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OF THE MILLENNIUM: TOWARDS  
A NEW PARADIGM?**

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## **ABSTRACT**

### **EC Regionalism at the Turn of the Millennium: Towards a New Paradigm?\***

This paper examines the development of regional trade agreements (RTAs) between the European Community (EC) and its partners during the past decade. It finds that EC regionalism has recently entered a new phase: RTAs with countries outside Europe. As a result of parallel initiatives by the United States, the world trading system finds itself in virgin, and potentially dangerous, territory.

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## **NON-TECHNICAL SUMMARY**

The last decade has witnessed a significant upsurge in the number of regional trade agreements (RTAs). During the five years since its establishment, in January 1995, 69 new RTAs were notified to the World Trade Organization (WTO), and 113 were in force in December 1999, including 91 notified to the GATT/WTO under GATT Article XXIV. The European Community (EC) is, by far, the most active WTO member in the field of regional trade agreements. It is a party to 28 of the 91 RTAs in goods notified under GATT Article XXIV and currently in force: the EC customs union, and 27 bilateral RTAs with third countries.

At the beginning of the 1990s, the EC already had bilateral RTAs in goods with many trading partners. These agreements fell into two distinct categories: reciprocal RTAs, i.e. customs unions or free trade areas providing reciprocal free access to both parties; and non-reciprocal RTAs, i.e. co-operation agreements providing duty-free access only for the non-EC partner. At the time, the implicit policy of the EC was that reciprocal customs unions and free trade areas were essentially reserved for potential EC members, whereas non-reciprocal co-operation agreements were generally set aside for extra-European countries.

By the end of the decade, the shape and content of EC regionalism were radically transformed. Not only did the number of RTAs increase substantially, but also the substance of EC regionalism changed dramatically in two ways. First, the fall of the Iron Curtain and the redrawing of Europe's political map resulted in the mushrooming of bilateral RTAs between the Central and Eastern European countries (CEECs) and the EC. The second radical change was the decision of the EC to gradually eliminate non-reciprocal RTAs and to set up reciprocal RTAs with extra-European countries, which have no vocation of becoming EU members. In 1990, the EC had just one reciprocal RTA with an extra-European country. By the end of 2000, five such RTAs will be in force and several others are already in the pipeline.

The redrawing of Europe's political map, after the fall of the Iron Curtain, has led to a veritable outbreak of intra-European RTAs. Today, there are dozens of RTAs in Europe. The European 'spaghetti bowl' contains three layers: the nucleus of the system is the EC and its 20 or so bilateral European RTAs; the second layer comprises the European Free Trade Area (EFTA) and its dozen bilateral intra-European RTAs; the last stratum consists of the nearly 30 RTAs among European countries that belong to neither the EC nor EFTA.

The present pan-European trading system suffers from three major weaknesses. The first and foremost is widespread discrimination. The second problem is the investment-deterrent effect associated with 'hub-and-spoke' systems, where the 'hub' country has free access to all 'spokes', but each

'spoke' country has only free access to the 'hub'. The last problem relates to EU enlargement and the status of RTAs between EU candidates and certain other non-EU countries. The issue derives from the fact that the EC is a customs union, which implies that its members cannot be parties to *bilateral* RTAs.

A solution, suggested elsewhere by the author, would be the creation of a Pan-European free trade area (PEFTA) incorporating all the countries of Europe that belong to the WTO. But, obviously, given the central role of the EU in the system, such a solution cannot be envisaged unless one spells out, at the same time, a clear vision of the pan-European political architecture. A possible model for the latter could run as follows. All the nations of Europe should belong to PEFTA, if and when they become WTO members. All the members of PEFTA fulfilling general criteria and willing to adhere to its aim, would become members of the European Union. In this scheme, the EU would comprise three, instead of the current two, integration levels:

1. The customs union, which would contain the current EU members, *plus* the candidates meeting the required conditions;
2. The single market, which would include the current EU members, *plus* some of the present candidates able and willing to conform to the relevant Community legislation; and
3. The monetary union, in which membership would remain subject to meeting convergence criteria.

Leaving aside intra-European RTAs, which fit into a completely different logic than pure trading agreements, EC regionalism has recently taken a new direction: full-blooded regional trade arrangements with countries outside the European continent. As a result of parallel initiatives by the United States, the world trading system clearly finds itself, at the beginning of the new millennium, in a *terra incognita*.

