REGIONAL INTEGRATION AGREEMENTS AND THEIR IMPACTS ON THIRD COUNTRIES

Bölgesel Entegrasyon Anlaşmaları ve Üçüncü Ülkelere Etkileri

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ÖZET

Araştırmanın temelleri: *Savaş sonrası dönem, ülkeler arasındaki ticaretin derinleşmesi ve genişletilmesine yönelik ticaretin serbestleştirilmesi ve bölgesel entegrasyon anlaşmalarının hayata geçirildiği bir dönem olma özelliğine sahiptir. Bu kapsamda, bölgesel entegrasyon anlaşmaları ile ilgili güncel tartışmalar bu anlaşmaların birliğe üye olmayan ülkelere etkileri üzerinde yoğunlaşmıştır.*

Araştırmanın amacı: *Bu çalışmanın amacı, bölgesel entegrasyon anlaşmalarını ve bunların üçüncü ülkeler üzerindeki etkilerini incelemektir. Bu kapsamda bölgesel entegrasyonun ticaret yaratıcı ve ticaret saptırıcı etkileri ele alınmaktadır.*

Veri kaynakları: *Çalışma, bölgesel entegrasyon anlaşmalarının üçüncü ülkelere etkilerini teorik açıdan ele alan bir değerlendirme çalışmasıdır. Çalışmanın veri kaynakları, bölgesel entegrasyon anlaşmalarının etkilerinin araştıran çalışmalardır.*

Ana tartışma ve sonuçlar: *Çalışma bölgesel entegrasyon anlaşmalarının fayda ve maliyetlerinin anlaşmaya üye ülkeler ile üye olmayan ülkeler üzerindeki etkilerini analiz etmeyi amaçlamaktadır. Çalışma, bölgeselleşme ile üye ülkeler arasında ticaretin önündeki engellerin azaltılmasının yanında üçüncü ülkelerle ticarette ticaretin saptırıcı etkilerinin çıkmasına neden olduğu sonucuna varmıştır.*

Anahtar kelimeler: Ekonomik entegrasyon, Bölgeselleşme, Bölgesel entegrasyon anlaşmaları

ABSTRACT

Bases of the research: *The postwar period has been characterized by the liberalization of trade and the formation of RIAs intended to deepen and widen the economic relations between member countries. In this context, most of the current debate on RIAs has focused on their impact on non-member countries.*

Purpose of the research: *The purpose of this article is to discuss the aspects of RIAs and their implications on non-member countries. In this context, this study raises the question of the effects of trade creation and trade diversion.*

Data Sources: *The study discusses the impacts of regional integration agreements on third countries from a theoretical approach. The data resources of the study are the research studies conducted on the role impact of regional integration agreements.*

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Main argument and the results: *This paper tries to find out how are the benefits and costs of RIAs are divided between member and non-member countries. The study concludes that regionalism not only reduce the barriers to trade among its member economies but also it result in at least some diversion of trade with non-member countries.*

Keywords: Economic Integration, Regionalism, Regional Integration Agreements

1. INTRODUCTION

There has been an explosion of regional integration agreements (RIAs) in the last decades. Almost every country in the world is a member of one or more RIAs and more then half of world trade occurs within these trading blocs. RIAs are the process of providing common rules, regulations and policies for a specific region. Recently, both theoretical and quantitative work on RIAs has been inspired by the resurgence of regionalism and the continued progress in the international trading system. Moreover, the literature on RIAs is growing as economists and policymakers analyze the question of whether RIAs have benefits or costs for the non-member countries.

