

CRS Report for Congress

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Regional Trade Agreements: Implications for U.S. Trade Policy

Updated December 12, 1997

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Summary

Since the 1980s, the United States and other major trading countries have begun to complement their efforts to liberalize trade at the multilateral level with regional trade agreements. Today almost all major economies belong to one or more regional arrangements.

The negotiation of regional trading arrangements is a relatively recent phenomenon in U.S. trade policy. Through much of the post-World War II era, U.S. policymakers emphasized the importance of multilateral trade liberalization, carried out primarily through the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO). During the 1970s and 1980s, however, many policymakers became impatient with the slow pace of multilateral trade liberalization and the apparent inability of the multilateral system to address new trade issues. The United States concluded free trade agreements with Israel and Canada in the 1980s, the North American Free Trade Agreement (NAFTA) in 1993. The Clinton Administration is pursuing additional regional arrangements in Asia and the Western Hemisphere.

The effects of reducing trade barriers at the regional level are quite different than multilateral liberalization. The GATT/WTO multilateral system is based on the principle of most-favored-nation treatment — extending reductions in trade barriers to all trading partners on a nondiscriminatory basis. In contrast, regional liberalization introduces elements of freer trade among the members of the arrangement while maintaining some level of protection against nonmembers. Some economists and trade policymakers argue that the growth of regionalism in world trade is contributing to a more open trading system by reducing trade barriers within regional blocs and fostering deeper forms of economic integration. Others are concerned that the new emphasis on regionalism may undermine the multilateral system and lead to the development of antagonistic and protectionist trade blocs.

The 105th Congress is considering important legislation that would influence U.S. policy toward future regional free trade agreements or modify existing agreements. One set of bills would extend “fast-track” authority for congressional approval of future trade agreements, including regional free trade agreements. (Fast-track authority provides that Congress will consider trade agreements within mandatory deadlines, with limited debate, and without amendment.) Several bills would require renegotiation of, or withdrawal from, NAFTA. Other proposals would authorize tariff and quota treatment for Caribbean countries that is equivalent to treatment of imports from Mexico under NAFTA. Some observers have proposed free trade areas with other regions, such as Europe or Sub-Saharan Africa.

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Regional Trade Agreements: Implications for U.S. Trade Policy

Regional trade agreements are expanding rapidly around the world. Almost all major trading countries either participate in, or are currently negotiating, such agreements, and they have become a major focus of U.S. trade policy. The Clinton Administration has begun preliminary negotiations to extend the North American Free Trade Agreement (NAFTA) to other Western Hemisphere countries, and has actively promoted the Free Trade Area of the Americas (FTAA) and the Asia Pacific Economic Cooperation forum (APEC) to eliminate barriers to trade on a regional basis.¹

The 105th Congress is considering important legislation that would influence U.S. policy toward future regional free trade agreements or modify existing agreements. One set of bills would extend “fast-track” authority for congressional approval of future trade agreements, including regional free trade agreements. (Fast-track authority provides that Congress will consider trade agreements within mandatory deadlines, with limited debate, and without amendment.) Several bills would require renegotiation of, or withdrawal from, NAFTA. Other proposals would authorize tariff and quota treatment for Caribbean countries that is equivalent to treatment of imports from Mexico under NAFTA. Some observers have proposed free trade areas with other regions, such as Europe or Sub-Saharan Africa.

The emphasis on regional agreements is a departure from the principle of nondiscrimination, which has been a centerpiece of U.S. trade policy and the multilateral trade system administered under the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO).² Although the GATT/WTO allows exceptions to the principle, the rapid proliferation of regional trade agreements has raised important policy questions in the United States and elsewhere. What are their effects on the domestic economies of member and nonmember countries? Are they an effective means of trade liberalization? And, how do they affect the multilateral trading system? This report examines the growth of

¹ The FTAA, a plan to create a free trade area for North and South America by 2005, was adopted by the United States and 33 other countries in December 1994. APEC is a group of 18 governments in the Asia Pacific region, including the United States, that agreed in November 1994 to eliminate barriers to trade in the region by 2010 or 2020, depending on each country’s level of development.

² The GATT is a multilateral agreement that was signed in 1947 and administered by a secretariat in Geneva that was replaced by the WTO in 1995. The WTO has 131 member countries that account for over 90% of world trade. The GATT is a complex set of rules and procedures that encourages liberalization of trade through successive rounds of negotiations.

regional trading arrangements, their economic effects, and their implications for U.S. trade policy.

Trends in Regional Integration

Regional integration arrangements are among several types of preferential trade arrangements that have been approved as exceptions to the multilateral rules developed in the GATT/WTO. They are formed when countries agree to integrate their economies by removing or eliminating barriers to economic transactions among the members of the group. While free trade agreements have been the most popular form of regional integration, governments have negotiated other types of regional agreements.

Types of Regional Integration Arrangements

There are four basic types of regional integration agreements, each representing a different stage of integration.

- The most common form of regional integration is a **free trade area**, in which members of the group remove tariffs and some nontariff barriers to trade among member countries. At the same time, each member retains its independent trade policy, including its tariffs, toward nonmember countries.
- A second level of economic integration is a **customs union**, in which a free trade area is established among members of the group, while the group adopts a common external tariff.
- A third level of integration is a **common market**, in which a customs union is established and supplemented by removal of barriers to capital and labor movements among members.
- The deepest form of economic integration is an **economic union**, in which members go beyond adoption of a common market to unify economic institutions, coordinate economic policies, and adopt a common currency.

Each form of economic integration has different implications for international trade. Since members of a free trade area retain separate trade policies toward nonmembers, for example, each will have different levels of tariff and nontariff protection. Such differences provide an incentive for exporters in nonmember countries to ship their products to low-tariff members and then transship them to high-tariff members. To avoid such transshipments and to maintain the integrity of their independent trade policies, member countries must maintain strong customs controls at borders inside the free trade area. In a customs union, on the other hand, the common external tariff obviates the need to protect against transshipment.

A common market, by removing controls on capital and labor movements, further facilitates trade and other economic transactions among member countries. Citizens in one country who want to invest in, or take a job in, another country, for

example, are free to do so. Free movement of capital and labor provides an additional stimulus to trade in goods and services. Creation of an economic union further facilitates trade. As countries move toward economic union, their trade tends to resemble domestic trade, facing less regulation and fewer institutional barriers than is common in international trade.