The EU and the US have both implemented RTAs with neighbouring developing countries designed to 'lock in' their economic reforms and foster regional stability. Both have also taken important steps towards preferential trading agreements with countries outside their vicinity, that offer important market potential. At the same time, the EU is also considering establishing a series of RTAs with its traditional African, Caribbean and Pacific (ACP) partners, with a view to fostering economic reforms, while also reinforcing traditional ties with potentially significant markets.

Hence, if the Free Trade Area of the Americas (FTAA) initiative and the idea of EC/ACP free trade areas are implemented, we could witness, by the end of the current decade, the emergence of two major 'hegemon-centred' trading blocs: one, focused on a European Union of 25-plus members, encompassing

most non-EU European countries, African countries from the North to the South of the continent, and some countries in the Near East; the other, centred on the United States, comprising the entire American continent. The EU-centred bloc is, and would continue to be, a hub-and-spoke system of bilateral FTAs; by contrast, the US-centred bloc is, under NAFTA, and would continue to be under the FTAA, a single FTA. The crucial point is that both blocs are, and would remain, free trade areas rather than customs unions, which entail costly systems of origin rules.

The two emerging trade blocs need not, but could, become closed, or even antagonists. The best way to lay aside existing worries would be to undertake an ambitious agenda of 'global free trade in our time'. In the meantime, it is of the utmost importance that the European Union and the United States, the two 'hegemons' of the system, agree to strengthen GATT/WTO rules on regional trade agreements, in order to minimize the discrimination they entail, and maximize their liberalization potential.

## **Introduction**

The last decade has witnessed a significant upsurge in the number of regional trade agreements (RTAs). During the 45 years of its existence, 109 agreements were notified to the General Agreement of Tariffs and Trade (GATT), and 62 were still in force in December 1994. By contrast, during the 5 years since its establishment in January 1995, 69 new RTAs were notified to the World Trade Organisation, and 113 were in force in December 1999. These 113 RTAs fall into three groups: 91 notified to the GATT/WTO under GATT Article XXIV; 11 notified to the GATT/WTO under the Enabling Clause<sup>1</sup>; and 11 notified to the WTO under Article V of the General Agreement of Trade in Services (GATS).

The European Community (EC) is, by far, the most active WTO member in the field of regional trade agreements. It is a party to 28 of the 91 RTAs in goods notified under GATT Article XXIV and currently in force: the EC customs union (CU) and 27 bilateral RTAs with third countries. It is also party to 8 of the 11 RTAs in services notified under GATS Article V that are currently in force: the EC itself and 7 bilateral RTAs with third countries. By contrast, the United States (US) is only party to 3 RTAs<sup>2</sup>, while Japan belongs to no regional trade agreement at all.<sup>3,4</sup>

Much has been written on the causes and importance of EC regional trade agreements.<sup>5</sup> The purpose of this short paper is to examine the development of EC regionalism over the past decade. The paper notes that EC regionalism has recently entered a new phase: regional trade arrangements with countries outside the European continent. As a result of parallel initiatives by the United States, the world trading system finds itself, at the beginning of the new millennium, in virgin territory. The paper argues that the emergence of trade blocs need not, but could become closed, or even antagonists. The best way to avoid negative outcomes would be to undertake an ambitious agenda of “global free trade in our time”. In the meantime, the European Union, the United States and other trading nations should strengthen GATT/WTO rules on regional trade agreements.

## **The transformation of EC regionalism during the 1990s**

At the beginning of the 1990s, the EC already had bilateral regional trade agreements in goods with 18 trading partners. These agreements fell into two distinct categories: reciprocal RTAs, i.e. customs unions or free trade areas providing reciprocal free access to both parties; and non-reciprocal RTAs, i.e. co-operation agreements providing duty-free access only for the non-EC partner (see Table 1). The 10

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<sup>1</sup> Or more precisely, the 1979 Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries.

<sup>2</sup> The North American Free Trade Agreement (NAFTA), in goods and services, and the US/Israel free trade agreement.

<sup>3</sup> The only other WTO members that are not parties to regional trade agreements are Hong Kong and Korea.

<sup>4</sup> Next to the EC, the country that belongs to the most RTAs is Switzerland, which is a party to 16 agreements.

