

# **How to Free Trade: Regional Trade Agreements**



**AED/IS 4540  
International Commerce  
and the World Economy**

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# Ways to freeing trade



## ❖ **Regional/bilateral trade agreements:**

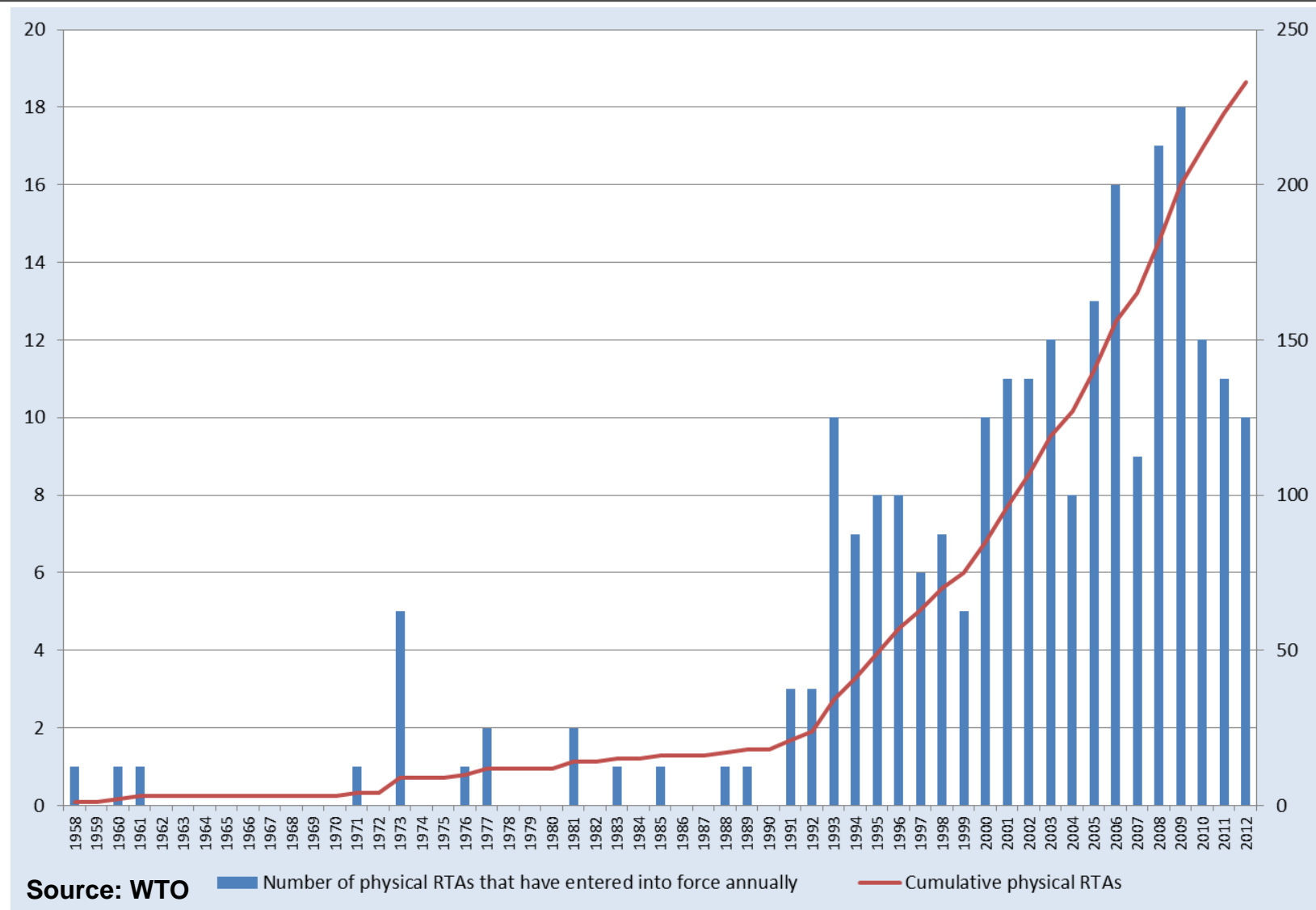
- **trade liberalization on a discriminatory basis, i.e., concessions only made between parties to agreement**
- **free trade areas (NAFTA) or customs unions (EU)**
- **in conflict with principle of non-discrimination in GATT/WTO Article 1, but allowed under Article 24 if tariffs are reduced for “substantially all trade” between parties**