The two largest regional groupings, NAFTA and the European Union (EU), provide examples of each stage of integration. NAFTA is a free-trade agreement between Canada, the United States and Mexico, which went into effect in 1994. Like other free-trade agreements, its central purpose is to eliminate all tariffs, most of which will be phased out over 10 years, and many nontariff barriers. In terms of regional integration, NAFTA goes beyond many other free trade agreements by liberalizing restrictions on investment and trade in services, providing rules to protect intellectual property rights, and establishing a special system for resolution of trade disputes.

The EU has established a customs union and a common market and is moving toward deeper integration. Between 1957 and 1968, all tariffs and quotas were eliminated in trade among member states and a common external tariff was established. The EU has also made major strides toward establishing a single market, gradually removing barriers to movement of labor and capital among its members. With few exceptions, citizens of one member country can freely travel, live, and work in any other member country. Producers can sell their goods and services across borders with few restrictions, and investors can invest in any member country. To avoid nontariff barriers to trade, the EU promotes harmonization of laws, regulations, and standards among member countries.

The ultimate goals of NAFTA and the EU are quite different. Whereas, NAFTA aims to reduce barriers to trade among members, the goal of the EU, elaborated in the 1991 Treaty on European Union, is to develop into a political and economic union. The EU has taken significant steps toward that goal. In addition to developing a single market, it promotes cooperation on political and security issues among member countries and is moving toward monetary union.

The WTO and Regional Integration

One of the key principles underlying the GATT/WTO multilateral system is most-favored-nation (MFN) or nondiscriminatory treatment. In practice, the MFN principle means that members of the WTO agree to extend any concessions that they make on tariffs and other trade barriers to all other members. Since regional integration arrangements provide for preferential treatment of their members, they would appear to violate the principle of nondiscrimination.

The GATT/WTO allows exceptions to the MFN principle, however, for the creation of free-trade areas and customs unions.³ Article I includes a grandfather

³ The GATT/WTO allows other types of preferential trading arrangements as exceptions to the MFN principle. The most common are agreements by the industrial countries to give
(continued...)

clause for agreements that were in effect at the time the GATT was adopted, and Article XXIV stipulates conditions under which GATT members may form new preferential trade agreements. Such agreements are considered compatible with the GATT if the signatories meet three conditions: they must eliminate trade barriers on substantially all trade among members; they must impose no trade barriers on nonmembers that are higher or more restrictive than those previously in effect; and they must employ interim arrangements leading to the free trade area for only a reasonable period of time. These conditions were intended to minimize the distortions of trade patterns that often result from preferential trading arrangements.⁴

In practice, Article XXIV's ambiguous wording has provided relatively little discipline: the GATT/WTO has never formally disapproved a free trade agreement or customs union. In most cases members have been unable to reach unanimous decisions about whether proposed preferential agreements are compatible with GATT/WTO rules. The Uruguay Round of multilateral trade negotiations, concluded in 1994, resulted in modest changes to strengthen Article XXIV: it clarified the conditions under which preferential agreements can be formed, strengthened GATT's review of new preferential arrangements, and provided for periodic reviews of existing arrangements.

The Proliferation of Regional Agreements

Despite the changes introduced in the Uruguay Round, WTO members continue to enjoy broad leeway to sign regional agreements, and the share of world trade covered by such agreements has grown. Until the 1980s, there was only one effective regional grouping among the major trading countries — the European Union. The United States, while supporting European integration largely for political reasons, generally opposed regional trade agreements. A number of smaller arrangements that were formed in the 1960s and 1970s proved to be short-lived or ineffective in terms of their ability to foster regional integration. But since the 1980s, the United States and other major trading countries have begun to build regional groupings. In the 1990s regionalism has become a major force, with the creation of major new regional arrangements and the reinvigoration of earlier arrangements. Now, almost all members of the WTO belong to a regional trade agreement.

³(...continued)

special tariff treatment, on a non-reciprocal basis, to the developing countries. The generalized system of preferences (GSP), which provides low or zero tariffs to some imports from developing countries, and special preferential tariffs provided by the United States and the European Union to certain developing countries are prominent examples.

⁴ Under the so-called "Enabling Clause," adopted by GATT members in 1979, regional trade agreements that include only developing countries are exempt from the requirements of Article XXIV if such agreements facilitate trade, do not create "undue difficulties" for nonmembers, and do not impose new trade barriers.

Major Regional Arrangements. Member countries have notified the GATT/WTO of 144 free trade agreements and customs unions,⁵ over a third of them formed in the 1990s. A 1994 study by the International Monetary Fund surveyed regional arrangements that had been recently created or reactivated.⁶ It highlighted some of the major integration developments in Europe, Africa, the Western Hemisphere, the Asia-Pacific region, and the Middle East and South Asia in the early 1990s.

- *Europe.* The European Union not only deepened integration internally, but further developed its web of regional trade arrangements with third countries. In 1994, it formed the European Economic Area (EEA) with Austria, Finland, Sweden, Iceland, Liechtenstein, and Norway. (The first three became members of the EU in 1995.) The EU also entered into association agreements (which have the ultimate goal of membership) with several Central European countries, partnership agreements (which may lead to free trade areas) with several countries of the former Soviet Union, free trade agreements with the Baltic countries, and a customs union with Turkey, and further liberalized preferential trading arrangements with several Mediterranean countries. The Central European countries and Baltic countries have formed regional trading arrangements among themselves and negotiated free trade agreements with the European Free Trade Association (EFTA — a grouping of Norway, Iceland, Liechtenstein and Switzerland). Some of the countries of the former Soviet Union have also negotiated regional integration agreements.
- *Africa.* Two regional agreements, the Central African Customs and Economic Union (UDEAC) and the Cross-Border Initiative (CBI) are representative of a general increase in regional economic cooperation. UDEAC, a common market formed in 1966 by Cameroon, Central African Republic, Chad, the Congo, Equatorial Guinea, and Gabon, made significant steps toward regional integration with agreements to put in place a common external tariff, replace quantitative restrictions with tariffs, and phase out tariffs on trade among members. The CBI was formed in 1993, when 13 eastern and southern African countries agreed to liberalize trade and capital flows among themselves.
- *Western Hemisphere.* The inauguration of the North American Free Trade Agreement (NAFTA) in 1994 by the United States, Canada, and Mexico was particularly noteworthy because of its size and influence. Several South American countries have expressed an interest in becoming members of NAFTA. In 1991, Argentina, Brazil, Paraguay, and Uruguay formed MERCOSUR, the Southern Cone Common Market. Among other regional agreements, the Andean Pact, first formed in 1969 by Bolivia, Colombia, Ecuador, Peru, and Venezuela, and the Central American Common Market

⁵ U.S. International Trade Commission. "A Closer Look at MERCOSUR," International Economic Review, February-March 1997, p. 9.