<sup>5</sup> See, for instance, Baldwin (1997), Sapir (1998) and Winters (1993).

reciprocal RTAs were all with West European countries,<sup>6</sup> except in one instance (Israel). By contrast, the 8 non-reciprocal RTAs were all with non-European countries, except in one case (Turkey).<sup>7</sup> In other words, at the beginning of the 1990s, the implicit policy of the EC was that reciprocal customs unions and free trade areas were essentially reserved for potential EC members, whereas non-reciprocal co-operation agreements were generally set aside for extra-European countries.

By the end of the decade, the shape and content of EC regionalism were radically transformed. The number of EC bilateral RTAs in goods had increased from 18 to 27, and is expected to reach 29 in the course of 2000 (see Table 1). But above all, it is the substance of EC regionalism that has changed at two different levels.

First of all, the fall of the Iron Curtain and the redrawing of Europe's political map have profoundly modified the economic relations between the Central and Eastern European countries (CEECs) and Western Europe. Closer relations have translated into bilateral free trade agreements (FTAs) between 10 CEECs and the EC; and also between these CEECs and the European Free Trade Association (EFTA).<sup>8</sup> As a result, the EC currently maintains reciprocal RTAs with 19 potential EU members: 13 EU candidates<sup>9</sup>, and 6 other trading partners<sup>10</sup>. Given that EU candidates are bound to become EU members at some point, and even if one assumes that additional European countries are likely to become EU candidates in the years ahead, one may reasonably foresee the day when there are only a handful of bilateral RTAs between the EC and other European countries.

The second radical change is the decision of the EC to gradually eliminate non-reciprocal RTAs and to set up reciprocal RTAs with extra-European countries, which, by definition,<sup>11</sup> have no vocation of becoming EU members. In 1990, the EC had just one FTA with an extra-European country (Israel). By the end of 2000, 5 such FTAs will be in force: 4 with "neighbouring" Mediterranean countries (Israel, Morocco<sup>12</sup>, the Palestinian Authority, Tunisia<sup>13</sup>), and one with a geographically-distant country (South Africa). Altogether, therefore, the replacement of non-reciprocal co-operation agreements by reciprocal customs unions or free trade areas will already have been completed for 3 countries (Morocco, Tunisia, Turkey), and negotiations are under way to also replace the remaining 5 co-operation agreements (with Algeria, Egypt, Jordan, Lebanon, Syria) by reciprocal FTAs. At the same time, FTA negotiations are

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<sup>6</sup> Throughout the paper I define Europe as the set of countries that belong to the Council of Europe. There are currently (i.e. in February 2000) 41 countries that are members of the Council of Europe. These can be grouped into 3 categories: 15 members of the European Union (EU); 13 EU candidates (Bulgaria, Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic, Slovenia and Turkey); and 13 other countries (Albania, Andorra, Croatia, Former Yugoslav Republic of Macedonia (FYROM), Georgia, Iceland, Liechtenstein, Moldova, Norway, Russia, San Marino, Switzerland and Ukraine).

<sup>7</sup> The EC also granted non-reciprocal duty-free access to African, Caribbean and Pacific (ACP) countries. However, the EC/ACP association agreement is not a RTA under GATT/WTO rules.

<sup>8</sup> Since Austria, Finland and Sweden joined the EU in 1995, the number of EFTA members has decreased from 7 to 4. The "survivors" are: Iceland, Liechtenstein, Norway and Switzerland.

<sup>9</sup> See footnote 6.

<sup>10</sup> Namely Andorra, Faroe Islands and the 4 remaining EFTA members (see footnote 8).

<sup>11</sup> This view is certainly not universally shared. For instance, Morocco is seriously considering applying, for the second time, to the EU.

<sup>12</sup> The date of entry into force of the EC/Morocco FTA was March 1, 2000.

<sup>13</sup> The date of entry into force of the EC/Tunisia FTA was March 1, 1998.



progressing with Mexico as well as Chile and MERCOSUR. Taking into account the possible FTAs with (groups of) ACP countries, one perceives a clear trend toward the multiplication of RTAs between the EC and extra-European countries in Africa, America and Asia.

The rapid development in the number and nature of EC regionalism raises several questions. Some pertain to individual regional trade agreements: What are the economic impacts of individual RTAs on the welfare of the EC, its trading partner, and third countries? Are individual RTAs compatible with GATT/WTO rules embodied in GATT Article XXIV and GATS Article V?

Other questions relate to the effects of EC regionalism on the multilateral trading system: What is the effect of EC regionalism on regional trade initiatives by other WTO members? What is the effect of all these agreements on the EC itself? What is their effect on other WTO members?

