Chapter 5
Regionalism Vs Multilateralism: Testing the Debate

5.1: Introduction

Both Regionalism and Multilateralism, as has been seen in the previous chapters calls for liberalisation of trade. Both are the outcomes of the realisation that “free trade is the first best policy”. The difference between the two is that, one creates a liberalised trading regime at the regional level, the other aims at creating the same at the global level. This led to the belief by the GATT contracting parties that regionalism might aid multilateralism.

The popularity of RTAs has raised some serious concerns among economists, policy makers and negotiators. The primary concern is the apparent trend of regionalisation of global trade. The main reason behind the concern is the trend’s inherent contradiction with the objective of rule based multilateral trading system. This contradiction leads to a possibility of regionalism dominating multilateralism, though the degree of the threat has not been conclusively understood.

In this chapter, we try to analyse the degree of threat posed by regional trading arrangements in achieving a liberalised global trading arena. For doing this, at first, we try to have a first hand knowledge regarding the claim that there has been an increased popularity of RTAs in the recent times. If this is found to be quite true, then the next step would be to analyse the reason behind the increased popularity. Then, an attempt has been made to analyse whether the regional trading arrangements lead to the creation of a tide against multilateral trade liberalisation. On one hand, it might be reasonable to argue that some discrimination is inbuilt within the RTA framework; thus any RTA is bound to create a movement against the multilateral trade liberalisation initiative. But, in
that case, the question that cannot be ignored is that then why did the GATT contracting parties agreeing to allow the formation of RTAs? There must be a way out which they felt would drive out the discrimination problem. But, if the experience is that the RTAs are regionalising global trade, one reason might be certain shortcomings in the provisions incorporated in Article XXIV of GATT 1994. Another reason of the above trend might be the improper implementation of the provisions. So, while analysing, the issue has been dealt from three angles. One is the theoretical aspect of RTA. Second is the set of provisions under the multilateral trading system allowing the formation of the RTAs. In the third place, empirical tools have been used to study the issue.

Accordingly, the chapter has six sections. The next section discusses the global trend for regional trading arrangements. This would help us to understand the extent of validity of the claim regarding an increased interest in formation of regional trading arrangements. In section 5.3 the theoretical issues of an RTA is analysed to find out to what extent they can lead to or adversely affect global trade liberalisation. Based on the belief that trade liberalisation at the regional level would lead to global trade liberalisation, the formation of RTA has been allowed under the multilateral trade discipline. The next section, section 5.4 critically evaluates the ability of the provisions for the formation of regional trading arrangements to make the latter act as building blocs to liberalise global trade arena. In section 5.5, certain techniques have been used to evaluate whether some of the important regional trading arrangements have created any wave against global trade liberalisation. The last section, section six (5.6) is the concluding one.

5.2: RTAs - The Global Trend

Regionalism is not so old a phenomenon in the global trading arena. In its proper framework, the world experienced the first form of regional grouping in the twentieth century. Exhibit 5.1 reveals that from the seventies there has been an
increased number of RTAs coming up in the global trading arena. This trend appears to have got sharpened during the nineties. In fact, the post-war trade liberalisation initiative at the multilateral level has been paralleled by the same initiative at the regional level through the regional trading arrangements. Breaking the period, two distinct sub-periods can be seen to reveal increased popularity of the regional trading arrangements. One is the seventies and the other during the nineties. (Exhibit 5.1).

Thus, data do support the claim that there has been an increased interest in signing regional trading agreements, especially in the nineties. After verifying the claim, the next stage is to look into the rationale behind the increased popularity. The question becomes important, considering the fact that the trade liberalisation initiative at the multilateral level was already in place during the whole period, and more during the two distinct periods.

Exhibit 5.1: Regional Trading Arrangements Notified Under the GATT/WTO

![Graph showing the increase in the number of RTAs notified under the GATT/WTO]

Source: WTO Secretariat

The popular answer to the question has been that the slow progress of the multilateral initiative led to the increased popularity of the RTAs. There is no doubt that the trade liberalisation initiative at the multilateral level, involving
quite a large number of countries and thus complex issues is expected to take comparatively longer time if compared with the relatively simple negotiating issues of an RTA. Added to this is the fact that the number of countries joining the multilateral trading system is increasing with the passage of time, making the negotiating process more complex with divergent issues, and thus increasing the expected time of the liberalisation process. The countries, quite eager to achieve a liberalised trade regime prefer to go for the faster process through regional trade liberalisation initiative.

This popular claim again demands verification from the data relating to the multilateral trading system negotiating process. Considering the two distinct periods of increased popularity of RTAs against the backdrop of the multilateral trading system, it can be claimed without doubt that the same is seen to reveal quite satisfactory progress during the two periods. The two periods that reveal a phenomenal increase in the number of regional trading arrangements coincide with the periods when the multilateral trading system was also revealing quite remarkable pace of liberalisation, along with disciplining the multilateral trading system. During the seventies the different non-tariff measures eroding away the benefits of the multilateral trade liberalisation started gaining attention in the negotiating forum. As such, the global trading system was expecting the emergence of a more disciplined trading environment aiding fair trade. Moreover, disciplining the non-tariff measures in turn implies removing unnecessary restrictions on trade and thus can be interpreted as a movement towards liberalisation. The late eighties and early nineties signalled the Uruguay Round approaching a successful conclusion with a much wider framework of trade liberalisation under the gamut of the World Trade Organisation.

This contradicts the popular claim that the slow progress of the multilateral trade liberalisation led to the increased interest in the regional trading arrangements. It
appears that the urge for liberalisation was not the only criteria driving nations to form regional trading arrangements.

From 1947 to 1994, 109 regional trading agreements were notified under GATT. Out of these 109, 98 were notified under Article XXIV of GATT and 11 under the Enabling Clause. The total number of regional trading arrangements increased to 240 in 2000. 172 out of this 240 were already negotiated while 68 were still in the negotiating process as of July 2000. (Exhibit 5.2). However, to certain extent this is an underestimation as it includes the Free Trade Agreements and customs Unions and the PTAs that aim to become so.

Exhibit 5.2: RTAs in Force and Under Negotiation (as of July 2000)

As has been pointed out by the WTO report (1995), three broad trends can be traced in the RTAs formed during the post-war period. In the first place, the RTAs have been primarily centred around Western Europe. Among the 109 regional trading agreements notified under GATT between 1948 to 1994, 76 are between Western European countries. The trend continues and going by the latest data available, around 50 per cent of the RTAs currently in force are situated in the Euro-Mediterranean region. (Exhibit 5.3). However, at present, it
is worth noting that the number of RTAs coming up in America is not far behind that of the European region.

Even for non-European countries, preferential trading arrangements featured in their trade policy. Consequently, when the World Trade Organisation came into operation on January 1995, majority of its members were parties to at least one regional trading arrangement notified under GATT. The notable exception turned out to be Japan.

The second feature found in the post-war period RTAs is that very few agreements among developing countries have met their original timetables for the establishment of a free trade area or a customs union. Coupled with this is the absence of wide sectoral coverage and this has resulted in limiting the potential gains to the members from liberalisation.

**Exhibit 5.3: Geographical Distribution Of RTAs, Both In Force And Under Negotiation**

![Diagram showing geographical distribution of RTAs](image)

Source: WTO Report
The third feature is that the level of economic integration achieved among the members of such agreements varies among agreements. Most of the RTAs are in the form of free trade areas; very few customs unions have been notified to the multilateral trading system. (Exhibit 5.2). The important custom unions notified are the European Community, CARICOM and MERCOSUR. In the year 2000, more than 85 per cent of the 172 existing regional trading arrangements are seen to be in the form of free trade area; only one out of the 68 negotiating RTAs are in the form of Customs Union, remaining 67 being in the form of Free Trade Areas.

<table>
<thead>
<tr>
<th>RTAs as of July 2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>RTA Status</td>
</tr>
<tr>
<td>Free Trade Area</td>
</tr>
<tr>
<td>Customs Union</td>
</tr>
<tr>
<td>Free Trade Area Under Negotiation</td>
</tr>
<tr>
<td>Customs Union Under negotiation</td>
</tr>
</tbody>
</table>

Source: WTO

At this point it might also be noted that the composition of RTA varies; on one extreme there is a simple bilateral RTA composed of two parties; on the other extreme there is an RTA in which all parties are themselves distinct RTAs. Bilateral RTAs account for 98, or almost 60 per cent, of the 172 RTAs in force, and for half of all RTAs under negotiation. Plurilateral RTAs account for 16 per cent of all RTAs currently in force, but make up less than ten per cent of RTAs under negotiation. The percentage of RTAs where at least one party is an RTA itself is about 30 per cent of both the RTAs under negotiation and those in force. The most noteworthy development expected in the next five years is the emergence of a new category, namely RTAs where each party is a distinct RTA itself. These account for 9 of the 68 RTAs under negotiation and are composed of both regional and cross-regional initiatives. (Exhibit 5.4). This is a new trend that is a reflection of the growing consolidation of established regional trading arrangements.
Let us try to analyse the trend that is seen. That would facilitate targeting the debate. In the first place, there is relatively higher number of RTAs formed among the developed countries. If we consider the argument that domestic compulsions force countries to enter a moderate level of liberalised trading regime through RTAs, then the trend should have been more RTAs among developing countries. However, at this point it needs mentioning that very recently an increased number of RTAs among developing countries are reported. But lack of authentic data bars detailed discussion.

This takes us back to our discussion of the rationale behind the formation of RTAs. Turning to the global trading arena and the developments in the multilateral trading system, one can very easily find a trace of protectionist agenda practised, not only by the developing but also for the developed countries. In fact, the fear of competition from newly industrialising courtiers led to the emergence of various NTMs in the global trading arena. In the context of
these RTAs, keeping these aspects in mind, can it be claimed that to certain extent the creation of a “safe heaven” for the member countries urge nations to go for RTAs?

In addition, data reveal that the RTAs among developing countries, using the Enabling Clause have not yet reached the stage of Free Trade Area or Customs Union. They are still in the PTA stage. This in turn implies that the domestic producers in the member countries continue to enjoy some form of protection, at least for the select sectors thereby not achieving the extent of welfare maximisation possible. Moreover, being notified under the Enabling Clause, the PTAs might have gone for selecting among the different sectors to be covered under the RTA, thus not allowing the maximum extent of trade creation possible. Under this situation then, can it be argued that the liberalisation zeal played a major role in urging nations to enter into regional trading arrangements?

The third issue is that there is a larger number of Free Trade Areas than Customs Union. As has already been discussed before, under free trade areas the member countries allow free movement of goods among themselves but retain their individual trade policy for the outside world. In case of customs union, member countries allow zero duty entry of goods among themselves and opt for a common external trade policy, especially in terms of tariff for the rest of the world. It needs to be recollected at this point that the multilateral trading system does not allow RTA countries to increase market barrier to the rest of the world after the formation of the RTA. Under such a condition then, the member countries having higher tariff are forced to bring down the tariff to the level of the members who already have a lower tariff for the rest of the world. This in turn implies that to certain extent the tariff for the non-members itself come down and gets bound, a movement favouring multilateral trade liberalisation. But the fact that RTAs are more frequently signed in the form of Free Trade Areas than in the form of Customs Union might be signalling that countries are
not interested in going for a liberalised trading regime with the rest of the world. This in turn brings us back to our suspicion that there exists some other motive apart from the zeal to liberalise behind the formation of RTAs. As such the debate of whether regional trading blocs are acting as building blocs or stumbling blocs to a liberalised global trading regime is well joined.

The underlying reason is that if the motive behind the formation is different, it implies that the motive does not match with the objective behind the multilateral trading system allowing the formation of the RTAs. As such it is quite irrational to believe that the RTAs would play the role of facilitator to liberalise the global trading regime as expected by the multilateral trading system.