# **Regionalism is growing**

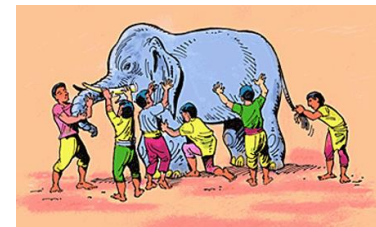
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- ❖ **Regional trade agreements (RTAs) have mushroomed since 1990**
- ❖ **US has RTAs in force with 20 countries, and until recently, was involved in ratifying/negotiating others, e.g., Trans-Pacific Partnership (TPP), and US-EU Transatlantic Trade and Investment Partnership (TTIP)**
- ❖ **East Asia currently has over 70 RTAs in force**
- ❖ **EU has negotiated more, e.g., with Canada and Japan**
- ❖ **GATT/WTO probably never envisioned this many RTAs coming into force – GATT Article 24 designed originally to allow formation of EEC**

# Regionalism is growing



# Is more regionalism good?



## Significant debate among economists:



- Jagdish Bhagwati (Columbia) – “...do trade blocs serve as ‘building blocks’ or ‘stumbling blocks’ for worldwide freeing of trade?”



- Larry Summers (Harvard) – “...I like all the ‘isms’, unilateralism, regionalism and multilateralism...”

- In assessing regionalism, Bhagwati sees discrimination, Summers sees liberalization – smacks of the blind men and the elephant!

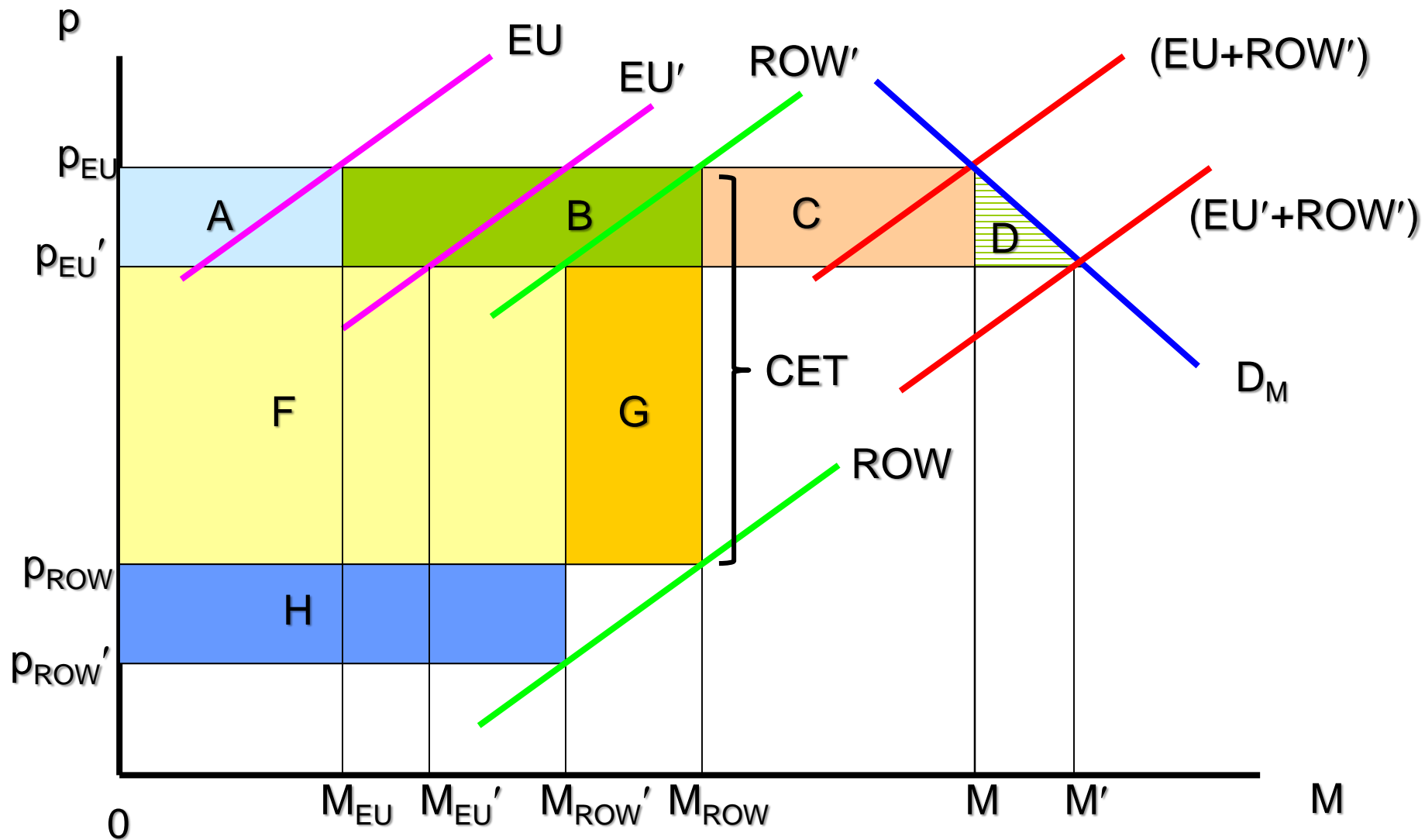
# Why might regionalism be bad?

