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Opinion

SAARC and other Regional Trade Agreements

A.R. Choudhury*

**Dr. A.R. Chowdhury teaches at Marquette University, Wisconsin, USA.*

Preferential trade agreements have multiplied dramatically over the last thirty years. They have proliferated to the point where virtually all members of the World Trade Organisation (WTO) belong to some form of regional trade agreements (RTAs). These RTAs, sanctioned by Article XXIV of the General Agreement on Trade and Tariff (GATT) are mostly in the form of a customs union, a free trade agreement, or an interim agreement leading to one or the other. By the end of last year, more than fifty percent of world trade is estimated to take place within RTAs.

Bangladesh, along with its regional trading partners in SAARC, formed the South Asian Agreement on Preferential Trading which later became the South Asian Free Trading Arrangement (SAFTA). Currently, there are a large number of similar regional trading arrangements including, among others, ASEAN, European Union, Mercosur, and NAFTA. The European Union and Mercosur represent a customs union while the others are examples of free trade agreements.

A question that has baffled policy makers around the world is whether these RTAs are beneficial institutions that complement WTO objectives, or do they act as serious impediments to globalism? Are there incentives for RTAs to keep expanding with more members so as to move towards multilateral free trade eventually, or will there be incentives instead to keep new members out? The desirability of these arrangements in themselves and vis-à-vis multilateral free trade has been the source of debate among many policy makers.

These trading arrangements are posing both an important challenge as well as a unique opportunity for the WTO. It is a challenge because RTAs can lead to high welfare costs for both the participating countries by diverting trade and investment. It can also generate important welfare gains for the participants as well as the rest of the world by creating regional dynamic forces in favour of freer trade.

RTAs have been an integral part of the world trading system throughout the period under the General Agreement on Trade and Tariff (GATT). They were originally accepted as exception to the GATT's most favoured nation (MFN) principle. Today, they are customary arrangements that have grown in significance. Most RTA formation has occurred in two bursts of activity: first, during the 1960s and 1970s when the growth was concentrated exclusively in Europe, and then again since 1990 when the growth has been more widespread.
The recent spurt in regional trade agreements can be attributed to the need of many smaller countries to complement internal efficiency gains from trade with external market access.

Trade creation occurs when a lowered trade barrier between member countries leads one country to import goods that otherwise would be produced at home or not produced at all. Trade creation generates efficiency gains for the member countries by encouraging goods to be produced wherever costs are lowest within the RTA.

Trade diversion, on the other hand, occurs when the preferential treatment causes a country to replace imports from the outside world with imports from a partner country. Trade diversion reduces global welfare when goods that could be bought from the outside world at a low cost are instead purchased from a regional source at a higher cost.

The potential for trade diversion depends upon the size of the external trade barriers maintained by the member-nations. If a country has moderate tariffs and other trade barriers, then relatively few importers will find an incentive to shift their imports from outside countries to member-countries once preferential access is granted. However, if a country has high tariffs and other trade barriers, then the preference given to member-countries will provide a substantial incentive for importers to look within the RTA rather than to the outside world. For this reason, WTO is showing more tolerance for RTAs formed among countries with liberal trade policies than those formed among countries with restrictive trade regimes.

There are some differences in the potential for trade diversion under the two main forms of RTAs. In a custom union, the members maintain common external tariffs as such the potential for trade diversion depend on the size of the tariffs. On the other hand, in a free-trade area, trade diversion arises especially from the administration of rules of origin. Each country maintains its own external tariff. If these barriers vary among the member-countries, there is always the incentive to import a good through the country with the lowest barriers.

In order to minimise the possibility of trade diversion due to the rules of origin, the WTO is encouraging partner countries to harmonise their external tariff levels and other trade barriers. Once the levels of protection are the same for countries in a free trade area, the rules of origin become superfluous. Until that is done, parties to an FTA should not use rules of origin to protect regional intermediate goods producers. Liberalisation of private investment flow is a necessary complement of trade liberalisation. Since 1975, foreign direct investment has increased twelve fold while the value of merchandise trade has multiplied nine times. Negotiators for Bangladesh must address the growing complementarity between trade and investment decisions in today's world. Recent trade agreements such as ASEAN, NAFTA, and Mercosur have recognised this.

An RTA leads to investment creation if individuals and firms in a member-country decide to invest in their partner country when they otherwise would have invested at home, or not at all. Investment diversion occurs if investment is a member-country displaces investment in the rest of the world. This can happen when a member country maintains restrictive barriers to investment from non-member countries while granting preferential treatment to investment from partners in the RTA.

Recent economic analysis have shown that RTAs may impact the extent and speed of unilateral trade liberalisation by members of the WTO. If, for example, members of an RTA become more willing to conduct unilateral trade reforms or grant concession in the context of a multilateral negotiations, then RTAs can be seen as contributing toward a more liberal trading system.

On the other hand, if countries that join an RTA develop a 'fortress mentality', they may see a strengthened regional market as an excuse for erecting barriers to external competition. This would be a further cause for global concern.

Thus the regional trading agreements have both trade-creating as well as trade-diverting effects. From a static perspective, RTAs are more likely to increase world efficiency if their primary effect is to create new investment and trade rather than to divert existing investment and trade. The probability of this happening depend upon existing trading pattern among the RTA members and the way in which the agreement is structured. The WTO whose major objective is to encourage trade cooperation and eliminate the negative effects on non-members of RTAs- have a keen interest in making sure that RTAs are structured so as to minimise their potential for trade and investment diversion. Given that multilateralism is a slow and inefficient way of getting to multilateral free trade, RTAs offer a faster and more predictable way of getting there.

Courtesy: Daily Star News, Internet Edition from Bangladesh, 10 June 2001.