5.3: Regionalism Vs Multilateralism - Theoretical Issues
The previous sections have revealed the following facts.

- There has been a phenomenal increase in the number of regional trading arrangements in the global trading arena.
- Periods revealing phenomenal increase in signing of RTAs coincide with quite fast pace of multilateral liberalisation initiative.
- There is a comparatively larger interest found in the formation of free trade areas than customs union.

Thus, the following issues came up in the previous sections.

- Increased reliance on a liberalised domestic policy for development.
- No Support of the claim that slow pace of multilateral trade liberalisation process led to the increased popularity of RTAs.
- Apparent interest in regional trade liberalisation initiatives and not in multilateral liberalisation initiative.
- Apparent contradiction between the objective behind the multilateral trading system allowing the formation of the RTAs and the motive of the countries to form RTAs.
To understand the situation, one needs to analyse the theoretical implications of a regional trading arrangement on trade. A regional trading arrangement, as has been discussed in earlier chapters, liberalises trade among the member countries of the RTA. A liberalised trading regime among the RTA members implies expanded market and increased competition for domestic industry of each member. The market would have been larger if the countries would have gone for the liberalisation initiative at the multilateral level. At this point, it needs mentioning that the countries are active participants in the multilateral initiative for trade liberalisation. So, through that they are getting markets in countries other than the members of the RTA. In return, they also are expected to give market access to those non-member countries in their own markets. Through the regional trading arrangement, what the member countries are trying to achieve is a higher degree of liberalisation at the regional level than at the multilateral level.

The point that cannot be denied is that a multilateral initiative for trade liberalisation through a negotiation process among a large number of countries is expected to achieve a lower degree of liberalisation as compared to a regional initiative over the same time frame. This might be a valid point for countries to go for trade liberalisation at the regional level, simultaneously with trade liberalisation at the multilateral level.

Another related point might be that though countries are interested in a liberalised trading regime, yet there exist certain domestic compulsions. One might be the existence of a strong producers lobby, arguing against liberalisation, as that would expose them to foreign competition. As such, the country might not give a high degree of market access at the multilateral level. But, it might be a viable option for it to gradually open up the market. Moreover, it is also true that a liberalised policy regime should not lead to de-industrialisation of the economy. Keeping this in mind, it seems quite logical for a country to first open up its domestic market to few countries and get prepared to face global
competition. Placing this against the backdrop of the global trend in RTAs, it might be quite consistent to claim that the fast pace of global liberalisation urged nations to get prepared to face global competition. The process they chose was through regional trade liberalisation. The above discussion can thus be summarised as

- Data on RTAs do not support the claim that the slow pace of trade liberalisation at the multilateral level led to their increased popularity.
- That signing of a regional trading arrangement is also a liberalisation initiative cannot be denied.
- The existence of certain forces operating within the economy against liberalisation cannot be ignored.
- The resultant of these two opposite forces is a limited extent of integration by countries with the global economy.
- RTAs thus might be seen as a road to a higher degree of multilateral liberalisation.

This to certain extent matches with the trend of increase in the number of regional trading arrangement at times when the trade liberalisation initiative at the multilateral level also reveals quite impressive progress.

If this is the motive behind the formation of RTAs, then at least theoretically it can be claimed that they would not act as stumbling blocs. The underlying reason is that with this motive, it is expected that the member countries would gradually go for higher degree of liberalisation at the multilateral level. Such a situation matches exactly with the objective of the multilateral trading system granting this exception under Article XXIV of GATT and the Enabling Clause Decision.

But the problem lies somewhere else. It is the discrimination inbuilt in a regional trading arrangement. Even if it is assumed that the urge for higher degree of
liberalisation urges countries to go for regional trading arrangements, one cannot deny the discriminatory impact of this on the trade of the non-members of the RTA with the members.

The trade liberalisation initiative at the multilateral level is promoted the World Trade Organisation, the successor of the General Agreement on Tariff and Trade (GATT). The system as has been already discussed is based on the principle of non-discrimination, embodied in the Most Favoured Nation Treatment and National Treatment. The Most Favoured Nation prohibits member countries of the multilateral trading system to discriminate among members. Restricting ourselves to the issue of market access, it can be said that countries are required to open up the market to the same extent to all members of WTO.

But if few WTO members come together to sign a regional trading arrangement, they exchange increased market access among themselves as compared to other WTO members.

In the first place, this is discrimination. However, it is well known that the formation of regional trading arrangements have been allowed as an exception to the MFN treatment.

But the fact that cannot be denied is that the discrimination emerges as a restriction for non-members of RTA to enter the regions market. The process is as follows.

Negotiations at the multilateral level ensure certain extent of market access in each of the WTO member country market. This increased market access mainly comes through decreased tariff (considering the case of goods only). This decrease in tariff results in decrease in protection to the domestic industry. The very fact of tariff existence reveals uncompetitiveness on part of the domestic producers vis-à-vis foreign producers. The decrease in protection level allows
foreign players to enter. But, some extent of protection still exists for domestic producers. This in turn implies an artificial competitiveness for domestic producers; but when it is the competition among foreign players in the domestic country market, everybody is at par.

With few countries coming together to form a regional trading agreement, the countries entering a members market are no longer at par. The ones who are members to the RTA enjoy increased market access vis-à-vis non-members through decreased tariff. The scenario is as follows. The RTA members on one hand face decreased competition vis-à-vis domestic producers that help them to acquire a larger market share in the country’s domestic market. (The underlying assumption is that the producers of the member countries are more competitive than the domestic producers for the products enjoying protection in the domestic country). This is the well-discussed trade creation aspect of a regional trading arrangement. On the other hand the RTA members because of the agreement get an advantageous position over the non-members, the former set facing less restriction in the domestic market than the latter set. This discrimination helps the RTA members to take away the share of the domestic market previously enjoyed by the non-members. This is the trade diversion aspect of an RTA. This trade diversion if analysed, can be taken as an erosion of the negotiated market access of the non-RTA members in the regions market. Thus, the in-built discriminatory mechanism of regional trading arrangement results in the erosion of negotiated market access in the regions market. That is, through the inbuilt mechanism, regionalism tends to create a wave against multilateralism.

In the next place we come to the issue of greater popularity of Free Trade Areas relative to a Customs Union. A Free Trade Area is trade liberalisation, or basically creating free trade within the region, without affecting the individual member country’s trade policy with the rest of the world. In case of customs union it is free trade within the region, similar to a free trade area, along with
harmonization of trade policy for the rest of the world. Looking purely from theory angle, there is not much to gain in terms of increased market access for non-members; the only advantage is that they face similar market entering conditions for the whole region. In fact, the issue, looking purely from theory side is more important for the members. In case of a customs union, each member having similar trade policy for the rest of the world, the non-member can enter the regions market through any country without having any extra advantage. But in case of a free trade area, the non-members can take the advantage of choosing to enter through the member-country having the minimum tariff and thus catering to the regions market. To ensure that this does not happen, it is necessary for the RTA to have a strict Rules of Origin.

Thus a customs union appears to be a less complex form of RTA to handle vis-à-vis free trade area. Moreover, the condition that no RTA members can increase the market entry barrier for the rest of the world after the formation of the RTA imposes a binding on members’ external trade policy. Also, members having higher entry barrier vis-à-vis other members have to accept a decrease in the external barrier as a result of the same clause.

But the fact that there appears to be greater preference for free trade areas than customs union puts a question mark on the motive of the members behind formation of the RTAs. Under a free trade area, member countries can retain their individual trade policies for the rest of the world. Thus, each country joining an RTA in the form of free trade area can continue a quite restrictive trade policy for the rest of the world while giving zero duty market access to the RTA members. By doing so, the country continues to protect the domestic producers from global competition.

In case of a customs union with the condition of non-increase of trade restriction for the rest of the world, member countries having comparatively more restricted
trading regime have to bring down the level of the restriction for the rest of the world to set in the common external trade policy. Otherwise, the condition of non-increase of trade restriction would get violated for the members having lower trade restriction for the rest of the world. Moreover, agreeing for a common external trade policy, no individual members can take unilaterally an external trade policy decision. Thus, even though the discrimination cannot be wiped out, yet, customs union appears to be a better option than free trade areas.

Under free trade area, with each country retaining quite restrictive trade policy for the rest of the world, the extent of discrimination is expected to be more complex and hence more problematic against the backdrop of global trade liberalisation. In this case, there is no binding on the individual members' external trade policy coming from the RTA. The RTA in this case can be considered to be more focussed on the welfare implications of the members rather than any motive of global liberalisation.

Another question comes from the issue of discrimination inbuilt in the RTAs. It cannot be denied that one source of benefits accruing to the members is the discrimination. Under such a situation, to what extent would the members be ready to sacrifice the discrimination? Sacrificing the discrimination in turn implies either depending only on the multilateral trade liberalisation initiative or gradually decreasing their trade barriers to the rest of the world. The second option basically implies the RTA gradually going towards increasing the extent of its liberalisation initiative; this might be in terms of membership or in terms of its trade policy towards the rest of the world. But so far there has not been a single RTA that does not have an exclusion criterion. That is, there is not a single RTA that has a policy of open membership, which implies that any country interested can join the RTA. Also, the experience of the existing RTAs has been that though some have gone for quite substantial degree of integration within the
region, when it comes to the rest of the world, the interest to give increased market access is quite limited.

From the above discussion it becomes quite clear that it is not only the urge to liberalisation leads to trade liberalisation at the regional level. Though this cannot be denied yet the inbuilt discriminatory mechanism of RTAs creates a force against trade liberalisation at the multilateral level.

5.4: Regionalism Vs. Multilateralism: GATT/WTO Issues

In the previous section we have seen that the in-built discrimination of RTAs creates the possibility of regionalism going against multilateralism. As has been discussed in the previous chapter, the GATT contracting parties, understanding and acknowledging this discriminatory feature of RTAs imposed certain conditions while allowing for the formation of the same. Through these conditions, the contracting parties tried to ensure minimisation of the discrimination. In this section we would discuss those conditions critically to see to what extent they fulfil the desired objective.

It has been elaborately discussed in previous chapter following Viner that the two most important implication of a regional trading arrangement is trade creation and trade diversion. It is a widely acclaimed statement that trade creation is good and trade diversion is bad. Trade creation is claimed to be good because it leads to the replacement of a less-efficient producer by a more efficient producer. Trade diversion is bad because it does the opposite that is replaces comparatively more efficient producers by less efficient ones.

This trade diversion aspect of a regional trading arrangement through replacing more efficient non-member producers by lesser efficient member producers leads to erosion of negotiated market access for the former set; this happens because of the inbuilt discriminatory mechanism. This has already been discussed in the last section.
At this point, the issue that comes in is that if the RTA has an inbuilt discriminatory mechanism then how is it allowed under the multilateral trading system that rests on the principle of non-discrimination.

This issue has already been discussed in details in the last chapter. That is, we have already discussed the circumstances and thus the provisions existing under the multilateral trading system to allow the formation of regional trading arrangements. We have analysed the four main conditions imposed on countries for entering into a regional trading arrangement. The discussion can be summarized as follows:

The four conditions imposed for countries to form regional trading arrangements in the form of free trade areas and customs union are:

- FTAs or CUs should cover all or substantial trade
- Member countries cannot raise the level of protection for non-members after the formation of the RTA
- Member countries should reduce internal tariffs to zero and remove internal quantitative restrictions other than those justified by other GATT/ articles within a reasonable time frame, if the RTA is an interim arrangement.
- WTO has to be notified regarding the formation of the RTA and the documents relating to the RTA need to be submitted to the same.