⁶ Harmsen, Richard and Michael Leidy. "Regional Trading Arrangements," in Naheed Kirmani, International Trade Policies: The Uruguay Round and Beyond. Volume II. Background Papers, Washington, November 1994, pp. 170-250.

(CACM) formed in 1961 by Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua, were both revived in 1990. In 1994, 34 Western Hemisphere countries adopted a plan, promoted by the U.S. Government, to create the Free Trade Area of the Americas (FTAA) by the year 2005.

- *Asia-Pacific.* Recent developments include the establishment of the ASEAN Free Trade Agreement (AFTA) in 1992 by Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand, and an agreement in 1992 to form a South Asian Association for Regional Cooperation (SAARC) preferential trading arrangement. Eighteen Asian and Western Hemisphere governments in the Asia Pacific Economic Cooperation Forum (APEC) agreed in 1994 to a long-term plan to eliminate barriers to trade in the region.
- *Middle East and South Asia.* The Gulf Cooperation Council (GCC), a free trade area formed in 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates, liberalized movements of capital and labor and worked toward establishing a common external tariff in the early 1990s. In 1992, the Economic Cooperation Organization (ECO), formed in 1985 by Iran, Pakistan, and Turkey, added the seven former Central Asian Republics of the Soviet Union and instituted a limited system of tariff preferences among members.

Motivations for Forming Regional Integration Arrangements. Various factors explain the increased interest in regional arrangements. Dissatisfaction with multilateral trade negotiations has been one important motivation. While the GATT/WTO has been successful in reducing tariffs, many critics are dissatisfied with its ability to discipline nontariff barriers and to address new trade issues. They believe that multilateral negotiations have been too slow, and that some WTO members have benefitted from reduced barriers among their trading partners, without opening their own markets sufficiently. Proponents of regional trade agreements think that negotiations among a small number of like-minded governments can liberalize trade more quickly and more effectively.

There are other important economic motivations for regional integration arrangements. Most participants in recent arrangements have regarded regionalism as an alternative way to increase their gains from trade. In particular, regional free-trade agreements and customs unions are seen as a way to achieve economies of scale and to attract foreign investment. For developing countries such agreements are often seen as a means to protect infant industries on a regional basis. Policymakers in some countries have argued that, if industries could first develop by competing in a regional market, they would become more competitive in the global market. Other governments have been motivated by the perceived need to avoid protectionist policies by trading partners: regional agreements are seen as a means of ensuring that the markets of other member countries will not be closed in the future. Some governments of developing countries and countries in transition have seen regional agreements as a way of locking in market-oriented reforms. Regional trade agreements, they think, may prevent future governments from reversing the market reforms.

As the example of the European Union shows, regional integration can also be motivated by noneconomic objectives, such as promoting political stability, avoidance of war, and regional security. In addition, smaller governments have sometimes regarded participation in a regional bloc as a way to enhance their influence in negotiations with other governments.

Changes in U.S. Policy

The negotiation of preferential trading arrangements is a relatively recent phenomenon in U.S. trade policy. Through much of the post-World War II era, U.S. policymakers emphasized the importance of multilateral trade liberalization, carried out primarily through the GATT.

GATT was established in the early postwar period to avoid the kind of unilateral or bilateral discriminatory trade policies that led to a breakdown of the international trading system in the 1930s. It was founded on the belief that nondiscrimination and negotiated solutions to trade disputes should be fundamental principles of trade policy. Although many U.S. trade policymakers have expressed misgivings about GATT, Congress has continually provided the necessary authorization for GATT's tariff-cutting negotiations and the U.S. government has vigorously supported eight rounds of multilateral negotiations to reduce trade barriers.

During the 1970s and 1980s, however, many U.S. policymakers became impatient with the slow pace of multilateral trade liberalization. While GATT negotiations had resulted in major cuts in tariffs for many industrial goods, U.S. negotiators had more limited success in opening foreign markets for U.S. exporters of agricultural products, high-technology goods, and services. Although negotiators in the Uruguay Round made substantial progress in these areas, it required 8 years of negotiation, and many of the agreements are being phased in over 5-10 years. Moreover, many U.S. exporters were disappointed with the limited results of the Uruguay Round agreements in some of the new trade areas, such as services, intellectual property rights, and trade-related investment measures. U.S. critics also maintained that the GATT was too tolerant of free riders — that some members were benefitting from open U.S. markets, but not opening their markets to U.S. exporters.

Largely because of the perceived shortcomings of GATT, U.S. trade policymakers have shown increasing interest in bilateral and regional free trade agreements. Since 1974, Congress has continually authorized and encouraged the executive branch to explore special trading arrangements with individual trading partners as an alternative or complement to multilateral negotiations. The Trade Act of 1974, for example, directed the President to enter into bilateral trade agreements if he determined that such agreements would promote the economic interests of the United States. Another provision of the 1974 Act expressed the sense of Congress that the United States should enter into a trade agreement with Canada to establish a free trade area. The Trade Agreements Act of 1979 amended the provision to require the President to study the desirability of entering into trade agreements with other countries in the northern portion of the Western Hemisphere.

The Trade and Tariff Act of 1984 authorized the President to enter into a bilateral trade agreement with Israel to be implemented under fast-track procedures.

The U.S. and Israeli governments signed an agreement establishing a free trade area in April 1985, and the agreement was implemented later that year by the United States-Israel Free Trade Area Implementation Act of 1985. The 1984 Act also authorized fast-track approval procedures for free trade agreements negotiated with other countries. In response to a request from the Canadian government, the United States and Canada negotiated a bilateral free trade agreement, which was signed in January 1988 and implemented by the United States-Canada Free-Trade Agreement Implementation Act of 1988.