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- ◇ Economic benefits, *trade creation*, may be outweighed by costs, *trade diversion*
  - trade creation occurs due to removal of tariffs between members of a regional agreement
  - trade diversion occurs because non-members face discriminatory tariffs on their goods
- ◇ Potential for complex *rules of origin* (ROOs) i.e., it really matters where an intermediate or final good comes from

Example: Mexico can export overcoats to US tariff-free, but if fabric used to make them is imported from outside NAFTA, overcoat is no longer Mexican and is subject to a tariff

# Effects of economic integration



# Effects of economic integration

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- ◇  $D_M$  is import demand for set of countries  $i$  in trade agreement,  $(EU+ROW')$  is aggregate supply, for other countries  $j$  in agreement (EU), and rest of world (ROW)
- ◇ Suppose that trade agreement is a customs union, with a common external tariff (CET) that shifts up ROW supply curve from ROW to ROW'
- ◇ Internal price is  $p_{EU}$ , and world price is  $p_{ROW}$ , with total imports by  $i$ ,  $M = (M_{EU} + M_{ROW})$
- ◇  $i$  earn tariff revenue  $(A+B+F+G)$  from ROW, but forgo tariff revenue on imports from other members  $j$  of customs union



# Effects of economic integration

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- ◆ Suppose increased integration in EU results in further reduction of trade barriers, moving aggregate supply curve to  $(EU' + ROW')$
- ◆ This drives down the internal price to  $p_{EU}'$ , and the world price to  $p_{ROW}'$ , with total imports of  $M' = (M_{EU}' + M_{ROW}')$ , imports from EU rising, imports from ROW falling
- ◆ Consumers in  $i$  gain  $(A+B+C+D)$ , while there is a net loss of tariff revenue of  $(A+B+G)-H$

# Effects of economic integration

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◇ Net effect is  $(C+D+H)-G$ :

(i) area C is terms of trade gain on original level of imports by  $i$  from other EU members  $j$

(ii) area D is gain on additional lower-cost imports by  $i$  from other EU members  $j$ , i.e., *trade creation*