The first condition attempts to ensure minimisation of trade diversion. The condition of “all or substantial trade coverage” tries to restrict lobbying activity of pressure groups. This in turn puts a restriction on part opening up of the economy, thus ensuring that trade creation also takes place, along with the limited extent of trade diversion that cannot be avoided. The restriction on part liberalisation ensures that the RTA member countries do not only exchange concessions on items which do not need protection, that is get engaged in “trade
diverting concession", but include all tradable items for exchanging concession, thereby signing a trade creating regional trading arrangement.

The second condition tries to ensure that the sanctity of the tariff bindings negotiated at the multilateral level does not get diluted. It also attempts to stick to the principle of going for higher degree of liberalisation at the regional level through regional trading arrangements. To understand this, it needs to be remembered that the benefits for RTA members come through increased market access in the regions market vis-à-vis non-members. This increased market access can come either through decrease in tariff for RTA member or increase in tariff for non-member; however the latter would lead to dilution of negotiated market access at the multilateral level. Thus, the second condition ensures that the benefits to RTA members come through decreased market restriction in member country markets and not through increased market barrier for non-members in the same. This on one hand ensures non-dilution of the market access negotiated at the multilateral level; on the other hand it upholds the basic rationale behind allowing the exception.

Condition 3 also tries to ensure that the rationale behind allowing RTA as an exception to the MFN clause of the multilateral trading system does not get diluted. The exception got incorporated under the belief that regional trading arrangements would act as building blocs to multilateral trade liberalisation initiative. So an interim arrangement is expected to attain the status of free trade area or customs union within a "reasonable time frame", so that on one hand, the liberalisation initiative intensifies and on the other hand the trade creation aspect gets maximised.

The fourth condition entrusts WTO a watch dog role to ensure WTO compatibility of the regional trading arrangements.
Now we try to critically evaluate Article XXIV to understand whether the provisions are enough to impart a "building bloc" role to regional trading arrangements.

The first condition claims to ensure limited trade diversion through substantial coverage of trade. The limited trade diversion would help to impart the "building bloc" role to the regional trading arrangement. As we have already seen in the last chapter, the non-inclusion of this clause would have resulted in the RTA members getting engaged in more of "trade diverting" concessions rather than "trade creating" concessions. This in turn would have resulted in a situation going against a liberalisation initiative as the gains coming to the RTA member countries in the regions market would have come more at the cost of non-members of the RTA rather than by displacing inefficient producers of the region.

However, as it has been already discussed in great details, no regional trading arrangement is possible without trade diversion taking place. In case of free trade area the member countries give duty free entry to goods among themselves, while retaining their individual trade policies for the rest of the world. Higher the entry barrier for the rest of the world, higher is the extent of trade diversion taking place as the extent of preference available to the members vis-à-vis the non-members is higher. In case of customs union also, though the member countries have uniform trade policy for the rest of the world, yet, the extent of entry barrier for non-members varies from commodity to commodity. This results in higher trade diversion for some items, depending on the comparative advantage enjoyed by members vis-à-vis non-members. Thus, even the substantial coverage condition does not ensure absolute stoppage of trade diverting activities. Yet, there is no doubt that without this condition, situation would have been worse.
Moreover, there is a different aspect associated with this condition. "Substantial Coverage" implies that the RTA would consider all or substantial items traded when going for the negotiation at the regional level. What is the other alternative? The RTA drops this condition and goes for negotiation in select items. Under such a situation, it is expected that the relatively more uncompetitive sectors would be left out. That is, for these sectors, the imports, whether from members or non-members would face the same level of protection in the import market. In case of substantial coverage and this sectors getting included in the RTA offer, member countries would have got increased market access. But the non-member countries would have been in a worse of situation compared to the situation of dropping this condition. That is, more the number of items outside the purview of RTA negotiation, lower is the discrimination advanced towards non-members. But the dropping of the substantial coverage would lead to lesser amount of trade creation, thereby having adverse implications on the welfare level. Thus, there is a trade-off found between the welfare implications of RTAs and adverse implications for third countries in the RTA markets.

The second condition restricts member countries from increasing trade restriction for the rest of the world after the formation of the regional trading arrangement. This condition attempts to ensure that the regional trading arrangements do not take away the market access of the non-members negotiated at the multilateral level. This in fact can be seen as an instrument to tackle the following situation. A regional trading arrangement, as has been repeatedly discussed is trade liberalisation at the regional level. This in turn can be seen as members gaining increased access in the regions market. This increased market access comes through lowering of trade barrier in each of the member country markets. Though this is the root of increased market access, yet two sources can be identified, one being trade creation, the other trade diversion.
The lowering of entry barrier leads to trade creation and thus increased market for members in the region. The lowering of trade barriers also results in the emergence of discrimination for non-member thus resulting in trade diversion. This diversion, and thus increased market for member in the region would be higher if they, while lowering the market barrier among themselves increase the same for the non-members. The members can also opt for a situation of just increasing the market barrier for non-members keeping it same among themselves. In the second case, the increased market would just come via trade diversion, without any trade creation.

But, the objective of the multilateral trading system is to go for a liberalised global trade regime through market access negotiation at the multilateral level. A regional trading arrangement leading to increased market barrier by members for non-members would go against the achievements of the multilateral trading system. To restrict this kind of taking back of negotiated market access, the second condition has been imposed.

Even then, it needs to be pointed out, that the condition is able to resist only taking back negotiated market access; it fails to ensure non-erosion of the negotiated market access which takes place through the inbuilt discrimination of regional trading arrangements.

The underlying reason is the discrimination in built in regional trading arrangements. Trade-diversion, being the gain of the regions market to members displacing non-members only because of the lowered market barrier enjoyed by the former, is nothing but an emerging restriction for non-member. This restriction would not have resulted in the absence of the regional trading arrangement. Looking from the other angle, this restriction is not allowed under the multilateral trading system as this entails taking away the market access,
which has been promised earlier through negotiations and hence can be termed as incompatible to the non-discriminatory principle of the system.

This incompatibility has been accepted as an exception under the system. But it cannot be forgotten that the exception was allowed on the belief that the regional trading arrangements being liberalisation initiative at the regional level would facilitate the same at the multilateral level. But as it has been seen, the exception is going against the principle of non-discrimination through erosion of the negotiated market access, while, the trade liberalisation initiative at the multilateral level moves ahead through market access negotiations. In this situation, will it be wise enough to accept the belief that RTAs would act as building blocs to a liberalised global trading arena?

The third condition can be perceived as a solution to an interim arrangement. As has been mentioned earlier, certain domestic compulsions compel countries to go for a restricted trade regime. Keeping this in mind, it might be problematic for a country to bring down tariff to zero for the member countries from the day it enters into a regional trading arrangement. This point comes as Article XXIV permits only the formation of Free Trade Areas and Customs Unions. In case the countries party to the regional trading arrangement cannot reach a zero duty stage right at the inception, they should do so, that is, attain least the status of a free trade area within a "reasonable time frame". This "reasonable time frame" has later been taken to be a period of ten years.

There is more than one point to be considered in this condition. First of all, the article talks of only free trade areas and customs union and not preferential trading arrangement. In case of the first two, the common condition is duty free movement of goods among the member countries. Preferential trading arrangement implies lesser duty for member countries. There should not be any doubt to claim that in case of duty free movement of goods among member
countries, the extent of trade creation would be larger than in the case of a preferential trading arrangement. As the rationale behind the allowance of the formation of RTA is more of trade creation, the multilateral trading system allowed the formation of free trade areas and customs unions only.

But the interim arrangement is nothing but a preferential trading arrangement likely to reach a free-trade arrangement or a customs union over a "reasonable time frame", agreed as ten years. During this interim arrangement then, trade creation is not at its maximum, that is the level that could have been in the case of a free-trade area. Moreover, with the permission of this interim arrangement, the situation might be such that member countries bring down tariff to zero for items in which they are competitive, thus not going for a large extent of trade creation, while keeping the uncompetitive items under protection till the last date possible, thus leading to a larger extent of trade diversion over the transition period. There appears to be no solution to tackle this aspect through Article XXIV.

In the next place we deal with the forms of RTAs allowed under Article XXIV. The first form of RTA allowed is the free trade area. Nobody can deny that the extent of trade creation, and thus the extent of gains in terms of liberalisation would be much higher. But under a free-trade agreement member countries reduce tariff to zero among themselves, while keeping the market barrier same for non-member countries. Higher the tariff for non-members, larger is the discrimination; thus more is the expected trade diversion. More the trade diversion, larger is the erosion of market access for non-members in the region negotiated at the multilateral level. Hence, the reduction of existing tariff to zero for members results in a proportionately large extent of erosion of negotiated market access. This, in fact is expected to be higher than the same under a preferential trading arrangement. In case of a preferential trading arrangement, there being some amount of tariff for members, first of all the difference between
market restriction faced by members and that faced by non-member is lower than in the case of free trade area. In the second place, in free-trade area, there is absolutely no artificial competition faced by members from domestic producers, while there exists competition for non-members both from domestic producers and other member country producers. This leads to a quite substantial extent of erosion of negotiated market access, as compared to a preferential trading arrangement.

The other form of RTA allowed under Article XXIV of GATT 1994 is customs union. A customs union, as has already been defined is a free-trade area along with harmonisation of market entry barrier for non-member. That is, in case of a customs union, the member countries have duty free trade among themselves along with same market entry restriction for the non-members. This, looking from liberalisation initiative, has one advantage over and above free trade agreement. Because of the second condition of non-allowance to increase trade restriction for the rest of the world after the formation of RTA, member countries having higher market entry are forced to reduce them to the level of other members who have lower barriers. This, thus automatically decreases the market barrier for non-members in those countries of the RTA who have higher market barriers. But, the aspect of discrimination exists here also.

Moreover, the clause of non-allowance of increase in trade restriction for non-members are not very clearly drawn. The wordings are as follows (Paragraph 5 of Article XXIV of GATT 1994):

\[\text{the duties and other regulations of commerce imposed at the institution of any such union or interim agreement in respect of trade with contracting parties not parties to such union or agreement shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union or the adoption of such interim agreement, as the case may be;}\]
the duties and other regulations of commerce maintained in each of the
constituent territories and applicable at the formation of such free-trade area or the
adoption of such interim agreement to the trade of contracting parties not included in such
area or not parties to such agreement shall not be higher or more restrictive than the
corresponding duties and other regulations of commerce existing in the same constituent
territories prior to the formation of the free-trade area, or interim agreement as the case
may be.

When the principle of "not on-the-whole higher or more restrictive" is used to
evaluate the common external tariffs of a customs union, the central question
that comes up is whether the new common external tariffs and the
presumably divergent set of pre-union national tariffs should be compared by using individual tariff-
classification headings, or by using average tariffs calculated annually on the
tariff level alone, or on tariffs weighted by trade volumes-and whether "bound" or "applied" tariffs should be used. The classic example of this ambiguity is the EEC case.

The fourth condition imparts a "watch dog" role to the multilateral trading
system, to test the compatibility of the RTAs. This is of utmost importance for the reason discussed below.

The formation of regional trading arrangement has been allowed as an exception
to the MFN clause of GATT/WTO. As has already been discussed elaborately,
the rationale behind this is that trade liberalisation initiative at the regional level
would help the same at the multilateral level. Not overlooking the
discriminatory aspect of regional trading arrangement, certain conditions are imposed to ensure minimisation of discrimination. Thus a close monitoring is required to see that the conditions are not ignored by the regional trading arrangements, which might otherwise take away, to a large extent the facilitating role of RTAs.

