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# WHAT ARE THE ECONOMIC EFFECTS OF REGIONAL TRADE AGREEMENTS?

Stephan Gerschewski, Hankuk University of Foreign Studies, Seoul, Korea\*

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## ABSTRACT

*The purpose of this study is to review the economic effects of regional trade agreements (RTAs). We examine whether RTAs lead to trade creation or trade diversion, thus raising or lowering world welfare. In addition, we investigate whether RTAs are contributing to or are hindering global free trade. Our review suggests that there is inconsistency in the trade creation and diversion effects of RTAs with empirical support for both effects. In addition, there tends to be no consensus in the literature on the role of RTAs as “building blocks” or “stumbling blocks” for global free trade. The study raises implications for future research.*

**Keywords:** Regional trade agreement, trade creation, trade diversion, global free trade, stumbling block, building block

## 1. INTRODUCTION

In the past two decades, there has been a large proliferation of regional trade agreements (RTAs) worldwide, especially in Asia. As of January 2013, 546 RTAs have been notified to the World Trade Organization (WTO) (WTO, 2013). The figure is expected to rise due to the large number of pending negotiations between countries (e.g. Free Trade Agreement between South Korea, China, and Japan) (Korea Times, 2012). In particular, Asian countries have aggressively pursued the establishment of RTAs after the Asian Financial Crisis in 1997 and this development has been described as “do-it-quick” and “do-it-soon agreements” (Sopiee, Yonosuke and Toshinori, 2004). One key feature of these new RTAs is their market-driven focus. This implies that the motive of the formation of Asian RTAs is to stabilize the regional economy rather than political reasons which were the key motives for the establishment of the European Union (EU). Unlike the EU, there is a lack of institutionalization in Asian economic integration which means that most Asian countries prefer loose and voluntary cooperation schemes. Other features include the preference of bilateral agreements and the focus on inter-regional rather than intra-regional RTAs (Lee and Park, 2005).

RTAs can take many forms, depending on the level of integration, ranging from preferential trade agreements (PTA) to customs unions and economic unions. Among RTAs, free trade agreements and partial scope agreements account for 90% of all RTAs, while customs union make up 10% (WTO, 2013). The proliferation of RTAs contrasts with the multilateral liberalization approach of multilateral organizations, such as the WTO. As a result, two seemingly contradicting developments have evolved: on the one hand, there is the multilateral approach expressed by the WTO, and on the other hand, the rising emergence of regional trade agreements which are often characterized by bilateral arrangements.

The purpose of this study is to provide a review of the literature on the economic effects of RTAs. The first issue is whether RTAs will lead to trade creation or trade diversion, thereby raising or lowering world welfare. This builds on the conclusion of Clausing (2001, p. 678) that “the empirical work has failed to reach firm conclusions on even the most basic issue regarding preferential trading agreements: whether trade creation outweighs trade diversion”. The second research question relates to whether RTAs can supplement the WTO efforts for global free trade or whether RTAs hinder global free trade.

The paper is structured as follows. In the next section, we provide the theoretical background and underlying principles of RTAs. Then, we examine the economic effects of RTAs by differentiating between static and dynamic effects of RTAs. We conclude the study by raising implications for future research.

## 2. UNDERLYING PRINCIPLES OF RTAS AND THEORETICAL BACKGROUND

The so-called Most Favored Nation (MFN) provision is an important factor in explaining regional trade agreements. It requires that “any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties” (GATT, 1994, p. 486). This implies that all trading partners should be treated equally. The MFN-provision was built into Article 1 of the General Agreement on Tariffs and Trade (GATT) in 1947. However, there is an important exception to the MFN-provision which is highly relevant for the existence of regional trade agreements. This is Article 24 which allows a free trade area (FTA) or customs union (CU) under certain conditions: First, “substantially all” trade barriers between members should be removed, and second, the barriers against non-members may not be raised (Frankel, Stein and Wei, 1995). Article 24 is a controversial issue due to its inexact wording (“substantially all”).