At the request of the Mexican government, negotiations to create the NAFTA began in June 1991. Leaders of the three countries signed the agreement in December 1992, and the United States implemented the agreement by enacting the North American Free Trade Agreement Implementation Act in 1993. In passing the NAFTA Implementation Act, Congress found that “Efforts by the United States to obtain greater market opening through multilateral negotiations have not produced agreements that fully satisfy the trade negotiating objectives of the United States.” Congress also directed the President to determine with which foreign countries the United States should seek to negotiate additional free trade agreements.⁷

The Clinton Administration is pursuing additional regional integration agreements. U.S. negotiators have begun preliminary negotiations to provide for Chile’s accession to NAFTA, and several other Latin American countries have expressed an interest in acceding to NAFTA in the future. The Administration has proposed a Free Trade Area for the Americas (FTAA), a plan to create a free trade area with 33 other countries in North and South America by 2005. Administration officials have formulated a comprehensive agenda for the FTAA negotiations to deal with a wide range of tariff and nontariff issues. The United States has also joined 17 other governments in the Asia Pacific region in the Asia Pacific Economic Cooperation (APEC) forum to eliminate barriers to trade in the region by 2010 or 2020, depending on each country’s level of development.

The Effects of Regional Trading Arrangements

Economists and policymakers have debated two general issues about the effects of regional trade agreements. How do they affect the economies of member and nonmember countries? And, how do they affect the multilateral trading system?

Economic Effects

There are important differences between the economic effects of reducing trade barriers on a multilateral, nondiscriminatory basis and reducing barriers on a regional or bilateral basis. The case for nondiscrimination in trade — the cornerstone of GATT/WTO — is based on the theory of comparative advantage. To the extent that multilateral trade liberalization is successful in removing trade barriers, all goods are produced at the location of lowest relative cost, and world efficiency and welfare are

⁷ P.L. 103-182, Sec. 108.

maximized. Discriminatory barriers to trade, on the other hand, can distort trade flows: relatively less efficient producers in some countries can be protected against foreign competition, and consumers may not reap the full gains of trade liberalization.

Thus, while economic theory suggests that a country usually gains from nondiscriminatory trade liberalization, it is ambiguous about preferential trade arrangements. Preferential trading arrangements introduce elements of freer trade among the members of the trading bloc, while maintaining some level of protection against nonmembers. Consequently, they do not always maximize efficiency and welfare gains.

Preferential trade arrangements generally lead to both trade creation and trade diversion.⁸ Trade creation occurs when the removal of trade barriers in a preferential arrangement increases the trade of a good and the more efficient production of that good. If, for example, removal of trade barriers under NAFTA leads Mexican purchasers to substitute relatively low-cost U.S. computers for high-cost domestic models, new trade is created. Trade creation leads to improved efficiency and welfare because production is shifted from relatively higher cost producers in one member country to lower cost producers in another.

Trade diversion occurs when the formation of a preferential trading arrangement causes a shift in production from a relatively efficient nonmember producer to a less efficient member country. If removal of tariffs under NAFTA induces U.S. importers to buy clothing from Mexico rather than from more efficient producers in Caribbean countries, for example, no new trade is created; it is merely diverted. Trade diversion, because it shifts production from lower cost producers in nonmember countries to higher cost producers in member countries, reduces the efficiency and welfare gains of trade liberalization. (See **Table 1** and **Table 2**)

Whether a particular free-trade agreement or customs union will lead to trade creation or trade diversion is an empirical question: the outcome depends on the specific provisions of the agreement and the nature of the economies involved. For example, if countries have extensive trade relations before a regional integration agreement, there is likely to be little diversion, because the agreement will probably simply reinforce patterns of trade that are based on comparative advantage or geographical proximity. Similarly, if a customs union adopts the least restrictive tariffs of the member countries, it is likely to lead to trade creation rather than diversion. If countries with high tariff barriers enter an agreement that maintains high external barriers, on the other hand, the agreement is likely to lead to more diversion.

⁸ Jacob Viner first developed the concepts of trade creation and trade diversion. While commonly called the theory of customs unions, Viner's analysis is relevant to all preferential trade agreements. Jacob Viner. *The Customs Union Issue*. New York, Carnegie Endowment for International Peace, 1950.

Trade Creation and Trade Diversion

The static effects of trade creation and trade diversion can be demonstrated with simple numerical examples. **Table 1** shows the cost of producing a good domestically in country A and the prices of the same good produced in countries B and C, if the good were imported to country A with a tariff of \$.50. Since the tariff would make the price of imports higher than the price of the domestically produced good, country A does not import, even though country B is a more efficient producer. If a customs union is formed between countries A and B, production will shift from the high-cost country A to the low-cost country B, and A will import the good from B. Since the price of the good produced in country C is not competitive with or without the tariff, it is not affected. Hence, there is only trade creation, and countries A and B can be expected to enjoy efficiency and welfare gains.

Table 1. Potential for Trade Creation

	Country A	Country B	Country C
Cost of production	\$2.00	\$1.75	\$2.50
Tariff	0	.50	.50
Price in Country A	2.00	2.25	3.00

Table 2 shows an example of potential trade diversion. The low-cost producers in country C export to country A even after paying the tariff. However, if countries A and B form a customs union, and country A removes the tariff on imports from country B, trade will be diverted from the more efficient country C to the less efficient country B. Such a customs union would result in trade diversion and the three countries would suffer efficiency losses.

Table 2. Potential for Trade Diversion

	Country A	Country B	Country C
Cost of Production	\$2.00	\$1.75	\$1.35
Tariff	0	.50	.50
Price in Country A	2.00	2.25	1.85

In evaluating the effects of regional integration, it is important to consider dynamic effects as well as the static effects of trade creation and diversion. By creating a large regional market, for example, a free-trade area or customs union may allow economies of scale that did not exist before. Removal of trade barriers may introduce competitive pressures and promote the transfer of knowledge and technology, thus promoting improvements in productivity. An enlarged market may also attract increased foreign investment. In fact, some regional agreements have raised concerns about diversion of investment from more productive uses in nonmember countries. Such investment diversion may occur when regional integration combines high external barriers with rules of origin that set highly restrictive conditions under which a product will be eligible for preferential treatment.