The experience is that, out of the GATT working parties formed to review each of the 109 RTA agreements notified to the GATT between 1948 and 1995, only 64 completed their reviews; of those 64, only 6 were able to reach a conclusion on the given RTA's compatibility with the conditionality of Article XXIV. This six does not include EC or FFTA. Moreover, only two out of the six are still alive (WTO1995, 16). In fact, "no agreement was reached on the compatibility of the Treaty...this examination and the discussion of the legal questions involved in it could not be usefully pursued at the present time; The examination of the EC agreement was never taken up again" (WTO 1995,11).

There are two main points coming up from the above discussion. In the first place, the conditions imposed under Article XXIV of GATT (1994) to ensure that the regional blocs aid global trade liberalisation fails to achieve the desired objective. The underlying reasons are mainly two. One is the inherent discriminatory nature of the RTAs that is very difficult to wipe out. Secondly, the conditions, in many cases are not adequately elaborate leaving scope for players to interpret according to their suitability. The second point that comes up is the implementation part of the conditions. A stricter role played by the multilateral trading system is expected to decrease the extent of opposite trait found in RTAs.

<table>
<thead>
<tr>
<th>The EEC Case</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EEC's view</strong></td>
</tr>
<tr>
<td>o Article XXIV's failure to specify a measure left that to be decided by the RTA signatories.</td>
</tr>
<tr>
<td>o The review process stalled for lack of consensus.</td>
</tr>
<tr>
<td>o An inconclusive report, the first of many to emerge from working parties, was released; no further challenge was made.</td>
</tr>
</tbody>
</table>


After discussing the provisions under Article XXIV, let us have a brief assessment of the same under the Enabling Clause. The enabling clause drops the condition of substantial trade coverage condition and the time frame of reaching a free trade area or a customs union. This in turn creates a wave for pushing ahead more of trade diverting rather than trade creating RTAs.

5.5: Regionalism Versus Multilateralism - Empirical Testing

In the previous section it has been seen that article XXIV and the enabling clause themselves fails to ensure regional trading arrangements to be stepping-stones for multilateral trade liberalisation. This section concentrates on analysing empirically whether the existing regional trading arrangements have aided in creating a free and fair multilateral trading regime or have paved the way for a restricted global trading arena.

As has been already mentioned, Article XXIV fails to ensure minimisation of trade diversion due to multiple factors. In spite of that, attempt to do so through the stringent conditions imposed cannot be denied. But, the diluted form of Article XXIV, the enabling clause, leads to worsening of the situation. Hence, what needs to be analysed is, are their any difference in implications of an RTA formed under Article XXIV and that formed under the enabling clause on the trade liberalization initiative at the multilateral level. As a second step, it would be useful to analyse the implications of the formation of an RTA that is just at its preliminary stage, on the global trade vis-à-vis the implications of deepening of the integration in an RTA.

Keeping these in mind, three regional trading arrangements have been identified.

(i) NAFTA
(ii) EU
(iii) ASEAN
The first RTA, that is NAFTA would reflect the impact of formation of a free trade area on the global trading system. At the point, it might be useful to mention that NAFTA would become a free-trade area only by 2005. So, analysing the impact of NAFTA on the global trading arena would also help in analysing the implications of an interim arrangement of a preferential trading arrangement or a free trade area without the substantial trade coverage condition.

The second one, that is European Union would help us to analyse the implications of deepening of an existing regional trading arrangement on the multilateral trade liberalisation initiative. European union, as is well known has reached a stage which is three stage ahead of a free-trade area. Hence an impact result of EU on global trade different from that of NAFTA might lead one to claim that the major problem lies in the way the regional trading arrangement is formed.

ASEAN, would on the other hand give a glimpse of the implications of a regional trading arrangement formed under the Enabling Clause. For ASEAN, there arise two aspects. One is that ASEAN, like NAFTA has still not reached the status of a free trade area. So, it is thus a preferential trading arrangement. As such, the potential trade creation, out of a free trade agreement has not been fully realized. The other aspect is that, being notified under the enabling clause, it does not have to fulfil two primary conditions; one attain free trade area by a "reasonable time frame"; second the "substantial coverage of trade". So, the impact of ASEAN formation on global trade will bring out actual performance of the Enabling Clause.

The empirical testing is done following three previously tested methodologies. The first two are based on Jacob Viner's trade creation and trade diversion aspects of a regional trading arrangement. That is, taking cases of the three
regional trading arrangements, an attempt has been made to evaluate the trade creation and trade diversion effect, using two different methodologies. One is the famous income elasticity concept used by Bela Balassa to analyse the trade creation and trade diversion aspects of the European Common Market. The second methodology is based on using the concepts of trade creation and trade diversion in a different way. The method has been used by Mordechai E. Krenin and Michael G. Plumber for analysing the trade structures of the East Asian Economies. If it is found that there has been net trade creation, then it cannot be claimed that the increased fascination towards regionalism is adversely affecting multilateral trade liberalization. The third methodology has been used by Lloyd to address the issue of regionalisation of the world economy with special reference to the Asian region. The same is based on factor price equalization theorem. That is, factor price equalisation claims that if free movement of goods are allowed, it leads to equalisation of goods prices that, through market adjustments lead to factor prices getting equalised across the borders. So, a liberalisation initiative is expected to reveal a converging trend of factor prices. If regionalism were not creating a tide against multilateralism, then the formation of regional trading arrangements would not lead to divergence of the RTA factor prices with that of the rest of the world.

As has already been mentioned, the three identified RTAs would be applied for the above-mentioned tests. Before going to the empirical testing, let us have an overview of each of the mentioned regional trading arrangements.

NAFTA

NAFTA is a Regional Trading Agreement among three countries. The countries are Canada, Mexico and USA. It is an RTA of the form

<table>
<thead>
<tr>
<th>NAFTA</th>
<th>Free Trade Area</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>RTA Form</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Members</strong></td>
<td></td>
</tr>
<tr>
<td>1. Canada</td>
<td></td>
</tr>
<tr>
<td>2. Mexico</td>
<td></td>
</tr>
<tr>
<td>3. USA</td>
<td></td>
</tr>
<tr>
<td><strong>Became Operational</strong></td>
<td>Jan 1, 1994</td>
</tr>
<tr>
<td><strong>Notified Under</strong></td>
<td>Article XXIV of GATT</td>
</tr>
</tbody>
</table>
of a Free Trade Agreement among the three countries. It became operational in 1994.

However, it has still not reached a stage of absolutely free trade. The member countries agreed to reach a Free trade Area by 2005.

**European Union**

The European Union is a Regional Integration Arrangement among 15 countries. EU is much more than a regional trading arrangement. It has crossed the stage of free trade area. Not only that, it has gone further than harmonization of its external trade policy; the countries have opted for harmonization of monetary and fiscal policies as well. It is a union of fifteen independent states based on the European Communities and founded to enhance political, economic and social co-operation. It was formerly known as European Community (EC) or European Economic Community (EEC).

The EU in its present form became operational on 1st January, 1995. However, it needs to be kept in mind that in 1995, what EU experienced was more of a deepening of the integration rather than expansion. The new entrants were Austria, Finland, and Sweden.

**ASEAN**

The Association of South East Asian Nations (ASEAN) was established on August 8, 1967 among five countries, namely Indonesia, Malaysia, Philippines, Singapore and Thailand. They are the original members of ASEAN, commonly
known as ASEAN-5. The sixth ASEAN member, Brunei Darussalam joined on January 8, 1984. Vietnam became a member of ASEAN on July 28, 1995; Laos and Myanmar got ASEAN membership on July 23, 1997. Cambodia is the tenth member of ASEAN becoming a member on April 30, 1999.

However, trade did not figure explicitly in 1967. The first attempt at regional trading integration in the form of a Preferential Trading Arrangement to enhance trade among the member countries was taken in 1979. This accorded tariff preferences to the five original member countries. Ten years later that is in 1987 during the Third ASEAN Summit in Manila an enhanced PTA programme was adopted. The ASEAN Free Trade Area has been launched in 1992 during the Fourth ASEAN Summit in Singapore. It launched the framework agreement of creating a Free Trade Area among the member countries over a period of fifteen years. This period of fifteen years has been re-planned as ten years during the Fifth ASEAN Summit in Bangkok.

5.5.1: The Trade Creation Trade Diversion Aspect Of An RTA – The Balassa Approach

Explanation

In the previous chapters and sections, the fact that has got highlighted is that the regional trading arrangements have on one hand certain advantages that have urged nations to enter into such arrangements and benefits that have made the multilateral trading discipline allow such exceptions to the Most Favoured Nation Treatment. On the other hand, there are certain disadvantages associated
with the formation of a regional trading arrangement that have given rise to
certain amount of scepticism. The very root of this scepticism is the trade
diversion aspect associated with the formation of a regional trading
arrangement. Trade diversion basically is the adverse implication faced by the
non-members after the formation of a regional trading arrangement. As has been
discussed in details previously, formation of a regional trading arrangement
would always have some amount of trade diversion because of the inherent
nature of such arrangement. But at the same time, the same leads to trade
creation also. As long as trade creation is higher than trade diversion, the
regional trading arrangement is believed to be welfare increasing.

The hypothesis that as long as trade creation is larger than trade diversion, the
regional trading arrangement is welfare increasing stems from the fact that trade
creation is the result of the displacement of less efficient producers by more
efficient ones while trade diversion is the opposite one. So, while there is a
movement towards optimal allocation of global resources taking place with trade
creation, with trade diversion it is a movement against the same. This is one
aspect.

The other aspect is that the non-member country, usually referred to as the third
country, is not affected by the trade creation aspect of a regional trading
arrangement. The trade creation aspect is related to the imports of a member
country from a member country after the formation of the RTA. Prior to the
formation of the RTA, the import restriction policies practised by the first
country restricted the entry of the item into the domestic market. With the
removal of the import restrictions for the member countries, imports of the item
under considerations starts flowing in. However, the import restriction remains
unchanged for the non-members. This leads to a discriminatory treatment for the
non-members, ultimately leading to the non-members losing their region’s
market to the members – the case of trade diversion.
Because this methodology attempts to analyse the impact of RTAs on multilateral trade liberalisation initiative based on trade creation-trade diversion, it might be advantageous to briefly point out the previously discussed problems for the multilateral trade liberalisation process arising out of trade diversion.

- The multilateral trading system aims liberalising the global trade arena, which is trade liberalisation at the multilateral level.
- Regional Trading Arrangements were allowed on the assumption that they would facilitate the process of multilateral trade liberalisation.
- Studies claimed that a net trade creating RTA is welfare enhancing.
- Based on this, to ensure RTAs play the facilitating role, certain conditions were imposed.
- However, trade diversion cannot be erased out from any regional trading arrangement.
- This trade diversion, by eroding away the negotiated market access of non-members in the RTA country markets creates the problem for the multilateral trading system.

At this point, it needs remembering that the multilateral body looking after trade affairs, the World Trade Organisation is a member driven body. So was its predecessor, the General Agreement on Tariff and Trade. Thus, GATT and then WTO accepting the formation of RTAs as an exception to the MFN treatment implies the interest of the signatories and members in formation of such agreements. But to ensure that the trade liberalisation at the regional level does not affect the same at the multilateral level adversely, the condition of trade creation to be greater than trade diversion has been imposed.

