fall into the sensitive category of products in EU which may be adversely affected by such liberalization.

iii) Scare Negotiator Resources

This argument points out that negotiations are not costless. For e.g. If U.S.A special trade representatives spend all time and capital on a regional agreement (e.g. NAFTA) there is less time and capital left to spend on multilateral negotiations. As with the incentive to protect agreement, regional trading arrangement may set back the process of negotiating worldwide trade liberalization under WTO.45

iv) Market Access

Trade blocs block market access to vast region. This gives the bloc a substantial leverage. The bloc can prevent further liberalistion of international trade and may foster the attitude that their markets are big enough. Moreover, when it is the question of a large and small country negotiations, RTAs make it easier for small countries to gain guarantee access to large markets thus exploiting economies of scale.

v) Regionalism as Insurance

The RTA may lock in tariff reduction for the small country and may offer some defense against other trade restrictions either in the form of agreed ‘disarmament’ e.g. Canada and Chile agreeing to do away with anti-dumping duties or through enhanced dispute settlement e.g.

45 Frankel (1997), p 214
NAFTA. This is often referred to as the ‘insurance motive’ for regionalism and this name highlights a potential problem for the multilateral system: moral hazard. A country with insurance might be less concerned about multilateral discipline than one without. Sapir (1995) notes that the Hungarian authorities appeared to pay more attention to EU discipline than multilateral discipline in determining their trade policy.46

vi) Domino Regionalism

An RTA may impose costs both mercantilist and welfare on nonmembers even if it does not raise levels of protection. Non-member suppliers become less competitive in member market because they continue to pay tariffs while member producers do not. Moreover, where there are economies of scale, regional integration may help lower member country firms’ costs by increasing their home market. Non-members may respond to the situation by trying to join the RTA that threatens them or by forming a bloc of their own. For e.g. EFTA was created in response to EEC. The decision of Finland, Sweden and Austria to join EU in 1990’s may be traced to European Union’s single market initiative.47

Thus, there is no shortage of arguments in which RTAs can operate as stumbling blocs and undermine multilateral liberalization. But fortunately they

46 Winters (1998), pp 50-51
47 Winters (1998), pp 51-52
may also operate as building blocs strengthening multilateralism as seen in Section 2.8.1. In Section 2.9 we analyze trade flows of selected RTAs.

2.9 INTRA AND INTER REGIONAL TRADE FLOWS

As discussed above, RTAs can act as a 'building blocs' and/or 'stumbling blocs' for the multilateral trading system. Analyzing the trade flows of selected RTAs, we may try to find the extent of increase in intra-RTA trade over the years of the RTA formation over extra-RTA trade. Such an analysis although raw, gives a tentative idea about the general effects of a RTA on trade.

From Table 2.10 we can say that:

i) Some RTAs are amongst high income countries (such EU), some only middle-income (such as MERCOSUR and ASEAN) and some only low income countries (ANDEAN and CEFTA). NAFTA contains a mixture of high-income and middle-income countries. In some RTAs most trade is with members, while in other very little. From Table 2.10 we see that in the year 2000 share of member countries exports that goes to other member countries is 63 percent for EU and 55 percent for NAFTA. In middle-income RTAs the share is smaller, at 24 percent for ASEAN and 21 percent for MERCOSUR. This share drops further for low-income RTAs at 8.9 percent for ANDEAN group and 11 percent for CEFTA.
<table>
<thead>
<tr>
<th>RTAs</th>
<th>Year</th>
<th>1990</th>
<th>1995</th>
<th>1997</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>APEC (21)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intra – exports</td>
<td></td>
<td>67.5</td>
<td>72.4</td>
<td>71.4</td>
<td>72.7</td>
</tr>
<tr>
<td>Extra – exports</td>
<td></td>
<td>32.5</td>
<td>27.6</td>
<td>28.6</td>
<td>27.3</td>
</tr>
<tr>
<td>Intra – imports</td>
<td></td>
<td>65.4</td>
<td>71.7</td>
<td>70.3</td>
<td>71.2</td>
</tr>
<tr>
<td>Extra – imports</td>
<td></td>
<td>34.6</td>
<td>28.3</td>
<td>29.4</td>
<td>28.8</td>
</tr>
<tr>
<td><strong>European Union (15)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intra – exports</td>
<td></td>
<td>64.9</td>
<td>64.0</td>
<td>61.4</td>
<td>62.7</td>
</tr>
<tr>
<td>Extra – exports</td>
<td></td>
<td>35.1</td>
<td>36.0</td>
<td>38.6</td>
<td>37.3</td>
</tr>
<tr>
<td>Intra – imports</td>
<td></td>
<td>63.0</td>
<td>65.2</td>
<td>62.9</td>
<td>60.3</td>
</tr>
<tr>
<td>Extra – imports</td>
<td></td>
<td>37.0</td>
<td>34.8</td>
<td>37.1</td>
<td>39.7</td>
</tr>
<tr>
<td><strong>NAFTA (3)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intra – exports</td>
<td></td>
<td>42.6</td>
<td>46.0</td>
<td>48.8</td>
<td>55.7</td>
</tr>
<tr>
<td>Extra – exports</td>
<td></td>
<td>57.4</td>
<td>54.0</td>
<td>51.2</td>
<td>44.3</td>
</tr>
<tr>
<td>Intra – imports</td>
<td></td>
<td>34.4</td>
<td>37.07</td>
<td>39.9</td>
<td>39.6</td>
</tr>
<tr>
<td>Extra – imports</td>
<td></td>
<td>65.6</td>
<td>62.3</td>
<td>60.1</td>
<td>60.4</td>
</tr>
<tr>
<td><strong>ASEAN (10)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intra – exports</td>
<td></td>
<td>20.1</td>
<td>25.5</td>
<td>24.8</td>
<td>24.0</td>
</tr>
<tr>
<td>Extra – exports</td>
<td></td>
<td>79.9</td>
<td>74.5</td>
<td>75.2</td>
<td>76.0</td>
</tr>
<tr>
<td>Intra – imports</td>
<td></td>
<td>16.2</td>
<td>18.8</td>
<td>20.2</td>
<td>23.5</td>
</tr>
<tr>
<td>Extra – imports</td>
<td></td>
<td>83.2</td>
<td>81.2</td>
<td>79.8</td>
<td>76.5</td>
</tr>
</tbody>
</table>
TABLE 2.10  MERCHANDISE TRADE OF SELECTED REGIONAL INTEGRATION ARRANGEMENTS (percentage share)
(concl’d)

<table>
<thead>
<tr>
<th></th>
<th>Intra – exports</th>
<th>Extra – exports</th>
<th>Intra – imports</th>
<th>Extra – imports</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CEFTA (8)</strong></td>
<td>-</td>
<td>16.2</td>
<td>13.6</td>
<td>13.0</td>
</tr>
<tr>
<td>Intra – exports</td>
<td>-</td>
<td>83.2</td>
<td>86.4</td>
<td>87.0</td>
</tr>
<tr>
<td>Intra – imports</td>
<td>-</td>
<td>12.3</td>
<td>10.0</td>
<td>10.2</td>
</tr>
<tr>
<td>Extra – imports</td>
<td>-</td>
<td>87.7</td>
<td>90.0</td>
<td>89.8</td>
</tr>
<tr>
<td><strong>MERCOSUR (4)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intra – exports</td>
<td>8.9</td>
<td>20.5</td>
<td>24.6</td>
<td>21.0</td>
</tr>
<tr>
<td>Extra – exports</td>
<td>91.1</td>
<td>79.5</td>
<td>75.4</td>
<td>79.0</td>
</tr>
<tr>
<td>Intra – imports</td>
<td>14.5</td>
<td>18.1</td>
<td>20.6</td>
<td>19.8</td>
</tr>
<tr>
<td>Extra – imports</td>
<td>85.5</td>
<td>81.9</td>
<td>79.4</td>
<td>80.2</td>
</tr>
<tr>
<td><strong>ANDEAN (5)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intra – exports</td>
<td>4.2</td>
<td>12.2</td>
<td>11.8</td>
<td>8.9</td>
</tr>
<tr>
<td>Extra – exports</td>
<td>95.8</td>
<td>87.8</td>
<td>88.2</td>
<td>91.1</td>
</tr>
<tr>
<td>Intra – imports</td>
<td>7.7</td>
<td>12.9</td>
<td>13.3</td>
<td>13.8</td>
</tr>
<tr>
<td>Extra – imports</td>
<td>92.3</td>
<td>87.1</td>
<td>86.7</td>
<td>86.2</td>
</tr>
</tbody>
</table>