Debates on the membership in an RIA are mostly political. There are three main issues that deal with the RIAs (World Bank, 2000:6). The first issue is security. The building up of an RIA is regarded as a basis for increasing security against nonmembers and an RIA may also enhance a member state's security in its relations with other member states. Thus, regions that are economically integrated may tend to have less internal conflict among the participating countries. Indeed, security has been an important argument in the foundation of the European Union (EU) and it also played an important role in initiating regional integration process in Latin America (to reduce tensions between Argentine and Brazil) and Southeast Asia (to reduce tensions between Indonesia and Malaysia). The second issue is bargaining power that RIAs may enter negotiations more effectively than an individual country might be able to. There is evidence that one motivation for the formation of the original EU was the desire to increase bargaining power relative to the US. The third issue is about the effects of the RIAs on domestic politics. An RIA may provide a commitment mechanism for economy, trade and other policy reform measures. An RIA membership has implications for almost all parts of the economy. The economic effects that are most apparent are economies of scale and larger markets. Competition and scale effects arise as individual national markets become more integrated in a larger market. The larger market permits economies of scale to be achieved and increase competition among producers in member countries. Besides, trade and location effects arise when the RIA changes trade patterns and production location. The direction of trade changes as imports from partner countries become cheaper, encouraging consumers to substitute these for local production and for imports from the rest of the world which is also known as trade creation and trade diversion effects. These effects create real income changes for consumers and producers, as well as changing government tariff revenues. In addition to this economic perspective carried out by the RIA membership, regional integration efforts can also help domestically for the governments to implement their political agenda. It may reinforce democracy in the member states due to increased security or bargaining power.

Integration process first took off in the end of 1950s with the establishment of the EU and regionalism has developed a remarkable new impetus in the 1980s outside Europe. It is considered that, regionalism is best established in Western Europe than in any other regions in the world. Indeed, the largest and most successful regional integration to date has been the EU. The EU is unique in having achieved that degree of integration as a Single Market and established a complex network of preferential arrangements with other trade partners. Since its establishment in 1958, the EU has transformed from a mere customs union (1968) into a complete internal market (1992) and than to a monetary union (2002) with the circulation of the single currency Euro.

Recently, three large regional trading blocs appear to be emerging: the EU, Asia Pacific, and North America. Some RIAs are just between high income countries (EU and European Economic Area-EEA) some only middle income countries (Association of Southeast Asian Nations-ASEAN and Southern Common Market-Mercosur) and some only low income countries.

This paper reviews the theory of economic integration and identifies the actual impacts of RIAs on trade and welfare of member countries and non-member countries (the rest of the world). In particular, the impact of RIAs on trade policy towards non-members will be analyzed by considering two primary types of RIAs: customs unions (CU) and free trade areas (FTA) respectively. This paper has three substantive parts. The first part of the paper reviews the theory of regional integration arrangements. Next, debate on whether regionalism is compatible with multilateral negotiations will be examined with the question of whether RIAs set up forces that encourage or discourage evolution toward globally freer trade. The third part of the paper considers the consequences of RIAs for the economic welfare of the integrating partners and non-members.

2. REGIONAL ECONOMIC INTEGRATION: CONCEPTUAL FRAMEWORK

The expression *international economic integration*, often termed as *regionalism*, may be defined as the institutional combination of separate national economies into larger economic blocs or communities and it is basically concerned with the promotion of efficiency in resource use on a regional basis* (Robson, 1998:1-2). It re-

* For more details, see El Agraa (2001), Molle (1997), McDonald and Dearden (1999) and Heatley (1995).

fers both to market integration and economic policy integration (Pelkmans, 2001:6). The fundamental significance of economic integration is the increase of actual and potential competition, and the benefits flowing from this (Pelkmans, 2001:13). In the context of RIAs, countries in the same geographic region offer each other more favorable treatment on trade issues than to non-member countries. The depth of such preferential treatment varies from one RIA to another.

The pattern and pace of international economic integration have been influenced by three important factors (Mussa, 2000); First, improvements in the technology of transportation and communication have reduced the costs of transporting goods, services, and factors of production. New technologies and more liberal trading regimes have led to increased trade volumes, increased production and larger investment flows. Second, the preferences of individuals and societies have generally, but not universally, favored taking advantage of the opportunities provided by declining costs of transportation and communication through increasing economic integration. Third, public policies have significantly influenced the character and pace of economic integration, although not always in the direction of increasing economic integration.