At the time of the formation of GATT, RTAs were believed to be contributing to global free trade due to the removal of barriers within a RTA and the prohibition to raise trade barriers against non-member countries (see Article 24). As a result, it was assumed that trade barriers would be lowered overall (WTO, 1995). However, Viner (1950) criticized the assumption that preferential trade liberalization is automatically beneficial. Viner (1950) argued that RTAs could be either trade creating or trade diverting, thus raising or lowering world welfare. Trade creation means that a high-cost domestic producer of the trade agreement is replaced by a low-cost member country within the free trade agreement. Trade diversion occurs when a low cost foreign producer is displaced by a high cost domestic member country. Viner (1950) argued that depending on the amount of trade creation and trade diversion, RTAs are either beneficial and raise welfare or not beneficial and contribute to lower world welfare. As a result, according to Viner (1950), free trade areas are not necessarily contributing to global free trade. In particular, Viner (1950) regarded the trade diversion effects as a major problem and was rather skeptical of preferential trade agreements. The distinction into trade creation and trade diversion was very influential and dominated further research on the effects of RTAs.

### **3. ECONOMIC EFFECTS OF RTAS**

The economic effects of RTAs can be generally distinguished into two groups. First, there are the static effects, which generally deal with the question of trade creation and trade diversion. Second, there are the dynamic time-path effects, which include the effects of RTAs on global free trade (Bhagwati, 1993). The empirical results of these effects are highly controversial and have been fiercely debated.

#### **3.1. Static Effects of RTAs**

The static effects of RTAs center on the distinction of Viner (1950) regarding trade creation and trade diversion effects. Akoorie and Scott-Kennel (2005) noted several key determinants for trade creation. For example, they argued that a similar economic level of the member countries is important for trade creation to occur. They also noted low transport costs and the size of a common large market to exploit economies of scale. In addition, they argued that the more competitive the member countries, the more likely trade creation will occur. Other conditions include the amount of initial flows between member countries prior to the trade agreement. In addition, the lower the external tariffs after the formation of a RTA, the more likely there will be trade creation (“Building blocks or stumbling blocks?”, 1992).

Krugman (1991a) raised a debate whether the formation of a trading block is trade diverting or creating and argued that trading blocks are good as long as they follow the natural lines of borders. Thus, Krugman (1991a) noted that countries mostly trade with close neighbors due to the proximity and low transportation costs. As a result, a continental trading block among close neighbors is preferential and likely to be welfare improving. Krugman (1991a) called this “natural blocs” and assumed that it is “natural” for countries to trade with neighbors. Krugman (1991a) argued that there is not much trade to be diverted as high transportation costs prevent the trade of countries from different continents. In contrast to “natural” trading formations, trading blocks of countries from different continents are “unnatural blocs” and less likely to be welfare-improving. Summers (1991) also argued that the formation of a trading block of geographically proximate “natural trading partners” is unlikely to be trade diverting.

Krugman's model was criticized by several scholars. First, critics claimed that it was based on the assumption that inter-continental transportation costs are infinitely high. Frankel et al. (1995) attempted to overcome this failure by incorporating transportation costs in their model which led to different results. In contrast to Krugman (1991a), Frankel et al. (1995) argued that not only "unnatural" FTAs, which are formed across different continents, are welfare-reducing, but also FTAs that are formed along natural continental borders will lead to welfare reduction under certain conditions. Frankel et al. (1995) called these welfare-reducing blocs "supernatural blocs". Another result of their study is that partial liberalization with regional preferential trade agreements is generally better than 100% liberalization.

Bhagwati, Greenaway and Panagariya (1998) also questioned the assumptions of Krugman's (1991a) model. They criticized the assumption that the higher the initial volume of trade between members, the less trade diversion. According to Bhagwati et al. (1998), not the scope of trade diversion is decisive, but the likelihood that trade diversion emerges. Thus, they argued that trade diversion depends on the elasticities of substitution among products and not on the initial trade volumes. In addition, Panagariya and Srinivasan (1998) questioned the natural trading partnership relationship which is assumed by Krugman (1991a) and argued that the natural trading relationship is neither symmetric nor transitive. Panagariya and Srinivasan (1998) noted that the US may be a natural trading partner for Mexico, but on the other hand, Mexico may not be a natural trading partner for the US, as evidenced by the fact that Mexico is not a major trading partner for the US.