Using this approach, we now try to see whether the existing regional blocs aid multilateral trade liberalisation or not. We use the methodology used by Bela Balassa to see the impact of the formation of the European Common Market on the global trade.
According to the method followed by Balassa, a comparison among the ex post income elasticities of import demand in intra-area and extra-area trade for periods preceding and following the integration would bring out the extent of trade creation and trade diversion. The underlying assumption is that in the absence of integration, the elasticities would have remained unchanged. So, according to Balassa "a rise in the income elasticity of demand for intra-area imports would indicate gross trade creation, while an increase in the income elasticity of demand from all sources of supply would give expression to trade creation proper. In turn, a fall in the income elasticity of demand for extra-area imports would provide evidence of the trade diverting effects of the union".7

$$\text{Ex post income elasticity of import demand} = \frac{\text{(Annual Average Rate of Change of Imports)}}{\text{(Annual Average Rate of Change of GNP)}}$$

The methodology has some other implicit assumptions. One is that, it is assumed that the formation of the regional integration is the single important phenomenon taking place in the global trading arena affecting trade flows. Moreover, long-run influences would not have appreciably altered the relationship between imports and GNP expressed by the income elasticities of import demand. However, comparing the intra and extra regional trade with GNP between the pre and post integration periods the method abstracts from changes in the growth rate of national income and provides comparable estimates of trade creation and trade diversion.

In this section, Balassa’s methodology has been used to judge whether RTAs namely NAFTA, EU and AFTA are aiding multilateral trade liberalisation or are acting as stumbling blocs.
Empirical Testing

The Case of NAFTA

The NAFTA countries' GDP has increased at an average of five per cent before the formation of the free trade agreement (1989 to 1994). After the formation of the same, during 1994 to 1997, the GDP growth has marginally decreased to 4.9 per cent.

The Intra-NAFTA imports have experienced an increase of 13.7 per cent during 1994 to 1997 as compared to 10.6 per cent previous to the formation of the regional trading arrangement (1989 to 1994).

NAFTA countries global imports have increased by over 10 per cent during the post NAFTA period (1994 to 1997) as against 7.4 percent during the pre-NAFTA period (1989 to 1994).

The NAFTA countries' imports from the rest of the world also experienced a quite significant increase in the post-NAFTA period. While during the pre-NAFTA days, NAFTA's imports from the rest of the world increased by 5.37 per cent, after the formation of the RTA, the same increased by 8.3 per cent.

The ex-post income elasticities of demand for the intra-NAFTA imports have increased to 2.80 during the post-NAFTA period from 2.12 during pre-NAFTA period. This indicates gross trade creation. That is, there has been an increased import demand for NAFTA country imports. This consists of both trade creation and trade diversion. That is, one part of the increased demand is for

<table>
<thead>
<tr>
<th>Ex-Post Income Elasticities of Demand</th>
<th>NAFTA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td>Pre-NAFTA (1989-94)</td>
<td>1.48</td>
</tr>
<tr>
<td>Post-NAFTA (1994-1997)</td>
<td>2.10</td>
</tr>
<tr>
<td>Percentage Increase</td>
<td>42.5</td>
</tr>
</tbody>
</table>

Source: Calculations Based on data from Direction of Trade Statistics Yearbook, IMF and International Financial Statistics, IMF; Different Volumes.
NAFTA goods in place of comparatively uncompetitive domestically produced goods; the other part of the increased demand is expected to be the same for relatively cheaper NAFTA produced goods in place of non-NAFTA goods, the difference arising out of the discriminatory treatment.

That there has been net trade creation is apparent from the fact that the ex-post income elasticity of global imports of NAFTA has experienced an increase of 42.5 per cent after the formation of the free trade agreement. Not only that, the ex-post income elasticity of demand for NAFTA’s imports from the rest of the world has increased from 1.14 during the pre-NAFTA period to 1.68 in the post-NAFTA period.

So, at the aggregate level there is no indication of very high degree of trade diversion arising out of the formation of NAFTA. In fact, on the contrary, the income elasticities of demand for NAFTA’s global imports and NAFTA’s imports from the rest of the world have increased by higher margin than that of Intra-NAFTA imports.

Hence, there is no indication of the third country getting adversely affected to a large extent for entering the NAFTA market. In that case, it might not be wrong to claim that the liberalisation initiatives negotiated at the multilateral level has not experienced any erosion because of the formation of the regional trading arrangement among USA, Canada and Mexico. As such, there is no indication that the phenomenon of formation of NAFTA has any adverse implications on the multilateral trade liberalisation initiative.

The Case of EU
The EU member countries’ average GDP growth experienced a decrease after the deepening of the integration process. The GDP growth rate decreased from 5.87 per cent during the pre EU period (1989 to 1995) to 3.5 per cent during the post-EU period (1995-1997).
The European Union's global imports increased by 7.82 per cent during 1989 to 1995. After the formation of the EU, the import growth experienced a marginal increase; global imports of EU increased by 7.93 per cent during 1995 to 1997.

The intra-EU imports increased by a little over nine per cent prior to the deepening of the integration process, that is during 1989 to 1995. The same increased by over 10 per cent during 1995 to 1997.

However, there has been a drop in the growth rate of EU's imports from the rest of the world. Prior to the deepening of the integration, EU's imports from the rest of the world increased by over 6 per cent; from 1995 to 1997, the same increased by 4.6 per cent.

The increase in the ex-post income elasticity of demand for EU's global imports signifies net trade creation. However, the interesting thing to note is that while the same increased by more than 90 per cent for intra-EU imports, the increase is just around 24 per cent for extra-EU imports.

But the fact that there has been no drop in the ex-post income elasticity of demand for EU's global imports or imports from the rest of the world implies not much adverse implication for the rest of the world in terms of trade diversion. Thus, there is no indication that the deepening of the integration has lead to a situation of substantial erosion of negotiated market access for non-members in the EU market.

**The Case of ASEAN**
ASEAN’s average GDP growth has dropped after 1995 considering 1995 as the benchmarking year, during 1995 to 1997, ASEAN’s GDP grew at the rate of 7.6 per cent as compared to 13.87 percent rate of growth during 1989 to 1995.

The drop in rate of growth has been experienced by the import sector also. ASEAN’s global imports while increasing by over 18 per cent during 1989 to 1995, increased by around nine percent during 1995-97.

Similar trend is seen for the break-up of ASEAN imports into import from within the region and from outside the region. While ASEAN’s imports from within the region increased by more than 22 per cent prior to the signing of the AFTA, the same increased by only a little over 11 per cent after AFTA is formed. The percentage growth for imports from outside the region increased by 17.7 per cent and 8.5 per cent respectively.

The ex-post income elasticity of global import demand decreased by 10 per cent after the formation of AFTA. The drop is much higher for ASEAN’s imports from the rest of the world. The same decreased by a little above four per cent for Intra-AFTA imports. The maximum drop is experienced by the income elasticity of import demand for imports from the rest of the world.

Though in 1995, AFTA plan got formally declared, yet, the initiative in terms of increased preference was taken in 1992 itself. Hence, it might be useful to use 1992 as the benchmark year.

<table>
<thead>
<tr>
<th>Ex-Post Income Elasticities of Demand</th>
<th>ASEAN Case 1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td>Pre-AFTA (1989-95)</td>
<td>1.33</td>
</tr>
<tr>
<td>Percentage Increase</td>
<td>-10.32</td>
</tr>
</tbody>
</table>

Source: Calculations Based on data from Direction of Trade Statistics Yearbook, IMF and International Financial Statistics, IMF; Different Volumes...
Even in this case, the same trend is more or less experienced. The ex-post income elasticities of demand experienced decrease after 1992. The only difference is that in this case, the drop in the same for intra-ASEAN imports is higher than the same for extra-ASEAN imports.

<table>
<thead>
<tr>
<th>Ex-Post Income Elasticities of Demand</th>
<th>Case 2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td>Pre-AFTA (1989-92)</td>
<td>1.23</td>
</tr>
<tr>
<td>Post-AFTA (1992-1997)</td>
<td>1.21</td>
</tr>
<tr>
<td>Percentage Increase</td>
<td>-1.91</td>
</tr>
</tbody>
</table>

Source: Calculations Based on data from Direction of Trade Statistics Yearbook, IMF and International Financial Statistics, IMF; Different Volumes

Conclusion

Thus we find that in the case of regional trading arrangement formed under Article XXIV, data reveal net trade creation. In the case of deepening of the integration process of a regional trading formed under the provision of article XXIV, the same is revealed by the ex-post income elasticities of demand. These two cases tend to send the signal that the formation of regional trading arrangement is not acting as stumbling blocs to the creation of a liberalized global trading arena.

But the ASEAN initiative of an RTA among the select Asian countries does not support the above claim. The ex-post income elasticities of import demand for ASEAN’s global imports signals net trade diversion. Added to this is the confusing trend that even for intra-ASEAN imports there is no sign of trade creation.

Does this indicate that some RTAs have the features of stumbling blocs inherent in them? If yes, what is the basis of those features that turn an RTA into a stumbling bloc?

At this juncture, we might recollect the purpose of including ASEAN in our empirical testing. ASEAN is formed under the enabling clause that is a much diluted form of Article XXIV. The dilution comes in the form of dropping the conditions of “reasonable time frame” for establishing a free trade area and the “substantial trade coverage” condition associated with the formation of an RTA.
As has been discussed in details before, the substantial trade coverage provision tries to ensure minimisation of trade diversion. It has also been discussed that a free trade area is comparatively a better option than a preferential trade agreement as the amount of trade creation is expected to be higher in the former, thus putting an upward pressure on net trade creation. These two conditions being absent might have led to the above situation.

5.5.2: The Trade Creation-Trade Diversion Aspect Of An RTA - An Alternative Approach

Explanation

Throughout the thesis, the point that has got elaborately discussed is that a regional trading arrangement aims at liberalising trade among a group of countries. Now, trade theorists have repeatedly claimed the free trade is the first best policy. It results in welfare gain through optimal allocation of resources. However, certain national policy objective compels countries to impose restriction on the external sector. Having a re-look at the traditional trade theories we recollect that each country enjoys comparative advantage in the production of certain products over and above other countries. Similarly, these countries are less competitive in producing some other products.

Under a situation of global free trade, each country would export the items which it can produce comparatively more competitively than other countries. That is, it would export those items in which it enjoys comparative advantage. On the other hand, imports of those products in which the country does not enjoy comparative advantage would increase. But this would result in adverse implications for the domestic industries producing those items, thus having serious implications for the economy. These considerations compel nations to impose import restrictions. Under the present multilateral trade discipline, in normal circumstances tariff is the only permissible import restriction allowed. If
a country has a similar tariff pattern for all its trading partners, then the level of restriction experienced by each of the trading partners is same. So the extent of decrease in competitiveness of their products in the tariff imposing countries market is also similar. The trading partners’ competitiveness ranking among them does not get affected in the tariff imposing county’s market. The only impact is that the partner countries’ competitiveness vis-à-vis the domestic producers gets reduced by the tariff percentage. So the optimal allocation of factors of production gets affected between the tariff imposing country on one hand and its trading partners on the other; the same does not get affected among the trading partner for tariff imposition in the mentioned country.

In the next stage, if a regional trading arrangement is formed among the tariff imposing country and some of the trading partners, then the restriction level faced by the members and non-members in the tariff imposing country’s market becomes different. As is well known, the member countries as a result gain increased market, one part through trade creation, the other through trade diversion. The major implications of the regional trading arrangement are as follows:

Coming back to the aspect of comparative competitiveness, we have been seen that the different levels of protection faced by the members and non-members in the regions market leads to a peculiar scenario. If the regional trading arrangement does not give rise to a high degree of trade diversion, then that would get reflected while comparing a country’s competitiveness globally with that of within the region. That is, if there exists high amount of trade diversion, then it implies that the difference in the level of protection faced by the member countries and the non-member counties is quite large. Hence the global competitiveness of the member countries is expected to be different from the competitiveness of the member countries revealed in the RTA market.
At this juncture it needs mentioning that one measure used to judge the extent of competitiveness of a country is known as the Revealed Comparative Advantage (RCA). It is defined as follows.

\[
RCA_i = \frac{X_{ij}}{X_j} \cdot \frac{(X_{iw}/X_w)}{(X_{iw}/X_w)}
\]

Where \(X_{ij}\) is exports of Commodity \(i\) by country \(j\)

\(X_j\) is global exports of country \(j\)

\(X_{iw}\) is world exports of commodity \(i\)

\(X_w\) is total world exports

More the competitiveness of a country in commodity \(i\), higher is the importance of that item in the country’s global exports. The competitiveness of the country in the commodity \(i\) will in turn get reflected in its global export performance of that item. As such, higher will be the ratio of the item \(i\)'s exports by country \(j\) in country \(j\)'s global exports to world exports of commodity \(i\) in total world exports. That is, higher the competitiveness, higher will be the dominance of the country in the export market of that item.