Not surprisingly, most of the empirical studies of the effects of regional integration have examined the EU, which provides the longest experience of major trading countries with a preferential trading arrangement. Most of the studies have concluded that for manufactured products, trade creation has far outweighed trade diversion. At the same time, the EU's Common Agricultural Policy, which establishes high tariff and nontariff barriers to agricultural imports from nonmember countries, has resulted in considerable trade diversion. Other studies have suggested important dynamic gains from European integration.⁹

Because NAFTA has been in effect only since 1994, there is limited evidence of its effects on trade flows. Most preliminary studies suggested little trade diversion because the three members already traded intensively with each other and had already lowered their barriers to trade.¹⁰ More recent studies have provided evidence that NAFTA and other regional agreements have led to somewhat greater regional concentration of trade — that trade among member countries has grown faster than trade with nonmembers. They suggest that such concentration of trade may be in part due to trade diversion.¹¹

The experience of regional integration in Europe and other areas was analyzed in a WTO study of regionalism in world trade.¹² The study found that intra-regional trade as a share of total West European trade increased from 53% to almost 70% between 1958 and 1993. (See **Table 3.**) It found smaller increases in intra-regional trade in Asia and North America and no major increases in other regions. There was a sharp decline in intra-regional trade in Central and Eastern Europe, and a smaller decline in the Middle East. The share of total world trade that is intra-regional

⁹ For a brief overview of studies of EU integration, see Caves, Richard E., Jeffrey A. Frankel, and Ronald W. Jones. *World Trade and Payments: An Introduction*. 6th ed., New York, HarperCollins, 1993, pp. 291-293.

¹⁰ The early studies are discussed in U.S. Library of Congress. *Congressional Research Service. North American Free Trade Agreement: Effects on Trade With Nonmember Countries*, by George D. Holliday. CRS Report 93-254 E.

¹¹ Carnegie Endowment for International Peace. *Reflections on Regionalism: Report of the Study Group on International Trade*. Washington, 1997, pp. 19-26.

¹² World Trade Organization. *Regionalism and the World Trading System*. Geneva, 1995.

increased from 40.6% in 1958 to 50.4% in 1993, primarily due to the Western European experience.

Table 3. Share of Intra-Regional Trade in Total Trade (Exports plus Imports) in Seven Geographic Regions, 1948-1995, Selected Years
(Percentage of Each Region's Merchandise Trade)

	1948	1958	1963	1968	1973	1979	1983	1993	1995
Western Europe	41.8	52.8	61.1	63.0	67.7	66.2	64.7	69.9	68.9
Central, East Europe, Former Soviet Union	61.2	71.3	63.5	58.8	54.0	54.0	57.3	19.7	18.9
North America*	27.1	31.5	30.5	36.8	35.1	29.9	31.7	33.0	36.0
Latin America*	20.0	16.8	16.3	18.7	27.9	20.2	17.7	19.4	20.8
Asia	38.9	41.1	47.0	36.6	41.6	41.0	43.0	49.7	50.9
Africa	8.4	8.1	7.8	9.1	7.6	5.6	4.4	8.4	10.0
Middle East	20.3	12.1	8.7	8.1	6.1	6.4	7.9	9.4	8.0
World	32.9	40.6	44.1	47.0	49.3	45.8	44.2	50.4	52.1

*Mexico is included in Latin America.

Sources: World Trade Organization, *WTO Focus*, No. 3, May-June 1995, p. 11; 1995 data are from World Trade Organization, *Annual Report 1996*, Vol. II, p. 23, Geneva, 1996.

The authors of the WTO study do not attribute the increase in European intra-regional trade primarily to trade diversion. They note that the increase was not associated with a significant decrease in European trade with other regions as a percentage of total production in the region. Barriers to trade with nonmembers were also lowered, and extra-regional trade grew commensurately with total European production. Thus, the authors of the study suggest that the increase in intra-regional trade primarily reflected the increasing importance of overall trade in Europe's economy, rather than diversion of trade from nonmembers.

Effects on the Multilateral Trading System

With the proliferation of new agreements, regional trading arrangements could, in the future, lead to a larger share of intra-regional trade in the world. (Table 1 does not reflect the influence of the many agreements that have been concluded in the 1990s: they are too recent to have significantly affected the data presented in the table.) The interaction of such trade blocs may in large part determine the future of the multilateral

trading system. Trade specialists are debating whether such arrangements will be “stumbling blocs” or “building blocs” for a more liberal multilateral system.¹³

The development of large, rival trading blocs could, according to some observers, undermine the multilateral system. Such arrangements inevitably result in some trade diversion and, thus, harm the trading interests of nonmember countries. In fact, concerns about trade diversion have already generated significant trade frictions. The European Union’s successive enlargements and its free trade agreements with Central European countries, for example, have led to complaints by the United States and others about trade diversion. Similarly, Caribbean and Asian countries have expressed concerns that NAFTA’s restrictive rules of origin for the textile and automobile industries are diverting trade.¹⁴

Moreover, trading blocs with great market power, such as NAFTA or the European Union, may have a greater temptation to impose restrictions on nonmembers because the risk of retaliation from relatively small trading partners would be small. Of particular concern is the possibility of greater resort to procedural protectionism (such as the use of antidumping duties merely to protect domestic producers) or restrictive rules of origin to reduce imports from nonmembers. Nonmember countries could react by forming antagonistic trade blocs, thus reducing the gains from trade that have been achieved through reduction of trade barriers in multilateral trade negotiations.

The negotiation of regional integration agreements could, on the other hand, reinforce the multilateral trading system. They could serve as a model for multilateral agreements that deal with many of the same issues that have already been addressed at the regional level. NAFTA, for example, includes significant agreements on such issues as trade in services, trade-related investment measures, intellectual property rights, and dispute settlement, that for a long time stymied negotiators in the Uruguay Round. NAFTA could also serve as a model for future trade agreements addressing issues related to labor standards and environmental degradation — issues that have not been addressed systematically in the WTO.