(iii) area G is *trade diversion* as cheaper imports from ROW are replaced by imports from EU

(iv) area H is a terms of trade gain from getting imports from ROW at a lower price

# Alphabeti spaghetti

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- ❖ **Multiple RTAs and R00s may cause production inefficiency**
- ❖ **R00s: determine country of origin of a product for purposes or trade - in regional trade agreement R00s determine what products benefit from tariff cuts**
- ❖ **Half-finished goods go around RTA networks based on differential tariffs in an attempt to deliver final good at lowest price – a “spaghetti bowl” effect (Bhagwati, 1995)**
- ❖ **If all WTO members signed an RTA with every other member, there would be over 11,000 strands of spaghetti**

# **Are all 'isms' good?**

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- ◆ **Uruguay Round of GATT not undermined by 1980s and 1990s regionalism, e.g., EU expansion, formation of NAFTA**
- ◆ **Key multi-lateralist countries have also been regionalists, e.g., US and members of the EU**
- ◆ **Multilateralism often a response to regionalism, e.g., the Kennedy Round of GATT in 1960s after formation of EEC**
- ◆ **Implies trade liberalization is dynamic**

# **Dominos and juggernauts\***

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- ◇ **Domino theory of regionalism:** formation of regional bloc eventually triggers membership requests, e.g, EEC6 in 1950s, entry of UK, Ireland, Denmark.....
- ◇ **Juggernaut theory of multilateralism:** once liberalization ball starts rolling it's difficult to stop, i.e., successive rounds of GATT/WTO
- ◇ **Dominos can start juggernauts:** regional blocs may be building blocks to freer trade, e.g., enlargement of EU has resulted in reform of the Common Agricultural Policy (CAP)

\* Richard Baldwin, "Multilateralising Regionalism: Spaghetti Bowls as Building Blocs on the Path to Global Free Trade", *World Economy*, 29-11 (2006): 287-331.