As such, an RCA value of greater than one reveals very high level of competitiveness of the country \(j\) in commodity \(i\). This is possible if the country \(j\) has a comparative advantage in producing commodity \(i\). So, higher the index, higher it is assumed to be in the ranking of goods by comparative advantage.

The RCA index is expected to get distorted in the presence of various trade policies. We use this linkage to apply this measure to analyse the debate of regionalism vs. multilateralism.

Let us consider a hypothetical situation to present the logic of application of the above analysis. We consider a situation of two countries entering into a bilateral trading arrangement. Let the countries be A and B. Let us consider a case that A produces and exports ten items. Now if the global RCAs are calculated they will have a particular ranking among them. Along with that, the RCAs for the ten
items of country A are calculated with respect to the region. The regional trading arrangement between A and B ensures a preferential entry of the ten items of A into B's market. If the extent of the difference in the level of protection faced by Country A in country B's market on one hand and the same faced by other countries in B's market is very high, then the possibility of trade diversion is also expected to be very high. This would lead to creation of artificial competitiveness of Country A's items in B's market. This in turn will change the RCA ranking.

So, from this it can be argued that if the regional trade arrangement is less distorting, then the global RCA ranking for country A items will be more or less preserved in case of the RTA also. Otherwise, the rankings would change. A spearman rank correlation would help us to arrive at a conclusion. A high correlation between the two series would imply the preservation of the ranking. If that is preserved, then it can be claimed that the RTA is not trade distorting to a large extent. As such the adverse implications for the third country is not very significant. Thus, the RTA does not act as a stumbling block to multilateralism.

**Empirical Testing**

**The Case of NAFTA**

We now compare the global RCA ranking of each of the member countries with their NAFTA RCA ranking. The data source is TRAINS CD, an UNCTAD database. The global RCA has the formula as discussed above. For calculating the NAFTA RCAs of the member countries, the formula has been used with the required modification. It is as follows.

\[
RCA_{i,\text{NAFTA}} = \left( \frac{X_{ij,\text{NAFTA}}}{X_{i,\text{NAFTA}}} \right) / \left( \frac{X_{ij,\text{NAFTA}}}{X_{j,\text{NAFTA}}} \right)
\]

Where

- \(X_{ij,\text{NAFTA}}\) is exports of Commodity i of country j to NAFTA
- \(X_{i,\text{NAFTA}}\) is total exports of country j to NAFTA
- $X^{\text{NAFTA}}$ is NAFTA global exports of commodity $i$
- $X^{\text{NAFTA}}$ is total NAFTA exports

This thus tells the importance of the item in the country's total exports to NAFTA against importance of the item in NAFTA's global exports.

As given in the table inside the box, there exists a negative relationship between the Global and NAFTA RCA ranking for USA. For the other two countries also, the correlation turns out to be quite low. This implies the presence of certain factors affecting the RCAs inside NAFTA. The main apparent difference between the global market and the NAFTA market is the preferential market access exchanged among NAFTA countries within the region. One aspect of this is the increased market access of NAFTA countries in the region through comparative competitiveness over non-members because of the discriminatory environment. This in turn implies that one part is the trade diversion benefit accruing to the members; a case of non-members getting adversely affected.

<table>
<thead>
<tr>
<th>Country</th>
<th>Pearson's Rank Correlation</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>-0.015</td>
</tr>
<tr>
<td>Canada</td>
<td>0.363</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.236</td>
</tr>
</tbody>
</table>

Source: "Trains", UNCTAD, and Calculations based on Data from TRAINS.

Thus, going by the disaggregated data, it is seen that there is a change in the RCA ranking for NAFTA. This can be taken as a different line of comparative advantage for each of the countries in case of intra-regional trade. NAFTA being the only visible change in the market scenario against the global market, it might not be too irrational to claim that NAFTA has given rise to artificial competitiveness to certain sectors inside the region, thus affecting non-members trade to NAFTA adversely.

The case of EU
Before going into the EU case, the problem regarding EU data needs to be discussed. The database used here does not report intra-EU data. It is quite difficult to get consistent data at the six-digit level. Without the intra-regional
data, the RCAs could not be calculated. Hence, in case of EU we have used a different methodology.

To understand the logic behind why we have chosen the particular methodology, we need to go back to the point of our analysis. The basic point that we are trying to analyse is that whether the formation of RTA among select countries adversely affects the exports of the third country in the member countries' or region's markets. EU, as has been discussed is an RTA going in for the highest level of integration. In fact in 1995 what EU experienced was a deepening of the integration through harmonisation of fiscal and monetary policies. This harmonisation in turn implies union of the member economies. This removal of all sorts of border restrictions among the member countries and harmonisation of national policies, both for the outside world and among themselves is expected to pose increased restriction for non-member countries. This restriction is expected to come from the discriminatory environment created out of the integration.

Considering this along with the data problem, what we have tried to do is study the impact of the third country in the EU market. That is, we try to compare the global RCA ranking of the third country with the RCA ranking of the third country in the EU market. If the RCA rankings do not match, then the RTA turns out to be one of the major reasons as the same has created discrimination thus increasing the restriction for the third country in the region's market.

We have chosen India as the third country entering EU market. EU happens to be the most important export destination of the country.

Another point that needs to be mentioned is that, to use this type of logic for the methodology the formula had to be modified. To understand the modification, let us analyse the original formula for the RCA. The formula for calculating a country's global RCA is as follows.
\[ \text{RCA}_i = \frac{(X_{ij} / X_j)}{(X_{iw} / X_w)} \]

Where \( X_{ij} \) is exports of Commodity i by country j
\( X_j \) is global exports of country j
\( X_{iw} \) is world exports of commodity i
\( X_w \) is total world exports

The numerator shows the importance of the item concerned in the total exports of the country. The denominator reveals the importance of the item in the world exports. In case the numerator is greater than the denominator, it reveals that the importance of the item in the country's trade is greater than the importance of the item in global exports; thus, the country is expected to have a comparative advantage that is getting revealed by the trade pattern vis-à-vis the world. On the contrary, an opposite situation would imply relatively lesser importance of the item in the country's export basket vis-à-vis world, not revealing a comparative advantage.

When this is used to calculate the RTA RCA of a member country, the formula is modified as
\[ \text{RCA}_{i, \text{RTA}} = \frac{(X_{ij, \text{RTA}} / X_j)}{(X_{i, \text{RTA}} / X_{\text{RTA}})} \]

Where \( X_{ij, \text{RTA}} \) is exports of Commodity i of country j to RTA
\( X_{i, \text{RTA}} \) is total exports of country j to RTA
\( X_{i, \text{RTA}} \) is RTA global exports of commodity i
\( X_{\text{RTA}} \) is total RTA exports

This holds when we are comparing the ranking for the member countries. But when it comes to the comparing of the ranking for the third country, this does not have much economic meaning. The underlying reason is that if in case of a third country, it is comparing the market access in the region's market, vis-à-vis the market access in the global market. Thus, it needs to be seen that whether the importance of the item in its global exports get retained in the region's market;
that is the importance in the global exports against the importance of the item in the imports of the region.

Let us elaborate the case. Suppose the global RCA reveals that a country has a comparative advantage in the \( i \)th commodity. If the region’s market does not pose any restriction then this comparative advantage would get retained. But if there occurs trade diversion, then the RCA ranking would change. Hence the formula has been modified as follows.

\[
RCA_{i,\text{RTA}} = \frac{X_{ij,\text{RTA}}}{X_{j,\text{RTA}}} / \left( \frac{M_{i,\text{RTA}}}{M_{\text{RTA}}} \right)
\]

Where:
- \( X_{ij,\text{RTA}} \) is exports of Commodity \( i \) of country \( j \) to RTA
- \( X_{j,\text{RTA}} \) is total exports of country \( j \) to RTA
- \( M_{i,\text{RTA}} \) is RTA global imports of commodity \( i \)
- \( M_{\text{RTA}} \) is total RTA imports

That is, the formula considers the importance of the item in the third country’s exports to the region vis-à-vis the importance of the item in the region’s global imports. If the numerator is greater than the denominator, then it implies that the importance of the item in the country’s exports higher than the importance of the same in the region’s imports; this implies a comparative advantage of the country in the commodity in the region’s market. The opposite implies a comparative disadvantage. So, if the global RCA ranking does not match with the region RCA ranking then it implies the presence of some external factor, the apparent one being the discrimination as a result of the RTA.

Following the above modified formula for calculating India’s RCAs in EU market, it is seen that the correlation between India’s global RCA ranking and India’s RCA ranking in the EU market turn out to be 0.45. So, the correlation between the two series is moderate, implying that India’s global RCA

<table>
<thead>
<tr>
<th>India in the EU Market Vis-à-vis the Global Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Person’s Rank Correlation</td>
</tr>
<tr>
<td>0.45</td>
</tr>
</tbody>
</table>

Source: "Trains", UNCTAD, and Calculations based on Data from TRAINS.
ranking is slightly different with the RCA ranking in the EU market.

The case of ASEAN

Finally, we come to the ASEAN case. Here also there exists some data related problem. As in the previous case, intra-ASEAN trade data are not very consistent from the TRAINS CD. So, we have tried two methods in case of ASEAN. The first one is like the EU case. However, there is a difference. As the data for all the ASEAN countries are not available, we could not go for examining India in the ASEAN market. But we have done the RCA calculations for India in each of the ASEAN market for which the data are available.

So, the RCA formula for India in the ASEAN market, that is the bilateral RCA is as follows.

\[
RCA_{ii} = \frac{(X_{ij} / X_i)}{(M_{iRTA} / M_{RTA})}
\]

Where

- \(X_{ij}\) is India's exports of Commodity \(i\) to a ASEAN country
- \(X_i\) is India's total exports to that country
- \(M_i\) is the country's global imports of commodity \(i\)
- \(M_{RTA}\) is the country's total imports

In the TRAINS, data for imports of ASEAN five are available. For those, we find India's Global RCA ranking quite dissimilar to the RCA ranking in the ASEAN Five market. This might be taken as the existence of some external factor contributing to this and thus the trade diversion due to the RTA cannot be denied.

| India in the ASEAN Market Vis-à-vis the Global Market |
|----------------|------------------|
| ASEAN Market   | Rank Correlation |
| Indonesia      | 0.33             |
| Malaysia       | 0.28             |
| Philippines    | -0.03            |
| Singapore      | 0.23             |
| Thailand       | 0.34             |

Source: "Train", UNCTAD, and Calculations based on Data from TRAINS.
In the next place, based on the availability of data, we have tried to calculate the bilateral RCAs among the ASEAN countries and compare them with the global RCAs. The underlying rationale is that the two series would not match in case the country is entering the member country's market because of the increased preference in spite of the fact that it does not have comparative advantages in some items. In this case the formula for the bilateral RCA is the same as in the above.

The same is possible for select ASEAN countries only. The correlation between Indonesia's global RCA and bilateral RCA appears to be quite low for all the three other ASEAN markets. Thus, the increased preference due to the RTA cannot be denied.