The problem of assessing the compatibility of RTAs with GATT Article XXIV goes back a long way. In broad terms, the requirements of Article XXIV are that a regional trade agreement should: (a) not 'on the whole' increase protection against excluded countries; (b) eliminate tariffs and remove 'other restrictive regulations of commerce' between members, other than those justified by certain other GATT articles; and (c) cover 'substantially all the trade'. These criteria have always raised a host of interpretative and political problems. Under GATT, the procedure for reviewing a new regional trade agreement involved setting up *ad hoc* working parties charged with making recommendations. Of the 69 such working parties established until 1995, only 6 concluded that their RTAs were in conformity with the GATT. All the others failed to reach a conclusion.

During the Uruguay Round, attempts were made to improve this situation. Unfortunately, while the resulting Understanding on the Interpretation of Article XXIV clarified some issues, it failed to address fundamental problems such as the definition of 'substantially all the trade' or 'other restrictive regulations of commerce'.

In 1995, during the first year of its existence, the WTO sought to improve the situation by creating a Committee on Regional Trade Agreements (CRTA), charged with examining the compatibility of individual RTAs with GATT/WTO rules and with considering the systemic implications of such agreements for the multilateral trading system.

Between May 1996 and October 1999, the CRTA held 24 sessions and reviewed 72 agreements notified to the WTO, including 18 notified by the EC (see Table 2). By the time of its 24<sup>th</sup> session, draft reports were being drafted or factual examination was well engaged for 31 agreements, and draft reports on the examination of 30 agreements were under consideration.<sup>14</sup> Unfortunately, the Committee has so far been unable to finalise draft reports on any of these examinations. As the CRTA admitted in its 1999 annual report:<sup>15</sup> "Progress in this regard was slowed, *inter alia*, by

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<sup>14</sup> Factual examination had not yet started for 11 RTAs.

<sup>15</sup> See WTO (1999a).

disagreement among Members on the interpretation of certain elements of those rules relating to RTAs, as well as on procedural aspects.” Similarly, regarding its consideration of the systemic implications of regional trade agreements on the multilateral trading system, the Committee concluded that it was not in a position to make recommendations to the WTO’s General Council. Documents submitted to the Committee by members and the Secretariat of the WTO indicate that the two key areas of contention remain the definition of ‘substantially all the trade’ and the scope of ‘other regulations of commerce’. Not surprisingly, the most active delegations in the discussions on these issues are those from members that are not parties to any RTA (Japan, Hong Kong, Korea), or from others particularly susceptible to the spread of regionalism (Australia, New Zealand).

Table 2 indicates that, in the case of RTAs submitted by the EC, the Committee takes about two years, from the time of notification to the WTO, to conclude its factual examination and to draft its report. The only exception to this rule is the EC/Turkey customs union, which the Committee started to examine in November 1996 and was still without a draft report in October 1999.<sup>16</sup> The reason for this exceptional delay lies in the WTO complaints against Turkey lodged by Hong Kong (dated 12/2/96), India (dated 21/3/96) and Thailand (dated 20/6/96) concerning Turkey’s imposition of quantitative restrictions on imports of textile and clothing products in the context of its customs union agreement with the EC. In February 1998, India requested the establishment of a panel. The Panel found that Turkey’s measures are inconsistent with certain articles of the GATT and rejected Turkey’s assertion that its measures are justified by Article XXIV. Turkey appealed against the Panel’s conclusion in July 1999, and in October the Appellate Body confirmed that Article XXIV does not justify the quantitative restrictions at issue. The next month, Turkey stated its intention to comply with the rulings of the Dispute Settlement Body, which had earlier adopted the Appellate Body report. In principle, this should clear the way for the completion of the CRTA draft report on the EC/Turkey customs union.

Coming back to the questions raised earlier, one must conclude from the work of the Committee on Regional Trade Agreements that, despite the recent proliferation of RTAs, WTO members still lack the collective political will to seriously address the two key questions of the compatibility of individual agreements with GATT/WTO rules and of the implications of the spread of RTAs for the multilateral trading system. Since the EC is clearly the most important player in this game, in terms of market size and number of RTAs, the remainder of the paper will focus on the implications of EC regionalism for the EU’s own economic and political international relations. In keeping with the earlier discussion, distinction will be drawn between intra- and extra-European EC regionalism.