Economic integration is concerned with any process by which hitherto separate economies are combined into a single, larger region. The complexity of international economic integration has led the economists to distinguish different forms of economic integration which dates back to Balassa (1961). Economic integration may take different forms such as; free trade areas, customs unions, common markets and economic and monetary unions. *Free trade areas* may be regarded as the weakest form of economic integration. In free trade areas, all impediments to trade such as import tariffs and quantitative restrictions are eliminated among parties and each member country can implement its own customs tariff with respect to third countries. The European Free Trade Association (EFTA), the Canada-US Free Trade Agreement (CUFTA) and North American Free Trade Area (NAFTA) are leading examples of free trade areas. *Customs union* is a second form of economic integration which involves all the provisions of a free trade area but also a common external tariff (CET) is implemented in member countries trade relations with the rest of the world. This additional dimension avoids the problem of 'trade deflection', which occurs when goods from outside world are 'deflected' to whichever country in a free trade area imposes the lowest tariff on imports, before being reshipped (tariff-free) to their ultimate destination elsewhere in the same free trade area (Healey, 1995:6). Thus, customs unions appear to be more conducive to higher degrees of economic integration among member countries. Central American Common Market (CACM) and the Caribbean Community and Common Market (CARICOM) are the examples of customs unions. One step up from a customs union is a common market which is composed of an internal market. *Common market* is an agreement signed between two or more countries that allow the free movement of capital, labor, goods and services across the borders of the member countries. A common market also requires the harmonization or coordination of economic policies in areas such as industrial policy, competition policy or taxation. The strongest and the most developed form of integration is *economic and monetary union*. *Economic union* contains making economic policy centrally, rather than harmonizing policy areas as in common market. In a *monetary union* a high degree of coordination or unification of monetary and fiscal policies are required as well as the adoption of a single currency and the establishment of a supranational central bank.

The theory of economic integration therefore has a very broad scope and RIAs have different content, form and objectives one from another. Some of the RIAs are simple in structure while others are more complex, and these distinctions go beyond differences between customs union and free trade areas. Besides these complexities, the RIAs have different time frames for implementation and different good coverage. Today, most of the RIAs reflect complex structures that may cover services, investment, intellectual property rights, cooperation in competition policy, technical barriers to trade, dispute settlement, supranational institutional arrangements and so on.

3. THE REGIONALISM VERSUS MULTILATERALISM DEBATE

The international trading system has witnessed a dramatic race between the forces of regionalism and the forces of multilateralism in the late twentieth century[*]. Moreover, the so-called "Regionalism versus Multilateralism" debate has become a much discussed topic among trade economists. *Regionalism* is defined as institutional arrangements designed to liberalize or facilitate trade and to coordinate foreign economic policies between countries on a regional basis, through free trade areas or customs unions. *Multilateralism*, on the other hand, can be defined as a characteristic of the world economic system. Regionalism vs. multilateralism debate focuses on the immediate consequences of regionalism for the economic welfare of the integrating partners to the question of whether it sets up forces which encourage or discourage evolution towards globally freer trade (Winters, 1996:4).

Regional integration is a higher degree of liberalization but among a limited number of countries. It offers many countries guaranteed access to larger markets and it is viewed as a solution to the recent major international economic problems. Especially the slow pace of multilateral trade negotiations has given a greater impetus to regional trade negotiations. Indeed, some economists argue that, RIAs can bring faster results than the multilateral process. However, RIAs can have negative effects as well by diverting trade away from lower cost producers outside the bloc.

RIAs also can undermine the multilateral system because of their inherently discriminatory nature. On the other hand, multilateral agreements are regarded as the preferred instrument for liberalizing international trade. These agreements ensure a non-discriminatory approach which provides political and economic benefits for

* For a review of the recent literature on "Regionalism vs. Multilateralism" debate see also, Bhagwati (1992), Winters (1996) and Krueger (1995).

the whole world. There are three components of that serve as the cornerstones of the GATT/WTO system: the principle of reciprocity, the principle of non-discrimination and the enforcement mechanisms. RIAs interact with the multilateral system in the light of these principles. The principle of non-discrimination and the drive for multilateral trade liberalization are the two most important elements of the GATT/ WTO. Free trade areas and customs unions are inconsistent with the principle of non-discrimination and they may be inconsistent with the drive for multilateral liberalization. RIAs are, by definition, discriminatory that trade concessions may be only granted to member countries whose preferential access to other members' markets may enable them to displace exporters from non-members' markets.