<table>
<thead>
<tr>
<th>Indonesia in Select ASEAN Markets vis-à-vis Global Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>Philippines</td>
</tr>
<tr>
<td>Malaysia</td>
</tr>
<tr>
<td>Singapore</td>
</tr>
</tbody>
</table>

Source: "Trains", UNCTAD, and Calculations based on Data from TRAINS.

Conclusion
The interesting thing that gets revealed is that in the disaggregate level of data, some extent of trade diversion gets revealed. That is, the actual problem gets revealed at this point. To understand this, let us get back to our previous discussion of the welfare implications of an RTA. It is generally accepted that so long as trade diversion is lower than trade creation, the RTA is welfare enhancing and thus not having adverse implications. But the fact lies that this welfare conclusion is based on the summation of welfare gains compared to welfare decrease. However the welfare gains is not accruing to the ones who are experiencing the welfare losses. Thus, when the individual country experiences erosion of market access in the RTA market, it is not compensated through an equivalent welfare gain. This is the problem of RTA vis-à-vis the multilateral trading system.
The fact that trade diversion is a permanent component of an RTA getting revealed by the data makes one think again regarding the existence of the provision allowing the formation of the same under the multilateral trading system.

5.5.3. The Factor Price Equalisation

Explanation

Factor-price equalisation has been built up on the claim that free trade is the first best policy. Starting from Adam Smith, till modern times, trade theorists have repeatedly claimed that liberalising the external sector always results in welfare gain. The main reason behind this increase in welfare is the optimal allocation of world resources. Liberalisation of trade by countries allows for re-allocation of factor production towards an optimal situation. More the number of countries going for a liberalised trading regime, nearer is the resource allocation to optimal allocation.

The re-allocation of factors of production after a country starts its liberalisation process is due to the difference in the factor intensities of the commodities produced and the level of factor endowments of the countries. As explained by trade theorists, the price differences among the items produced in different countries which results from the difference in factor intensities and availability of factors of production, leads to trade taking place among countries. With gradual liberalisation of trade among countries, the differences in the prices tend to narrow down. This happens because of the easy availability of items produced by a more competitive producer. This narrowing down ultimately ends up in equalisation, if trade is absolutely free. The process continues and ends up with equalisation of the prices of the factors of production among the countries.

At this point, it might be useful to recollect that the above-mentioned models are based on a two country-two commodity framework. Let us have a brief
discussion of one of the traditional trade theories followed by the factor-price
equalisation result before proceeding for the empirical testing.

Let us have a brief discussion of the Hecksher-Ohlin theorem to recollect the
commodity price equalisation under free trade. The H-O theorem is a two
commodity-two country-two factor model of trade. It is based on five important
assumptions:-

(i) Trade is absolutely free between the two countries and transport cost is
non-existent.
(ii) Both commodity and factor markets are perfectly competitive.
(iii) Production functions reveal constant returns to scale.
(iv) Commodities reveal different factor intensities.
(v) Production functions are different between commodities but same
across countries.

Under these assumptions, H-O theorem states that a capital-rich country would
export capital-intensive items and import labour intensive ones from a labour
abundant country. The logic behind is that a capital rich country is able to
produce the capital-intensive item at a comparatively cheaper rate than the
labour rich country, while the opposite holds for the labour rich country. Thus,
with liberalisation of trade, the above mentioned export-import pattern is found.

With this, over a time period, the commodity prices would get equalised
between the two countries. The equalisation occurs because after liberalisation of
trade, the capital rich country gets the labour-intensive item from the labour rich
country. The increased supply of the labour intensive commodity at a lower
price in the capital rich country tends to decrease the price of the labour intensive
commodity in the capital rich country. This also decreases the domestic supply
of labour intensive item in the capital reach country. Contrary, the supply of the
capital intensive item at a lower price increases in the labour rich country, thus
bringing down the price of item there. This in turn decreases the domestic supply of capital intensive item in the labour rich country. Thus, the production structure of the labour rich country gradually shifts towards labour intensive item. This in turn increases the demand for labour and decreases the demand for capital in the labour rich country. As a result, the wage rate starts moving up while the rate of interest starts going down in the labour rich country. The opposite thing is found in the capital reach country. This would ultimately lead to a situation when the capital and labour are expected to fetch similar returns in both countries—the equalisation of factor-prices.

In the next place, let us discuss the application of the factor-price equalisation theorem in empirically testing the debate of regionalism versus multilateralism. This methodology to study regionalism was done by P.J. Lloyd in the paper "International Trade and Economic Integration" (1996). However, Lloyd used factor price equalisation theorem not exactly to analyse the debate of regionalism versus multilateralism but to measure the extent of regional economic integration achieved by a regional trading arrangement over a time period. He studied the level of economic integration achieved in the Asian region by applying the factor-price equalisation theorem.

According to Lloyd, with gradual liberalisation of trade among the countries of a region, the commodity prices and ultimately the factor prices are expected to show a converging trend among the members. That is,

\[ Y = wL + rk \]  

(1)

\[ Y = \text{the income broadly divided into returns for labour and capital} \]
\[ L \text{ and } K \text{ are Labour and Capital respectively} \]
\[ w \text{ and } r \text{ are returns to labour (wages) and returns to capital (interest) respectively} \]

Equation 1 can be written as
\[(Y/L) = w + r (K/L). \] \hspace{2cm} (2)

With the assumption of production function exhibiting constant returns to scale.

\[K/L = f(p) \] \hspace{2cm} (3)

That is, capital labour ratio is a function of prices \(p\).

With prices moving towards equalisation in the two countries as a result of free trade, the capital labour ratio would tend towards equalisation (equation 3). The factor price equalisation theorem would lead to equalisation of wage \((w)\) and interest rate \((r)\) across countries. This in turn would lead to equalisation of \((Y/L)\), by equation 2. \((Y/L)\) is nothing but the per capita income of countries. Thus, we get that liberalisation of trade is expected to reveal convergence of per capita income across countries.

In the next stage, we try to superimpose this process in analysing the debate of regionalism versus multilateralism. We have already discussed that if regional trading arrangement results in increased economic integration among the member countries then the GDP per capita of the same would reveal a converging trend.

Now, the debate is whether these regional trading arrangements are aiding multilateral trade Liberalisation or are creating higher trade restriction in the global trade arena.

A regional trading arrangement aims at liberalising trade among the member countries. In the present multilateral trading system, certain conditions need to be fulfilled to ensure that the regional trading arrangement turns out to be trade creating in the net sense. However, it has already been seen in previous discussions that the formation of RTA among a group of countries adversely affects the third country. However, the formation of the regional trading arrangements were allowed as an exception to the non-discriminatory principle.
of the multilateral trading discipline on the assumption that the Liberalisation exercise getting initiated among a group of countries would gradually get extended and ultimately help in global integration.

If the above phenomenon is actually taking place, then, extending Lloyd's argument, not only would the GDP per capitas of the RTA countries converge, but also, the world GDP per capita would reveal a converging trend. That is, if regionalism is aiding multilateralism, then the world GDP per capita would be seen to move towards the converging RTA GDP per capitas. The opposite would hold if regionalism, instead of aiding multilateralism is creating a more restrictive global trade scenario.

We apply this on three regional trading arrangements experienced in the world: -

(i) The North American Free Trade Agreement
(ii) The European Union
(iii) The Asian Free Trade Agreement

**Empirical Testing**

**The Case of NAFTA**

The North America Free Trade Agreement came into existence in 1994. It is a free trade agreement among three countries, namely, USA, Canada and Mexico. As has already been discussed, a free trade agreement is a form of regional trading arrangement where goods move across borders of the member countries without facing any trade restrictions. Under that situation, what is expected, following pure theory claims is that prices of commodities would get equalised among the member countries; following the factor price equalisation theorem, the prices of the factors would get equalised among the member countries; following Lloyd, thus, the GDP per capita of the member countries would tend to get equalised.
NAFTA, as has been discussed before is a proposed free trade area among USA, Canada and Mexico. NAFTA countries have initiated the process of attaining a free trade agreement. Following the clause of “coverage of all trade” within a “reasonable time frame”, defined in the Uruguay Round of Trade Negotiation as ten years, the regional trading arrangement will become a complete free trade agreement by 2005.

To analyse our hypothesis, that is, whether NAFTA is aiding multilateralism or creating an opposite wave, we need to compare the NAFTA average per capita with the average world GDP per capita. The underlying reason is as follows.

Each of the three NAFTA countries is a member of the world trade organisation. That is, they are parties to the liberalisation initiative at the multilateral level. The WTO came into operation in 1995 with 123 member countries. Most of the important global trading players were the existing members. Notable exceptions were China and Russia. Under this situation, then following Lloyds hypothesis based on the factor price equalisation theorem, member country GDP should reveal a converging trend.

Coming to the case of the three NAFTA countries being the members of the WTO, their GDPs are expected to reveal a converging trend with the global GDP. That is, if the free trade agreement, as expected by the multilateral trading discipline supports the liberalisation initiative at the multilateral level, then there should not be any diverging trend seen between the average NAFTA countries GDP per capita's with the same for the rest of the world. That is, NAFTA creates an environment of higher degree of trade liberalisation among the member countries vis-à-vis the rest of the world. In that case, there would be higher degree of trade among the member countries. On the other hand, being WTO members, each of the NAFTA countries have given some amount of market access to the trading partners. If there is no adverse impact on this negotiated
market access in the NAFTA market for the non-members felt as a result of NAFTA formation, then the multilateral trade liberalisation initiative cannot be claimed to have been adversely affected by the free-trade agreement. Under such a situation then, there should not be any divergence seen between the average NAFTA GDP per-capita and the average rest of the world GDP per capita. At most, the NAFTA countries GDP per capita’s might reveal a higher rate of convergence. If on the other hand, an opposite trend is found, then it cannot be claimed that the formation of NAFTA has no adverse implications on the trade liberalisation initiative at the multilateral level. The root of this adverse implication is the trade-diversion aspect associated with regional trading arrangements. That is, if a large part of increased intra-NAFTA trade results from displacing third country producers, then, market access in the NAFTA region market negotiated with the rest of the world trading partners at the multilateral level gets eroded away. The reason is, to a large extent the displacement of third country producers after the formation of any RTA is a result of the discriminatory environment getting creating and not out of real competitiveness. Hence, the increased benefit coming to the NAFTA region would be at the cost of the rest of the world, thus leading to the diverging trend.

Thus, if the two reveals a converging trend, then we can say that creation of NAFTA has not lead to trade diversion to the a large extent so as to erode away the benefits of multilateral trade liberalisation initiative. On the contrary, an opposite trend might be taken as NAFTA having some adverse implications on the multilateral trade liberalisation initiative.

To carry out the empirical testing, the GDP per capitas of the individual countries and the global GDP per capita are required. The individual country GDP per capita data are available from the United nations Statistical Yearbook. The global GDP per capita data are not available. The same has been calculated taking the average of the individual country GDP per capitas.
Data do reveal a converging trend when the trend line is considered. (Exhibit 5.5).

**Exhibit 5.5: Average NAFTA GDP Per Capita Vs Average Rest of the World GDP Per Capita (Simple Average)**

Source: Calculations based on Statistical Yearbook, IMF data

As has already been mentioned that the world GDP per capita data are not available; the same has been calculated by summing up the individual country GDP per capita and then dividing by the number of countries. So, here we have compared the simple average of the NAFTA countries GDP per capita with the same for the rest of the world.

Here, it needs mentioning that the way the global GDP per capita figures have been calculated is not without problem. By taking the simple average, each of the countries is given the same weightage. The same logic holds, definitely to a much lesser extent for the NAFTA countries.