### **Intra-European EC regionalism**

The redrawing of Europe’s political map, after the fall of the Iron Curtain, has led to a veritable outbreak of intra-European regional trade agreements. Today, there are dozens of RTAs in Europe. The European “spaghetti bowl” contains three layers. The

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<sup>16</sup> The only other RTA for which the Committee has failed to draft a report after such a long time is MERCOSUR.

nucleus of the system is the EC and its 20<sup>17</sup> bilateral European RTAs. The second layer comprises the EFTA and its 11 bilateral intra-European RTAs. The last stratum consists of the nearly 30 RTAs among European countries that belong to neither the EC nor EFTA.

The present pan-European trading system suffers from three major weaknesses. The first and foremost is widespread discrimination. Take, for instance, a country like the Czech Republic. Inside Europe, different rules apply depending on whether it trades with: the European Union; the Slovak Republic, its fellow custom union member; a partner in the Central European Free Trade Area (CEFTA, which comprises of Bulgaria, the Czech Republic, Hungary, Poland, Romania, the Slovak Republic and Slovenia); an EFTA member; Estonia, Latvia, Lithuania or Turkey (partners in bilateral FTAs notified to the GATT/WTO); or the Former Yugoslav Republic of Macedonia (FYROM)(a partner in a bilateral FTA not notified to the GATT/WTO).

The second problem is the investment-deterrent effect associated with “hub-and-spoke” systems, where the “hub” country has free access to all “spokes”, but each “spoke” country has only free access to the “hub”. As already noted by Baldwin (1994), the European situation clearly favours the EC “hub” at the expense of its numerous “spoke” partners. However, the problem has been attenuated by the newly-created (1/1/1999) pan-European system of diagonal origin cumulation, which encompasses the EC, EFTA and the CEFTA member states, the Baltic countries, and Turkey.<sup>18</sup>

The last problem relates to EU enlargement and the status of RTAs between EU candidates and certain other non-EU countries. The issue derives from the fact that the EC is a customs union, which implies that its members cannot be parties to *bilateral* RTAs. Two situations may cause problem. On the one hand, nearly all the 13 EU candidates participate in bilateral and/or plurilateral RTAs with other EU candidates that may join the EU later than itself. Potential situations of this type include: the customs union between the Czech and Slovak republics; the Baltic Free Trade Area among Estonia, Latvia and Lithuania; and the FTA between Bulgaria and Slovenia. On the other hand, some of the 13 EU candidates are parties to bilateral RTAs with countries that are not (at least, at the moment) EU candidates. Examples of this situation include: the FTA between Croatia and Slovenia; the FTA between Moldova and Turkey; and the FTA between Lithuania and Ukraine. In both situations, a country acceding to the EU would have to withdraw from such RTAs, which could disrupt existing trade flows. Whether or not the other parties to these RTAs would be entitled to compensation under GATT Article XXIV:6 is a further issue.

A solution, suggested by Sapir (2000), would be the creation of a Pan-European free trade area (PEFTA) incorporating all the countries of Europe that belong to the

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<sup>17</sup> The 19 potential EU members referred to above, minus the Faroe Islands (which are not members of the Council of Europe), plus the Former Yugoslav Republic of Macedonia (FYROM) and San Marino (two members of the Council of Europe which have bilateral RTAs with the EC that are not notified to the GATT/WTO).

<sup>18</sup> Typically, bilateral RTAs between the EC and candidate countries set at 50% the rate of local content requirement for industrial products to qualify for preferential treatment. However, under the so-called “diagonal rule-of-origin cumulation”, if raw materials and/or components, originating in any EC, EFTA, CEFTA or Baltic country, or in Turkey, are processed in a candidate and/or EFTA country and then re-exported to the EC, the value of raw materials and components will be considered local content.

WTO.<sup>19</sup> But, obviously, given the central role of the EU in the system, such solution cannot be envisaged unless one spells out, at the same time, a clear vision of the pan-European political architecture. A possible model for the latter could run as follows. All the nations of Europe should belong to PEFTA, if and when they become WTO members. All the members of PEFTA fulfilling general criteria and willing to adhere to its aim, would become members of the European Union.

In this scheme, the EU would comprise three, instead of the current two, integration levels: (1) the customs union, which would contain the current EU members, *plus* the candidates meeting the required conditions; (2) the single market, which would include the current EU members, *plus* some of the present candidates able and willing to conform to the relevant Community legislation; and (3) the monetary union, in which membership would remain subject to meeting convergence criteria.