The last two decades have seen a rapid proliferation of RIAs and many RIAs have been negotiated among countries, which may range from free trade areas to customs unions. Regionalism has emerged as a major trade policy issue in many countries across the world and RIAs became an increasingly important element of the international trade relations. Thus, there is an increasing concern about regionalism and RIAs, as the number and complexity of such agreements is expanding rapidly.

In 2009, 37 new notifications on RIAs -which include bilateral and inter-regional FTAs- were received by the WTO. This is the largest number of RTA notifications in any single year since the WTO's establishment in 1995 (WTO, 2010:56). The recent number of RIAs notified to GATT/WTO and in force as of the end of 2010.

In a similar manner, the major regional trade blocs and their share of world exports. Indeed, most countries are members of a regional trade bloc, and more than a third of world trade takes place within such arrangements (World Bank, 2010:377). Among the RIAs the EU's and NAFTA's dominant size in this respect is clear. Although the APEC has no preferential agreements, it is included because of the volume of trade between its members.

On the other hand, the sum of exports by members of a trade bloc to other members of the bloc as of 2008. In case of bloc exports, it is necessary to indicate that several blocs came into existence and membership may have changed over time. Moreover, some countries may belong to more than one RIA. The EU is the highest trade block that exports to the other members of the EU, which accounts about 67%. The next block that has the highest share in terms of exporting within the block itself is APEC, which is about 62%.

The slow pace of multilateral negotiations has given a greater impetus to bilateral and regional trade negotiations. As a consequence, slow progress of the GATT negotiations has led the world divide into three trading-blocks, which are Europe, the Americas and East Asia. As Winters (1999) stated in his article "Regionalism vs. Multilateralism", the EU is regarded as the only RIA that is both big enough to affect the multilateral system and long-enough lived to have currently observable consequences. From an international perspective, these developments are of vital importance for the rest of the world. By the way, the proliferation of non-tariff barriers in the world trade had made regional integration as an attractive policy option. On the other hand, building up an integration in a region led the other regions to contemplate a defensive block of their own.

There are some important questions that deal with the regionalism versus multilateralism debate such as; What are the effects of regionalism on the international trading system? Is regionalism a crucial stepping stone to the establishment of an even more integrated world trading system? Are RIAs building blocks or stumbling blocks towards a more effective multilateral trading system as in Bhagwati's (1991) memorable phrase? Or are RIAs going to lead to a more open multilateral trading system? Can RIAs foster free trade? Are RIAs successful in promoting more rapid economic growth for members, and what are the consequences for third parties? Is it possible to structure RIAs in a way to create gains for the member countries without harming any non-member countries? Answers to these questions are of crucial importance for the future of international trading system.

In the light of these main questions, the interaction between regionalism and multilateralism is based on a number of arguments. First, it is argued that RIAs represent a way of strengthening the latter by moving at a faster pace than WTO rules. Second, RIAs may be more effective in dealing with new areas like services, investment, intellectual property rights, technical standards and public procurement compared to multilateral system. Third, despite the trade diverting effects, the empirical evidence suggests that trade creating effects dominate in major RIAs thus enhancing global welfare and prosperity. The biggest area of disagreement between supporters and opponents of regionalism in the 1990s is over the best means to the agreed end of international trade liberalization. If RIAs are easier to negotiate, then they can permit experimentation and eventual extension of codes on trade-related measures such as investment, intellectual property rights, trade and the environment and so forth. In this view, they are building blocks to a better world trading system. If RIAs evolve into exclusive blocs which disrupt multilateral trading patterns, then they are stumbling blocks in the way of creating a better world trading system (Pomfret, 1997:9). Bhagwati and Panagariya, who are generally in favor of multilateralism (who generally oppose RIAs) has raised the question as to whether RIAs pose a threat to the multilateral trading system and expressed concerns about the negative effects of growing regionalism. They also worry that RIAs divert attention from the multilateral trading system. Thus, the main problem of the RIAs for the GATT/WTO is whether regional integration facilitates or undermines multilateral trade liberalization. In this context, the main arguments about the debate on regionalism and multilateralism.