To minimise the extent of the problem, in the next place we have considered the weighted average GDP per capita of the individual countries to calculate the global GDP per capita. The weight has been considered as the contribution of that particular country in the global GDP.
\[ W = \text{GDP of the particular country} / \text{the world GDP excluding the NAFTA countries.} \]

The same procedure has been followed for getting the average NAFTA GDP per capita. The weight in this case is

\[ W_{\text{NAFTA}} = \text{GDP of individual NAFTA countries} / \text{NAFTA GDP} \]

In this case also, a converging trend of the two trend lines is visible. (Exhibit 5.6).

Thus, by this methodology, the formation of NAFTA cannot be claimed to be going against the multilateral initiative of trade liberalisation.

Exhibit 5.6: Average NAFTA GDP Per Capita Vs Average Rest of the World GDP Per Capita (Weighted Average)

Source: Calculations based on Statistical Yearbook, IMF data

The Case Of EU

The European Union is a regional agreement among 15 countries, as has already been discussed. It has also been discussed that the arrangement is much more than a trading arrangement. In 1995, the regional bloc experienced both increase in the numbers and increase in the extent of the integration process. In fact, the
expansion, as has already been pointed out is not that significant; the more important part is the deepening of the integration process. As compared to NAFTA, the EU is already a free trade area among the 15 countries. On top of that it has no barrier in the movement of factor services. Moreover, most of the countries among the 15 members are dominant trading players. All these countries going for an uniform policy environment is expected to lead to quite substantial implications for the global economy. Keeping the importance of the countries as global traders in mind, analysing the impact of EU on global economy would help one to understand the implications of the deepening of the integration process on the global trade.

Using Lloyd’s method based on factor price equalisation theorem, if there is a converging trend found between the average GDP per capita of the EU and the average GDP per capita of the rest of the world, then it can be claimed that the deepening of the integration process is not seen to have any adverse implications on the multilateral liberalisation initiative.

Calculating the average GDP Per capitas of the EU countries and the rest of the world using the simple average method does not reveal a converging trend. There is in fact a parallel trend found between the two. (Exhibit 5.7)

As has been discussed in case of NAFTA, the simple average system assumes all countries on the same plane. So, in case of EU also, we go for the weighted average method, the weight for the Rest of the World GDP Per Capita being

$$W = \frac{\text{GDP of the particular country}}{\text{the world GDP excluding the EU countries}}$$

and the weight for the EU GDP Per Capita being

$$W_{EU} = \frac{\text{GDP of individual EU countries}}{\text{EU GDP}}$$
Comparing the weighted average GDP Per Capita of EU countries with that of the rest of the world, we find a converging trend. (Exhibit 5.8)

Thus, even in case of EU, going by this measure it cannot be claimed that the deepening of the integration has resulted in any adverse implications on the liberalisation initiative at the multilateral level.

The Case of ASEAN

In the last place, we attempt to analyse the implications of the formation of a regional trading arrangement in the form of a preferential trading agreement under the diluted provision of Enabling Clause on the multilateral initiative for a liberalised global trading regime.
A diverging trend found while comparing the average GDP per capita of the ASEAN countries with the same for the rest of the world might be considered as reflecting the fact that the provisions of the enabling clause leaves scope for a quite high degree of trade diversion, thereby leading to an opposite trend.

At this point, it requires to be noted that Laos and Cambodia have been excluded as they have got acceded to ASEAN only in 1997. As such, impact analysis is not possible including them keeping in mind the data availability.

Comparing average GDP per capitas of the ASEAN countries with the rest of the world, the calculation of the average GDP per capitas done on the basis of simple average, a bit of diverging trend is visible. (Exhibit 5.9). In fact the interesting thing to note is that till 1995, that is prior to the declaration of the AFTA proposal, a converging trend is visible between the two average GDP per capitas. But, the post-1995 experience is that of a diverging one.
As has been repeatedly noted, the simple average method of calculating the average GDP per capitas suffer from the problem of not taking care of the different developmental level of the individual countries. To decrease the intensity of the problem, in this case also, the weighted average method has been calculated to go for the comparison. The weights are defined as below.

The weight for the Rest of the World GDP Per Capita is

\[ W = \frac{\text{GDP of the particular country}}{\text{the world GDP excluding the ASEAN countries}} \]

(However, Laos and Cambodia are included)

The weight for the ASEAN GDP Per Capita is

\[ W_{\text{ASEAN}} = \frac{\text{GDP of individual ASEAN countries}}{\text{ASEAN GDP}} \]

(Note: Excluding Laos and Cambodia)

Comparing the weighted average GDP per capita of the ASEAN countries with that of the rest of the world brings out the fact that even in this case, the two reveal a diverging trend. In fact, the scenario is same as in case of the simple average method. That is, after formal launching of the AFTA plan, the two are seen to reveal a diverging trend. (Exhibit 5.10)
Thus, the formation of the AFTA is seen to reveal a trend towards discrimination. That is, the trend can be taken to be a higher degree of trade diversion taking place after the creation of AFTA in the AFTA market, thereby eroding away the market access negotiated by the other trading partners under the multilateral forum.

**Conclusion**

Using this methodology results similar to the Bella Balassa case are seen. That is, in first two cases (NAFTA and EU), there is no indication of any movement created against the multilateral initiative of a liberalised global trading regime. It might be justifiable at this juncture to point out that the above results are seen in spite of the fact that the majority member countries of the two RTAs are developed ones; thus a diverging trend between the average GDP per capita of each of the two RTAs with that of the rest of the world would not have been very surprising. In fact even under normal circumstances, that without any regional integration initiative, the diverging trend would not come as a surprise. This holds all the more in the case of this, that is the regional integration initiative is
present. As has been discussed in details that any RTA is bound to have some amount of trade diversion. This trade diversion creates a discriminatory environment for the non-members in the RTA market, thus eroding the market access negotiated at the multilateral level to some extent. Hence, a movement towards restriction for non-members is visible in the RTA market. Under such a situation, one cannot expect the average GDP per capitas to converge. Larger is the extent of trade diversion, greater is the intensity of the adverse situation and lower is the probability of convergence.

NAFTA, as is well known is aiming towards a free trade area by 2005. The EU is much more than just a free trade area. It has gone for a harmonised policy environment regime. In spite of such strong regional integration, there is a converging trend seen between the EU average GDP per capita and the same for the rest of the world. The same trend is seen for NAFTA also.

Contrary to this is the case of ASEAN. That is, there is a diverging trend seen between the average GDP per capita of the ASEAN countries with the same for the rest of the world. This in turn implies a tide against the global liberalisation. The striking reason to explain this contrast is the set of provisions under which the AFTA has been formed.

5.6: conclusion
The above discussion brings out some important aspects regarding the debate of Regionalism Versus Multilateralism. In the first place, there has indeed been an increased popularity of RTAs in the global trading arena. This increased popularity has been observed simultaneously with the multilateral initiative of trade liberalisation. In fact, data regarding the formation of RTAs contradicts the popular claim that the slow pace of the multilateral trade liberalisation initiative resulted in the increased popularity of the same at the regional level. There is seen to have been a substantial increase in the number of RTAs at periods when
the multilateral trading system revealed quite satisfactory pace of trade liberalisation initiative.

This fact brings us to the second aspect; what is then the rationale behind the formation of RTAs, if it is not treated as a substitute for trade liberalisation initiative at the multilateral level. The importance of the question lies in the fact that in case of some alternative rationale behind the formation of RTAs, the whole purpose of allowing this exception under the multilateral trading system gets diluted. That is, acknowledging the discriminatory environment created by the formation of the RTAs, the multilateral trading system allowed the formation of the same, thinking that they would facilitate creation of a freer trade regime.

Analysing the question, one needs to turn towards the theoretical implications of RTAs. It cannot be denied that a major portion of benefits enjoyed by RTA members come from the discriminatory environment created. If the objective of the multilateral trading system behind formation of RTAs is to be fulfilled, then what is required is gradual expansion of the liberalisation initiative. This gradual expansion is likely to come either through allowing new members or through gradual decrease in the MFN trade restrictions along with the decrease in the RTA trade restrictions. But in both cases, it would be gradual erosion of the discriminatory environment, in turn having adverse implications on the benefits of RTA members.

Thus, the discrimination in built in regional trading arrangements puts a doubt on the role of RTAs as facilitator to trade liberalisation initiative at the multilateral level.

The multilateral trading system, to impart the role of facilitator to liberalisation of global trade, included the provisions for forming RTAs. The central provision allowing the formation of regional trading arrangement under the multilateral trading system tries to ensure minimisation, if not removing the adverse
implications of regional trading arrangements on the liberalisation initiative at the multilateral level, yet the in-built mechanism of regional trading arrangement erodes away the intension.

Added to this is the formation of regional trading arrangements among the developing countries. This as has been discussed, is a much lenient form of Article XXIV of GATT. It drops the condition of substantial coverage and the time schedule of an interim arrangement leading to the stage of free trade area on customs union. The dropping of the first condition increases and decreases that of trade creation. The dropping out of the time frame condition affects the motive behind regional trading arrangement.

Thus, when Article XXIV with all the stringent conditions fails to ensure a facilitating role of RTAs, the lenient enabling clause is expected to lead to a higher extent of adverse implications on liberalisation initiatives undertaken at the multilateral level.

Moreover, the important dimension that cannot be ignored is the trade off between the benefits to members and non-members. The conditions imposed through Article XXIV and the enabling clause tries to ensure that the RTA is more of trade creating. But even through these provisions the adverse implications on trade of third countries cannot be wiped out, thus leading to erosion of negotiated market access.

As pointed out by Yi (1996, 97), a customs union can be thought to be a coalition of countries. No body denies that the formation of a customs union does harm outsiders and benefit the member countries. According to the literature on coalition formation, the general principle is that if an exclusive coalition generates a negative externality on non-member then it will not expand to embrace all countries. Keeping this is mind, the basic rational behind allowing customs union and free trade areas was that starting from free trade among few
countries, liberalisation would spread gradually. But when one of the source of the benefits coming to the member is the exclusion of non-member, a free trade area or custom union among few countries cannot be expected to move towards global trade liberalisation.

Using three different methodologies to test the debate, no definite conclusions could be reached. At the aggregate level, the formation of an RTA under Article XXIV of GATT and the deepening of the integration process of an RTA does not reveal any adverse effects. However, it might be kept in mind that at the aggregate level, the gains and losses are likely to get balanced, which is basically the welfare implications of the RTAs. To understand this we have to turn back to the belief that an RTA is welfare enhancing if it gives rise to net trade creation. The two RTAs, NAFTA and EU are likely to lead to quite substantial net trade creation; thus they appear not to have substantial adverse implications on the global trading arena. This point gets confirmed by the fact that ASEAN, the RTA formed under the Enabling Clause gives rise to adverse implications. Being formed under the enabling clause, ASEAN drops out the condition of substantial coverage of trade. This in turn reduces the potential trade creation aspect thus reducing net trade creation.

But the aspect of the erosion of market access for the third country in the region’s market does not get so much of focus at the aggregate level of study. The methodology using disaggregated data does reveal trade diversion – erosion of market access for third countries in the region’s market.
Examples include the RTAs signed between the EC and EFTA, as well as those signed by CARICOM and the CACM with third parties.

Examples include EC-MERCOSUR and Closer Economic Relations (CER)-Association of South East Asian Nations (ASEAN).

Source: NAFTA Secretariat

Ex post income elasticities of import demand have been defined as the ratio of the average annual rate of change of imports to that of GNP.

Data Source: Direction of Trade Statistics Yearbook, IMF and International Financial Statistics, IMF; Different Volumes

Data Source: TRAINS, UNCTAD, and Calculations based on the TRAINS CD Data. Data are considered at six digit ITC (HS) Code level

Data Source: Statistical Yearbook, United Nations; Different Volumes.