Another critique relates to the geographic proximity of countries. Bhagwati (1993) argued that it is not natural that geographically close countries trade more with each other, as assumed by Krugman (1991a). Bhagwati (1993) mentioned the trade between India and Pakistan as an example of the failure of trade relationships of two geographically close countries. Regarding trade diversion, Lloyd (2002) raised some key points. Arguing that regionalism has created unequal access to world markets, Lloyd (2002) stated that as most of the bilateral agreements are between developed countries, the developed countries have increased their market access to a much larger extent than developing nations. As a result, developing countries cannot benefit from trade liberalization and trade is diverted away from them. Lloyd (2002) noted that the gains from trade liberalization and RTAs go mainly to developed countries.

Another important factor that is relevant for the trade creation vs. trade diversion debate relates to the anti-dumping actions of countries. In this regard, Bhagwati et al. (1998) referred to the favored policy of protectionist countries of raising barriers to gain protection and advantage against foreign rivals. Bhagwati et al. (1998) stated that member countries of a FTA are tempted to misuse anti-dumping actions to protect each other at the expense of non-members. As a result, protection becomes "endogenous" to the FTA and a trade creating FTA can turn into a trade diverting FTA (Bhagwati et al., 1998).

### **3.1.1. Statistical Models to Measure the Trade Effects of RTAs**

Two main models are predominant for testing the trade effects of RTAs: (1) a gravity model which is based on Newton's Law of Gravitation, and (2) a computer generated equilibrium model (CGE).

The gravity model predicts that the volume of trade between two countries increases with their size (proxied as GDP) and decreases with transaction costs (measured as distance). (Ghosh and Yamarik, 2004). The higher the GDP, ceteris paribus, the higher the trade volume. The lower the distance, ceteris paribus, the higher the trade volume. Tinbergen (1962) and Pöyhönen (1963) were the first to apply the gravity model to trade flows. The variables of the gravity model are compatible with trade theories of imperfect competition and the Heckscher-Ohlin model (Ghosh and Yamarik, 2004). In applying the gravity model to the trade effects of RTAs, many authors included additional variables, e.g. exchange rate volatility or common land border; see Ghosh and Yamarik (2004) for an overview.

There have been ambiguous results as to whether RTAs create or divert trade. Some studies found support for trade diversion effects of RTAs. For example, Yeats (1997) found empirical evidence for large trade diversion in a study of MERCOSUR. In addition, a study of Wei and Frankel (1995) revealed trade diversion in the EU insofar as "trade with countries outside the region in 1970 was 30% more than random non-Western European countries" (Wei and Frankel, 1995, p. 25). Frankel, Stein and Wei (1997)

conducted a study among trade patterns in EC, EFTA, NAFTA, MERCOSUR, the Andean Pact, AFTA, CER and East Asian Economic Caucus. The results showed that there was a significant increase in intrabloc trade, but a high decrease in extrabloc trade (trade diversion). Gilbert, Scollay and Bora (2001) examined regional trading agreements in the Asia-Pacific. As for the ASEAN+3 (i.e., ASEAN and Japan, Korea, and China), they concluded that there would be welfare gains for all member states, in particular, for the new member countries. However, ASEAN +3 would also likely lead to high welfare losses for non-member states, such as the US. This implies that there are strong trade diversion effects of ASEAN+3.

Urata and Kiyota (2003) examined Asian RTAs and found that there are increases in GDP for the members of ASEAN+3. For example, Thailand would increase its GDP by 16% in a potential East Asian trading block. On the other hand, the GDP of Australia and New Zealand is estimated to decrease substantially. As a result, Urata and Kiyota (2003) showed that ASEAN+3 is likely to have more trade diversion effects than trade creation effects. Carrere (2006) found in a study of seven RTAs, including MERCOSUR and NAFTA that intra-regional trade largely increased, combined with a reduction of imports from the world and exports to the world, thus suggesting trade diversion. Ghosh and Yamarik (2004) concluded that the trade creation effects of RTAs are “fragile”.