The formation of an RIA raises trade barriers against non-member countries. This development could seriously undermine the achievements of the GATT/WTO by diverting the attention from multilateral to regional negotiations. An open multilateral trading system is especially important for developing countries that are undertaking structural reforms including the liberalization of their trade regimes. On the other hand, RIAs may have important elements of economic and also political cooperation that covers the issues which are not negatioated during the GATT/WTO rounds. Therefore, RIAs should not undermine the importance of global liberalization and the ultimate purpose of achieving a liberalized world trading arena.

4. THE EFFECTS OF RIAs ON THIRD COUNTRIES

Debate on regional integration arrangements have began with contributions to the "Customs Union Theory" by J. Viner. In his classical study "*The Customs Union Issue*" (1950), Viner seeks to understand the welfare implications of integration in terms of trade creation, trade diversion and terms of trade. Thus, customs union theory clearly identified the distinction between the trade creating and trade diverting effects of a customs union agreement. The main presumption of the customs union theory is that trade creation is welfare improving, while trade diversion is welfare reducing.

According to Vinerian argument, trade creation occurs when some domestic production in a country that is a member of the customs union is replaced by lower-cost imports from another member country. Thus, a trade creating customs union also increases the welfare of non-members because some of the increase in its real income spills over into increased imports from the rest of the world. However, creating a customs union could also have a trade diversion effect. Trade diversion occurs when lower-cost imports from outside the customs union are replaced by higher cost imports from a member country. Trade diversion reduces welfare because it shifts production from more efficient producers outside the customs union to less efficient producers inside the union. If barriers on imports from non-member countries are kept down, then trade diversion is less likely. In contrast with a customs union, free trade areas do not commit members to a common external tariff and thus allows them to minimize the effects of trade diversion.

Trade creation, trade diversion, and terms of trade effects constitute the welfare impacts of an RIA. The fundamental significance of regional economic integration is the rise of efficiency and economic welfare in the member countries caused by the increase of actual or potential competition that producers face. RIAs generally aim to improve the welfare of members by reduction and elimination of restrictions impeding closer integration of among its members. However, what matters from an international perspective is the RIAs impact on non-member countries, where the focus is put on the trade diversion (McMillan, 1993:6).

The effects of RIAs on member and non-member countries have been analyzed in several papers. According to de Melo and Panagariya (1992) the relative size of trade creating and trade diverting effects depends on three key factors. First, the larger the pre-free trade area tariff, the more likely that trade creating effects will dominate. The reason is that a high initial tariff implies that the sources of supply are concentrated in the home country. If the initial tariff is prohibitive, all supplies come from domestic sources. Thus, a free trade area allows specialization within the RIA and leads to a replacement of high-cost domestic production by low-cost imports from the partner country. Second, the greater the demand for each country's goods by the partner country, the greater the scope for specialization and hence the greater the potential for trade creation. Third, the lower the external tariffs after the formation of an FTA, the less the trade diversion, because lower external tariffs offer less scope for the displacement of imports from countries outside the union.

Most of the empirical studies find that existing RIAs have positive impacts on member countries' welfare and living standards and inconsequential impacts on non-member countries' welfare and living standards. On the other hand, there have certainly been concerns about the negative effects of RIAs on trade. According to Balassa (1961), a regional integration project has external effects on non-members, through diversion of trade, investment, aids and funds. RIAs are likely to improve investment opportunities in various ways within the region. However, if the RIAs external barriers are high, foreign direct investment that would have gone to non-members may flow to the members of the RIA after its formation. In his study, Jaumotte (2004) found evidence of a negative partial correlation between the foreign direct investment received by RIA countries and that received by non-members, possibly reflecting diversion effects. According to Laird (1999) non-members, as well as countries whose free trade areas have relatively extensive product coverage, are among those which normally argues in favor of relatively stringent interpretation of the coverage requirement of Article XXIV regarding 'substantially all the trade'. Laird also indicated that lesser product coverage would imply lesser trade diversion against non-member countries. Yeats (1997) found the evidence of trade diversion in Mercosur and member countries' exports to partners increased most strongly in products where extra-bloc exports were weak and protection was relatively high. Since member country exports compete with the same non-member suppliers inside the bloc as outside it, he pointed out that the greater success of some of the exports within the bloc was attributable to trade preferences. As a consequence, he inferred that Mercosur trade barriers are diverting trade from cheaper goods made outside the bloc to more expensive domestic goods.