Renato Ruggiero, Director General of the WTO, reflected the ambivalence of many trade officials toward regional trade agreements in a September 1996 speech.¹⁵ The increase in regional agreements, he said, “has generally been for the good.” They had provided “stepping stones to global liberalization,” and “served as important crucibles for trade policy innovation...” Ruggiero expressed concern, however, that,

¹³ For a further discussion of the debate, see de Melo, Jaime, and Arvind Panagariya. *The New Regionalism in Trade Policy*. Washington, The World Bank, September 21, 1992.

¹⁴ Legislation has been introduced in the 105th Congress to provide preferential treatment to the Caribbean countries that is roughly equivalent to that of Mexico under NAFTA, thus avoiding trade diversion. See U.S. Library of Congress. Congressional Research Service. *Caribbean Basin Interim Trade Program (NAFTA/CBI Parity)*, by Vladimir N. Pregelj. IB95050, continually updated.

¹⁵ Renato Ruggiero, “Beyond Borders: Managing a World of Free Trade and Deep Interdependence,” Speech to the Argentinian Council on Foreign Relations, Buenos Aires, September 10, 1996. World Trade Organization Press Release No. 55. Available at http://www/wto.org/Whats_new/press55.htm.

if regionalism proceeds faster than the WTO process, “there is a danger that we will lack a common framework of rules and disciplines.” He warned that the growth of regionalism could lead to a “fragmented world — one which fosters inter-regional frictions and rivalries, but lacks the global architecture of rules and procedures needed to manage them.”¹⁶

In short, the effects of regional integration on the multilateral system, like its effects on economic efficiency and welfare, are uncertain. Some economists and policymakers argue that regional agreements could lead to the unravelling of the intricate multilateral rules that promote an open trade regime. Others argue that regional integration agreements are a “second best” solution: while they are not as effective as multilateral trade liberalization in promoting economic efficiency, regional integration arrangements are preferable to maintaining existing trade barriers.

Implications for U.S. Trade Policy

Questions about the economic and systemic effects of regional trade agreements may play a role in the 105th Congress’ consideration of legislation to enact new authority for fast-track implementation of trade agreements. In the past, Congress delegated considerable discretionary authority to the President to decide which kinds of agreements best served U.S. trade interests. The President was authorized, from 1975-1994, to negotiate on a wide variety of issues in multilateral, bilateral, or regional negotiations and have the resulting agreements implemented with fast-track procedures. In considering new fast-track authority, Congress may choose to continue such broad authority, to provide more specific direction on negotiating objectives and on the kinds of agreements that the President may submit to Congress for fast-track implementation, or not to agree to fast-track authority at this time.

Since the inception of fast-track authority, Congress has conditioned fast-track implementation of trade agreements on close consultation between the President and Congress during trade negotiations and on the President’s success in achieving the negotiating objectives that are spelled out in the authorizing legislation. Generally, authorizing legislation has contained “overall” and “principal” trade negotiating objectives. The former include broad, long-term goals of U.S. trade policy, such as improving access for U.S. exporters to foreign markets, strengthening the multilateral trading system, and fostering economic growth; the latter include specific, more immediate goals, such as targeting foreign barriers in certain sectors or reforming

¹⁶ The WTO’s 1996 annual report gives examples of regional rules that take precedence over multilateral rules. In dispute settlement on issues that arise under both NAFTA and the WTO, for example, a complaining NAFTA member can choose which provisions to use. If the two parties disagree on which to use, NAFTA provisions take priority. Similarly, in EU association agreements with countries in Central Europe, the regional rules take precedence in most cases. For example, the EU applied safeguards against steel imports from the Czech and Slovak Republics in 1992 in a way that suggested that GATT obligations had been suspended. World Trade Organization, Annual Report, 1996, Volume I, Geneva, 1996, p. 39.

certain trade rules.¹⁷ In passing fast-track authority, Congress has directed the President to keep the relevant committees informed of the progress of negotiations and, after negotiations are completed, to report to Congress how the agreements have achieved the legislated objectives.

Since 1994, the Clinton Administration and some Members of Congress have continually advocated a renewal of fast-track authority. On September 16, 1997, the President sent a legislative proposal to Congress that would provide fast-track authority for any agreement — bilateral, regional, or multilateral — that met the conditions set forth in the law and that was entered into before a stipulated date (October 1, 2001, with a possible extension to October 1, 2005).

There is substantial opposition in the Congress to the Administration's proposal for broad fast-track authority. Some Members are concerned about the adverse effects of past trade agreements. (NAFTA has been a particular target of fast-track critics.) They oppose fast-track authority because they think that it will facilitate agreements that increase import competition. Others approve of trade liberalization, but only after careful consideration of the costs and benefits of trade agreements. The latter oppose fast-track authority because they think that it prevents such careful consideration.

Other Members support the renewal of fast-track authority, but disagree with the Administration's negotiating objectives. In particular, the proposed use of trade agreements to promote higher labor and environmental standards in other countries has generated a major debate. Some Members have supported legislation to restrict the President's authority to include such provisions in trade agreements, while others have insisted that future trade agreements contain provisions that require stronger labor and environmental standards. On November 10, 1977, citing an inability to ensure victory of a measure that had been approved by the House Ways and Means Committee, President Clinton announced an agreement with the House leadership to postpone a planned vote in the House. Administration officials have announced that they will try again in 1998 to enact fast-track authority.

In deciding whether fast-track should be authorized and, if so, what kind of trade agreements should be pursued, Congress may consider which approach — multilateral or regional negotiations — is most likely to achieve the U.S. negotiating objectives that are included in fast-track authority. If new fast-track legislation includes authority for both multilateral and regional free trade agreements, it may also consider whether the two kinds of agreements are mutually compatible.

¹⁷ For example Section 1101 of the Omnibus Trade and Competitiveness Act of 1988 (P.L. 100-418), which last authorized fast-track implementation included principal negotiating objectives related to dispute settlement, the operation of the multilateral system, transparency, developing countries, current account surpluses, trade and monetary coordination, agriculture, unfair trade practices, trade in services, intellectual property, foreign direct investment, safeguards, specific barriers to trade, worker rights, access to high technology, and border taxes.

Achieving U.S. Trade Negotiating Objectives

U.S. trade negotiators have had some notable successes in achieving U.S. negotiating objectives at both the multilateral and regional levels, and the Clinton Administration proposes continued negotiations both in the WTO and in regional fora such as NAFTA, the FTAA, and APEC. Trade specialists offer different assessments on which approach should be emphasized in furthering the U.S. negotiating objectives that are being discussed today.