However, there are also studies which lend support to the trade creation effect of RTAs. For example, Aitken and Obutelewicz's (1976) study of RTAs of developing countries showed large trade creating effects among African countries and the EEC. Similarly, Soloaga and Winters (2001) found trade creation effects in Latin America during the 1990s. Kandogan (2005) found that the majority of liberalization agreements in Europe were trade creating, thereby improving the welfare of the involved partners, in particular in human and physical capital-intensive sectors. Koo, Kennedy and Skripnitchenko (2006) also found trade creation effects of the ASEAN Free Trade Agreement (AFTA).

The second model to test the trade effects of RTAs is the computer generated equilibrium model (CGE). The CGE-model simulates the economic effects of RTAs and is often used for predicting trade effects of proposed RTAs (Lloyd and McLaren, 2004). For example, Lee and Park (2005) suggested that there would be no trade diversion effects for non-member countries in a potential ASEAN+3. They found that an ASEAN+3 is likely to raise intra-bloc trade in the region without having significant negative impacts on non-member countries. Brown, Deardorff and Stern (2003) found in a study of ASEAN+3 that if the member countries removed all tariffs on agricultural and manufactured products and removed barriers to services, there would be welfare gains for Japan, Singapore, South Korea and China. In comparison to the gravity model, the CGE-model is not as frequently used for measuring trade effects of RTAs.

### **3.2 Dynamic Effects of RTAs**

Bhagwati (1993) introduced the dynamic effects of RTAs. The main issue is whether RTAs can contribute to non-discriminatory global free trade or not. In other words, are RTAs building blocks or stumbling blocks towards global free trade? (Bhagwati, 1993). Similar to the question of whether RTAs are trade creating or not, there has been a highly controversial debate as to which extent RTAs can contribute to global free trade. The following arguments lend support to the notion of a stumbling block.

Krugman (1991b) showed that the formation of trading blocks could lead to a reduction of welfare and described a scenario in which individual countries form larger groupings and become more protectionist against other groups. The underlying reason for becoming protectionist is that any group will set its external tariffs in order to maximize economic welfare. The larger the group, the more collective power it has to raise tariffs against other blocks. Frankel et al. (1997) called this the “incentive to protect” by referring to the “tariff war” by Johnson (1954). Another description for the situation of the trade blocks is the “prisoners’ dilemma”. Krugman (1991b) concluded that the world would be better off with many small RTAs and argued that 3 is the worst number of trading blocks. According to Krugman (1991b), as large trading blocks become more protectionist, they form a stumbling block against global free trade.

Another important factor which illustrates the potential challenges of RTAs relates to the so-called “spaghetti bowl”-phenomenon by Bhagwati et al. (1998). This describes the overlapping of trade formations which may lead to confusion and complicated discriminatory trade. As a large number of

countries are members of several RTAs, the “who is whose” problem becomes evident. As trade in RTAs occurs on the basis of origin, it is important to evaluate the source of origin. However, the problem is how to evaluate the source of origin as there are often multiple sources of origin and the traded product is not necessarily manufactured in only one, single country. This leads to arbitrariness of determining the source of origin. A large number of countries have different external tariffs to the same good depending on the source of origin, e.g. EU. As a result, the “spaghetti bowl” facilitates protectionism and increases the transaction costs for firms. The concept of the “spaghetti bowl” has received much attention. For example, Lee and Park (2005) warned of a spaghetti bowl scenario of a potential East Asian trade block. As there are many Asian countries involved in several bilateral agreements, Lee and Park (2005) suggested common tariffs and a harmonization of policies to avoid confusion. Krüger (1995) noted a similar problem of exploiting the rules of origin. Referring to FTAs where there is no common external tariff, Krüger (1995) described how industries can be protected by diverting trade from foreign suppliers.

Wonnacott (1996) introduced the terminology of “hubs and spokes”. A hub is a country which has at least two distinct bilateral RTAs. This hub has spokes which relate to the countries to which it has separate bilateral RTAs. The problem is that the hub enjoys more market access than the spokes as the hub has preferential trade to all spokes whereas the spokes have only preferential access to the hub.

Bhagwati (1993) noted another factor which leads to protectionism and argued that RTAs may not be willing to expand due to the potential unwillingness of the governments of its member countries. This may be attributed to the fact that the RTA is often already a large market and there is no need to add new, additional members. Bhagwati (1993) called this the “our market is large enough” syndrome. Similar to this scenario is the “these are our markets” syndrome (Bhagwati, 1993). This implies that interest groups in member countries are not interested in an expansion of its RTA as they benefit from trade diversion.