There are broadly four options available to non-member countries in response to an RIA (Adriamananjara, 2004:2); *i)* to apply for a membership to or at least association with the existing trading bloc, *ii)* to participate vigorously in multilateral trade negotiations, *iii)* to form their own group as a counterbalance, *iv)* to adjust their trade policies in order to minimize the negative effects of the RIA. The fear of trade diversion can induce non-members to seek entry. It is always possible to add a country to an existing integration agreement in such a way as to improve the welfare of the members of the expanded integration agreement without causing harm to those who remain outside (McMillan, 1993:5-6). Thus, non-members will have an incentive to join an RIA to improve their economic performance. The costs of being a non-member increase as other non-members join the RIA.

Non-members can become insiders either by joining an already existing economic integration or by creating their own regional group. If the RIA has no interest in accepting new members and if accepting new members will not bring any economic or political advantages, then they may form their own regional group. On the other hand, members would accept new members only if the expansion would increase their welfare. Exporters in a member country would also support the entry of new members to take advantages of the larger markets. On the other hand, importers in a member country would be against the entry of new members because of increased competition in their domestic markets*.

Non-member countries may reap some gains to the extent that the discrimination inherent in the regional group is low and progressively decreased by liberalization. Trade diversion may be minimized if regional partners are important trading partners with each other prior to formation of the RIA. Through efficiency and economies of scale gains induced by increased competition, a RIA may be able to export at a lower cost. This would imply a favorable move in the terms of trade for non-member countries and would offset deterioration in terms of trade that non-members may experience as a result of trade diversion. Some significant gains may also stem from the spillover effects of increased demand for non-members imports by the RIA and the reduced cost of access to a wider market that is no longer restricted by external barriers, regulations, and technical standards.

5. CONCLUSION

Regionalism is not a new phenomenon and regional integration has been a crucial feature of global trade agenda in the post-war period. Recently, there is still a great potential for increases in the number of RIAs in Europe, the Americas, Africa, Asia-Pacific and the Middle East. Since RIAs became an increasingly important feature of the international trading system and new RIAs are being formed, they should be structured to minimize potential negative effects on world welfare and maximize potential positive effects to both member and non-member countries. It is possible that some member countries will not benefit from an RIA.

Regional economic integration expands markets and promotes competition by eliminating trade barriers among the partner countries. Most of the RIAs that are currently in force have both trade creating and trade diverting effects. Both producers and consumers in non-member countries are hampered by trade diversion effects. Firstly, production efficiency declines if non-member countries must now produce goods they previously imported at lower cost from RIA countries. Besides, consumption efficiency declines since a non-member country must now pay for higher cost domestic product.

One of the primary concerns of non-member countries on RIAs is the terms of trade effects. But their actual implementation remains limited. And most of the

* The other reasons for a non-member country to seek membership in an RIA are also indicated in Fernandez (1998) and Whalley (1996).

WTO members have notified their participation at least in one or two RIA. Although international economic integration is not a new phenomenon, the number of RIAs -through trade, factor movements, and communication of economically useful knowledge and technology- has grown substantially in the world trading system over the last decade.

Although some economists argue that RIAs may impulse or restrain multilateral trade liberalization, most of the economists concerned with any process by which hitherto separate economies are combined into a single, larger region. Such a process may involve negative measures of integration which may involve the removal of obstacles to economic exchanges between countries or positive measures which require the establishment or modification of new institutions and the appropriation of resources in order to achieve specified ends. Thus, the compatibility of RIAs and the GATT/WTO is crucial. However RIAs that push forward the liberalization process are stepping stones or stumbling blocks to multilateralism remains an open question.

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