Accomplishments in GATT/WTO Negotiations. The record of successful trade liberalization in the GATT/WTO, combined with the evidence that multilateral liberalization maximizes the gains from trade, has led many trade specialists to urge continued emphasis on multilateral trade negotiations. Eight rounds of trade negotiations in the GATT have resulted in a major reduction in trade barriers, contributing to a rapid increase in world trade. GATT's accomplishments in lowering tariff barriers are most apparent: among the industrial countries, average tariffs on manufactured goods have fallen from 40% in the 1950s to less than 5% today.

In the Tokyo and Uruguay Rounds of GATT, negotiators also made significant progress in reducing nontariff barriers and establishing rules for new trade issues. The Tokyo Round (1973-1979), for example, resulted in important agreements on government procurement, technical barriers to trade, customs valuation, import licensing, antidumping, and subsidies. The Uruguay Round (1986-1993) reduced barriers and established new rules in areas such as agriculture, textiles, services, intellectual property rights, and trade-related investment measures, that had received relatively little attention in previous rounds.

In future negotiations, some analysts see a particularly important role for GATT/WTO in negotiating matters that involve a large number of producers in many different countries.¹⁸ The Uruguay Round's agreement to liberalize trade in textiles and apparel and its agreement to improve market access and reduce subsidies in agricultural trade are examples of success in addressing difficult trade issues in such industries. (While regional agreements have also liberalized trade in textiles and agriculture among member countries, they have often maintained, or increased, protection against producers in other countries.) Supporters of multilateral trade negotiations also claim that post-Uruguay Round sectoral agreements, such as the Information Technology Agreement that was initialled in 1996, will bring significant benefits to the economies of the United States and its trading partners. The GATT/WTO's record suggests to some observers that it may be the best venue for reducing barriers to trade in similar industries.

Criticisms of Multilateral Trade Agreements. Despite the considerable achievements of GATT/WTO, U.S. trade negotiators, like their counterparts in other countries, have become increasingly interested in regional agreements largely because they perceive multilateral negotiations as slow and ineffective in addressing key issues

¹⁸ Hufbauer, Gary, and Anup Malani. "The World Trade Regime: GATT, Regional Cooperation, Bilateral Confrontation." *The International Spectator*, No. 2, April-June, 1993, p. 66-68.

on the current trade agenda. Critics of GATT/WTO are particularly dissatisfied with its slow progress on new trade issues—trade in services, trade-related investment measures, intellectual property rights, and labor and environmental standards. Such issues are precisely the areas that have been emphasized in U.S. negotiating objectives.

The Uruguay Round, for example, required over 8 years to complete, and many observers were disappointed with achievements on the new trade issues. While the Uruguay Round resulted in agreements on services, foreign investment, and intellectual property rights, critics found many shortcomings. The agreement on services contains exceptions for countries that choose not to extend nondiscriminatory or national treatment for foreign providers, and mixed results with regard to market access for specific service industries. Negotiators were unable to reach agreement on financial services, maritime services, and basic telecommunications services. (Negotiations on the telecommunications agreement were concluded in 1997; they are continuing for the others.) The Uruguay Round agreement on trade-related investment measures, according to some observers, did not bring significant reform; it discourages a limited number of practices that discriminate against foreign investors, but allows exceptions for developing countries. The agreement on intellectual property rights, while generally credited with setting new standards for enforcement, has been criticized for allowing long transition periods for developing countries.¹⁹

Those who advocate including provisions on labor and environmental standards in trade agreements have been among the most vocal critics of the GATT/WTO. The Clinton Administration acknowledged that U.S. negotiators failed to include workers rights issues on the agenda in the Uruguay Round,²⁰ and, at the first WTO ministerial meeting in Singapore in 1996, members declined to undertake any future work in the WTO on such issues. Many environmental groups were also dissatisfied with the Round's limited results on environmental issues — an agreement to establish a committee in the WTO to carry out an environmental work plan.

Are Regional Negotiations a Better Approach. Those who favor greater emphasis on regional trade agreements maintain that such arrangements, because their membership is limited to a small number of like-minded governments, can resolve differences on difficult new issues, more quickly and effectively.²¹ They compare NAFTA's achievements favorably with the Uruguay Round's. In a relatively short time, negotiators in NAFTA concluded agreements on investment rules, intellectual property rights, and trade in services, that are in many respects more comprehensive and more effective than the Uruguay Round agreements. NAFTA's investment rules, provide

¹⁹ For an overview of the accomplishments and shortcomings of the Uruguay Round agreements on new issues, see Schott, Jeffrey J., assisted by Johanna W. Buurman. *The Uruguay Round: An Assessment*. Washington, Institute for International Economics, November 1994. P. 99-123.

²⁰ President of the United States, Uruguay Round Trade Agreements, Texts of Agreements, Implementing Bill, Statement of Administrative Action, and Required Supporting Statements. H.Doc. 103-316, v. 1, 103d Congress, 2d Session. Washington, U.S. Govt. Print. Off., 1994, p. 1142.

²¹ See for example, Hufbauer, Gary and Jeffrey J. Schott. *Toward Free Trade and Investment in the Asia-Pacific*. The Washington Quarterly, Summer 1995. P. 37-45.

more effective restrictions on performance requirements than multilateral rules. (Performance requirements stipulate that the foreign investor must achieve targets set by the host government on exports, domestic employment, technology transfers, and other matters.) While the Uruguay Round General Agreement on Trade in Services applies only to service industries that are listed in the agreement, NAFTA adopted a negative list approach; it lists services not subject to the agreement and extends national treatment to all others. NAFTA's agreement on intellectual property rights includes products that were under development when the agreement was signed; the Uruguay Round did not cover such products.²²

Some observers also maintain that NAFTA achieved significant agreements on the controversial issues of environmental and labor standards. It preserves national environmental standards and commits member countries to work together to enhance their standards through upward harmonization. A NAFTA side agreement on environmental matters promotes enforcement of national environmental laws and cooperation among the member governments on environmental matters. A side agreement on labor promotes enforcement of each country's labor laws. (The NAFTA provisions gained the support of some environmental groups. The labor agreement, however, received little support from U.S. organized labor. In fact, the perception that NAFTA has had adverse effects on U.S. jobs and wages has led some Members of Congress to propose that the United States negotiate revisions to NAFTA or withdraw from it.²³)

Other observers question whether regional trade agreements are necessarily a quicker and more effective way to negotiate such issues. U.S. negotiators may experience greater difficulty as they attempt to negotiate regional agreements with a larger group of more diverse countries. In fact, the schedules for the FTAA and APEC suggest that the potential members of the larger regional arrangements may anticipate difficult, time-consuming negotiations. Completion of the FTAA is planned for the year 2005; prospects for APEC are even more distant — 2010 for the industrial countries and 2020 for the less developed countries. The schedule for the larger regional agreements suggests to some observers that U.S. objectives could be better served by concentrating on multilateral negotiations.