ii) We look at the extra–RTA exports to find out whether it is declining.

The steepest decline in extra–RTA exports is observed for NAFTA from 57.4 percent in 1990 to 44.3 percent in 2000 and MERCOSUR from 91 percent in 1990 to 79 percent in 2000. Closely following them are ASEAN, EU and the ANDEAN group.
iii) The extra-RTA imports of Asia Pacific Economic Cooperation (APEC), NAFTA, ASEAN, MERCOSUR and the ANDEAN group have declined while that of EU and CEFTA have increased.

However, this data fails to distinguish the effects of regional integration from other economic changes – for example external trade liberalization, which may have taken place and have an effect on external trade. Moreover, the picture is sufficiently mixed and no clear conclusions such as whether intra-RTA trade has increased over extra-RTA trade over the years of the RTA formation can be drawn from this sort of aggregate exercise.

2.10 CONCLUSIONS

The RTAs may serve as building blocs rather than stumbling bloc for global free trade. It combines markets and increases competition, succeeds in attracting FDI and also brings about relocation of economic activity within the region. But on the other hand, RTAs bloc market access to vast regions and may prevent further liberalization of international trade. The detailed analyses of the EU reinforce the view that RTAs can serve as vehicles for enlarging trade, markets and economic growth. Today, the Union is a sprawling entity of 25 states (15 EU countries + 10 accession countries which joined the Union in May 2004)48 and 455 million people. Such a large sized market provides tremendous scope and opportunities to the developed and the developing countries. For Hungary and Poland there are many advantages that arise because of regional integration. For example, there is considerable scope for

---

48 The ten countries are: Hungary, Poland, Czech Republic, Slovenia, Slovakia, Lithuania, Latvia, Estonia, Malta and Cyprus.
gains from ‘competition and scale effects’. Firms in Hungary and Poland would benefit from an enlarged market, which allows them to exploit economies of scale more fully, and competition would force them to reduce internal inefficiencies. It will also bring about changes in trade flows. Elimination or reduction in tariffs on industrial goods offered under ‘Europe Agreements’ to Hungary and Poland brings two fold benefits: (i) they enjoy a competitive edge as suppliers in EU markets compared to other countries, (ii) they provide new opportunity to firms to diversify their production structure so as to match the demand requirements of its preferred partners. Much of this might be driven by FDI, as Hungary and Poland become more attractive destination for capital inflows that brings new technology and better marketing practices.

Membership in GATT / WTO has conferred many benefits to these economies, a few of them are discussed. As members of WTO, it was ensured that trading partners would apply MFN rates instead of protectionist measures. The dispute settlement mechanism is important for the transition economies as the political and economic structure is too fragile, but the presence of a multilateral system prevents the more powerful economies from pressuring the weaker ones. While examining the achievements of the Uruguay Round we have seen that Hungary and Poland are committed to tariff reductions, bindings, tariffication and have sparingly used NTBs, one implication is that these economies are becoming more open. The Trade Policy Review Mechanism has provided two fold benefits to these economies: i) it enables Hungary and Poland to reflect and reevaluate their trade policies, ii) it enables a country to establish institutions under the disciplines of GATT / WTO which
would be useful in establishing trade policies conducive to their successful integration into the world economy.

The GATT played a significant role in locking in trade policy reforms of Hungary and Poland, as these countries had low bound tariffs. However, the ‘Europe Agreements’ go far beyond the WTO, basically extending much of the single market rule to Hungary and Poland.