On the other hand, there are also many arguments which propose that RTAs can serve as a supplement to the WTO, thus contributing to global free trade. One key theory is the so-called “domino-theory” of Baldwin (1993) which describes the phenomenon of incentives for non-members to become members of a RTA. The reasons for joining a RTA are that the non-members’ competitiveness in RTA market declines as the non-member country faces barriers to trade. In addition, the gains from the trading block resulting from freer trade are distributed only among the members of the trading blocks. As a result, non-member countries experience losses and are eager to join the RTA in order not to be isolated. Thus, the formation of a RTA can trigger a domino-effect (Baldwin, 1993). Kemp and Wan (1976) introduced an aspect different to the perspective of Viner (1950). They found support for a customs union where the welfare of non-members remained unchanged and the welfare of the member countries improved. Hence, customs unions may contribute to global free trade. This is one of the main foundations of the proponents of RTAs and its force for global free trade.

Another factor which underlines the “building block” aspect of RTAs is “competitive liberalization” (Frankel et al., 1997) which implies that countries dismantle trade barriers to compete for international capital. Trade liberalization is more likely to occur in a region where countries are prospering due to liberalization. In times of the growing importance of international capital, the relevance of “competitive liberalization” is emphasized. In addition, Kahler (1995) argued that negotiations with a small number of RTAs are more efficient and easier than global negotiations as RTAs often have one common external policy. Lloyd (2002) stated that regionalism may also have a positive impact on unilateralism. Unilateralism refers to the lowering of trade barriers of each country individually on a MFN basis and is considered to contribute to trade liberalization. Lloyd (2002) argued that regionalism will not affect unilateralism negatively. However, Schiff and Winters (2003) argued that the gains of a RTA come only at the expense of consumers and government revenue, and, thus, a RTA might not be preferential to unilateralism.

#### **4. CONCLUSIONS AND IMPLICATIONS FOR FUTURE RESEARCH**

Research on the economic effects of RTAs is highly controversial and has resulted in many different conclusions. As a result, there is a multitude of diverging opinions and arguments whether RTAs are trade creating or trade diverting. On the one hand, there are scholars who argue that RTAs are trade creating and increase world welfare (e.g. Clausing, 2001; Soloaga and Winters, 2001; Kandogan, 2005).

On the other hand, there are many skeptics who state that RTAs lead to protectionist actions, thus lowering welfare and diverting trade (e.g. Frankel et al., 1997; Ghosh and Yamarik, 2004; Lee, 2010). In addition, it seems there is no consensus on the effects of RTAs on global free trade. While scholars, such as Bhagwati (1993), Wonnacott (1996), and Lee and Park (2005), are skeptical about the contribution of RTAs to global free trade, other studies refer to competitive liberalization and the domino-effect, thus proclaiming the “building block” ability of RTAs (e.g. Baldwin, 1993; Lloyd, 2002; Menon, 2005).

One limitation of the economic models of trade is that they often do not consider FDI in their modeling. As FDI plays an increasingly important role in world trade and economic integration, we suggest that future research should be more focused on the role of FDI and be incorporated into the models. In addition, most of the models adopt a macro-economic perspective, while the firm-level approach is neglected. Many models assume that the formation of a RTA is the only cause which will lead to trade creation or trade diversion respectively. Therefore, we recommend that future research considers a firm’s trading behavior to analyze the effects of trade liberalization and RTAs. For example, the investment behavior of firms often plays a critical part in regional economic integration. If this is taken into account, the effects of RTAs are likely to be better understood and, thus, lead to more extensive and richer results.

In conclusion, regional economic integration is an extremely complex issue and is of critical importance to policymakers. It can be confidently assumed that the number of RTAs is likely to rise in the years to come. Hence, research in this area is highly relevant and should be further intensified.

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## 6. AUTHOR PROFILE

Dr. Stephan Gerschewski (Ph.D., Victoria University of Wellington) is Assistant Professor of International



Business at Hankuk University of Foreign Studies, Korea. His research interests include international entrepreneurship, export performance and cross-cultural management.