Reconciling Regional and Multilateral Trade Agreements

How can policymakers ensure that regional trade agreements serve as “building blocs” rather than “stumbling blocs” for a more effective multilateral system? Many observers, concerned that the limited reforms of the Uruguay Round will not provide

²² Lawrence, Robert Z. *Regionalism, Multilateralism, and Deeper Integration*. Washington, The Brookings Institution, 1996, p. 71.

²³ For example, H.R. 978, introduced in the 105th Congress by Rep. Kaptur, would require renegotiation of certain provisions of NAFTA, and withdrawal from NAFTA if certain conditions are not met.

significantly greater discipline to regional arrangements, have proposed more fundamental reforms to the GATT/WTO rules.²⁴

New Rules for Regional Trade Agreements. Some economists have proposed reforming GATT/WTO rules to allow only customs unions. That is, free trade arrangements such as NAFTA would not be allowed. From those economists' perspective, customs unions are preferable because they require a common external tariff. Since the GATT requires that tariffs not be increased against nonmembers, the reformers think that tariffs tend to be reduced to the lowest level prevailing in the customs union. They also think that customs unions are less likely to use rules of origin for protectionist purposes. (Rules of origin play a more prominent role in free trade areas because they must be used to protect against transshipment through the member countries with the lowest tariffs.) For many governments, however, there is a disadvantage to customs unions: since they are required to adopt a common external tariff, they must share the power to regulate their trade with nonmember countries.

Others have proposed establishing new conditions under which regional trade agreements could be formed. Some economists have pointed out, for example, that the rule requiring members of a regional agreement to eliminate barriers to "substantially all" trade does not necessarily maximize global welfare. Since removal of some internal barriers leads to trade diversion, while removal of others leads to trade creation, trade theory suggests that partially removing internal barriers (that is, avoiding removal of barriers that would lead to trade diversion) could improve welfare. While theoretically sound, this proposal may have practical problems. First, it might be difficult to determine whether removal of a certain barrier would create or divert trade. Second, without the rule that all internal barriers be removed, members of regional arrangement might not make decisions on the basis of world welfare. Instead, they might choose to liberalize selectively to protect politically powerful producers from outside competition.

Another proposal is to revise the GATT/WTO rule that members of a new regional arrangement must not *raise* tariffs on nonmembers. Instead, some propose that the rule require all members of a regional arrangement to *lower* external tariffs sufficiently to maintain existing levels of imports from nonmembers. Such a rule, it is argued, could eliminate trade diversion by setting guidelines on the results of regional agreements. This proposal would encounter both practical and conceptual problems. Most countries want to know what the level of tariffs on nonmembers will be before they enter a regional arrangement. A requirement that they maintain existing levels of imports would create uncertainty. Moreover, a lower level of imports from nonmembers might not be caused by trade diversion; it might be the result of improved efficiency of producers within the regional group. One would not want to adopt a rule that discouraged changes in trade that are based on new patterns of comparative advantage.

Open Regionalism. A more general proposal is that new regional arrangements be based on the concept of "open regionalism" — that the elimination of barriers to trade within a bloc be accompanied by simultaneously lowering barriers to nonmembers. Some member governments of APEC, for example, have proposed that all trade

²⁴ These proposals are summarized in Lawrence, *Regionalism, Multilateralism, and Deeper Integration*, pp. 95-104.

liberalization measures undertaken by member countries simply be extended on a most-favored-nation basis to nonmembers. In this manner, APEC would avoid becoming a preferential bloc like NAFTA or the European Union. Such an approach, however, may be difficult to implement. It would mean that APEC members would extend concessions on tariffs and nontariff barriers on a non-reciprocal basis — an approach that governments have been reluctant to follow in past trade negotiations.

Another proposal is to establish new WTO rules of accession for regional arrangements. Some economists have proposed that the WTO encourage members of regional arrangements to allow any country willing to abide by the rules and responsibilities of an arrangement to join it. This approach would require that any new member reciprocate by reducing its trade barriers to the same level as existing members. Opening a regional arrangement to any country would tend to reduce trade diversion, since nonmembers could avoid discrimination against their exports simply by joining the arrangement. Such a rule, however would also reduce the power of member governments to regulate their trade. Many governments would be reluctant to accept new WTO rules that would diminish their power to choose their free trade partners.

A Stronger Multilateral Trading System. In short, there are formidable obstacles to implementing any of the proposed fundamental reforms of regional trade agreements. It appears unlikely that member governments will reach a consensus on proposals that strictly limit their ability to form new regional arrangements.

Some observers think that a more practical way of discouraging the formation of discriminatory trading blocs is to strengthen the WTO's surveillance of regional trade agreements. In 1996, the WTO moved in this direction by creating a new Committee on Regional Arrangements to review the operation of free trade agreements and customs unions and to try to ensure that they are compatible with WTO rules. In its first year of operation, the Committee began to review the 31 regional agreements that had been reported to the WTO but not examined. Among the first to be reviewed were NAFTA, the enlargement of the European Union, and the Southern Common Market Agreement (MERCOSUR).

Many observers think that another way to discourage discriminatory agreements to pursue multilateral trade liberalization more energetically. As multilateral agreements reduce tariffs worldwide, for example, the margin between MFN rates and preferential rates becomes smaller, thus reducing the value of preferential tariffs in free trade agreements and customs unions. Moreover, if future WTO negotiations succeed in reducing non-tariff barriers and resolving more effectively the new trade issues, the development of hostile trade blocs may become less likely.