## **Asia: a case of unilateralism to regionalism**

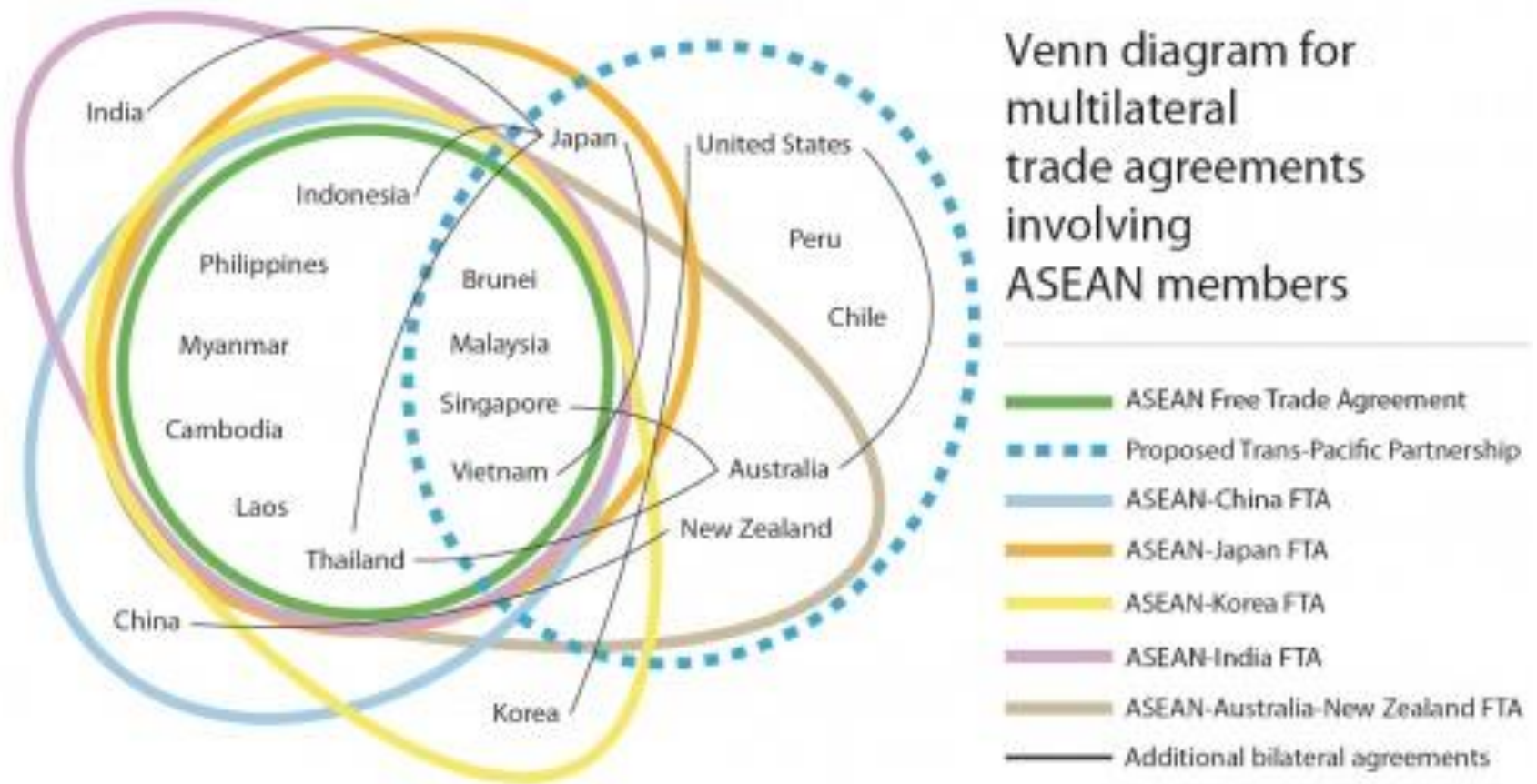
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- ❖ **Until 1980s, tariff-cutting in Asia limited to Japan**
- ❖ **In mid-1980s, “factory Asia” led to “race to the bottom” unilateralism**
- ❖ **China’s entry to WTO sparked a domino effect with signing of multiple RTAs**
- ❖ **Created Asian “noodle bowl”**

# Asian noodle bowl



## The Free Trade Noodle Bowl Phenomenon



# Woes of the WTO

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- ◆ **GATT/WTO “magic” has stopped working. Why?**
  - **Lost dominance of developed economies in WTO**
  - **Many developing countries too small to form “offensive” coalitions, and blocked opening up of their markets**
  - **Growth of RTAs means WTO is not “only game in town”**
  - **“Deep provisions” means RTAs are going beyond tariff-cutting**
  - **Rise of offshoring and unilateral tariff-cutting by developing countries has made WTO less attractive to developed countries**



# Woes of the WTO

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- ◆ **Challenges have had several effects on WTO:**
  - **Multilateral negotiations are more difficult than they were under GATT, i.e., more players can use veto**
  - ***Applied* tariffs in developing countries typically lower than *bound* tariffs – developed country exporters have less to push for**
  - **Growth of offshoring has created demand for disciplines on behavior in global supply chains, e.g., protection of tangible and intangible property rights**
  - **Not included in WTO agenda, therefore, mega-regionals (TPP and TTIP) have been attempts to multilateralize these disciplines**

# **Is lack of multilateralism a problem?**

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- ❖ **Empirical evidence suggests trade diversion through RTAs is really not that big an issue**
- ❖ **Deep provisions in RTAs typically do not involve discrimination, e.g., Japan-Thailand RTA allows any bank registered in Japan to sell financial services in Thailand**
- ❖ **Rise of China, offshoring and unilateralism means Doha agenda is not “win-win” bargain for all members**
- ❖ **Trade in intermediate goods and services, investment and intellectual property protection being governed by mega-regional deals – although China/India currently left out**