There are two main advantages of this solution: it would put an end to trade discrimination in Europe; and it would allow the rapid enlargement of the EU, thereby removing political and economic uncertainty for the candidate countries. At the same time, the proposed scheme raises a host of difficult questions. What of nations such as Russia, Ukraine or the FR of Yugoslavia which may not meet the conditions for WTO membership for quite a while and would therefore remain excluded from PEFTA for several years? On the other hand, what would be implication of PEFTA for the Trans-Atlantic relationship if Russia were actually to join it? What would be the implication of PEFTA for other EU regional trading partners and for the multilateral trading system?

### **Extra-European EC regionalism**

Regional trade agreements between the EC and other European countries are parts of the European integration process. This is clearly demonstrated by the fact that 13 of the 20 European RTA partners of the EC are declared EU candidates. Hence, free trade agreements or customs unions involving the EC and other European countries should not be regarded as purely commercial arrangements, but rather as first steps towards deeper economic, and political, continental integration.

By contrast, regional trade agreements between the EC and extra-European countries tend to be more commercial in nature, although broader economic, or even political, considerations are often also present. Looking at the current, and likely future, partners of the EC in regional trade agreements, one can distinguish three types of situations.

The first concerns RTAs with Southern Mediterranean countries. Like NAFTA, these regional trade arrangements involve a large developed country and a neighbouring developing partner. A major purpose of such RTAs is to foster economic growth in developing countries by helping them to “lock in” their trade reforms and induce trade and investment flows from their large developed country partner. The latter’s motivation is partly commercial (i.e. preferential access to a growing market), but above all it is regional stability (and reduced migration pressure) that the developed

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<sup>19</sup> Enders and Wonnacott (1996) also propose the establishment of an all-Europe FTA.

country is seeking. The “lock in” strategy seems to have worked remarkably well in the case of Mexico, where trade and investment flows have skyrocketed since the implementation of NAFTA in early 1994.

At the moment, it is still unclear whether the EC/Mediterranean country RTAs will achieve similar results. In particular, there is some doubt as to whether the Southern Mediterranean countries have the same political will as Mexico to undertake major structural reforms. The fact that these countries certainly did not initiate the RTA negotiations with the same ambition as Mexico is clearly a matter of concern in this respect. Moreover, contrary to NAFTA, the reciprocal EC/Med RTAs are the successors to long-standing non-reciprocal RTAs. When Mexico launched the NAFTA initiative, its government was able to “sell” the project to its domestic constituency by (rightly) claiming that, in exchange for opening its market, the country would obtain free access to the large US and Canadian markets. By contrast, because Mediterranean countries have long enjoyed free access to the EC market under the old co-operation agreements, there is little that governments can now claim in exchange for opening up their markets to EC products. The only possible *quid-pro-quo*s are better access to the EC market for Mediterranean agricultural products or additional financial aid. Since the former is near-impossible, increasing financial aid is the viable option, and the one actually adopted in the new EC/Med agreements. Whether this creates a good environment for trying to bring about economic reforms and investment flows in the Mediterranean countries remains to be seen.

The second type of situation is exemplified by the EC/South Africa free trade agreement. Contrary to the EC/Med RTAs, this agreement is clearly not about regional stability, since South Africa is not a neighbouring country of the European Union. Rather, it is a purely commercial arrangement, that provides the EC with preferential access to the largest African market, in exchange for preferential access by South Africa to the vast EC market. In view of the relatively high protection of South Africa in industrial products<sup>20</sup>, the discrimination in favour of EU producers is likely to be viewed with great suspicion by third countries, especially developed ones, that compete with the EU in the South African market for these products.<sup>21</sup> Third countries have two options, if they suffer damages inflicted to them by the EC/South Africa FTA. One is to seek compensations under GATT Article XXIV:6, as is normally the case in such circumstances. The other option is to negotiate their own regional trade agreement with South Africa, an approach that could very well be embraced by the United States, the country’s second largest trading partner (far behind the EU), in order to restore a “level playing field” with the European Union. A US/South Africa free trade area could also be desirable from South Africa’s perspective, because it would reduce the potential trade diversion associated with the EC RTA, and help establishing a balance in its economic (and political) relations with the two world giants.

The last type of situation is the counterpart of the previous one. Here we have instances where countries have implemented regional trade agreements that discriminate against EU producers, and where the European Union is seeking to

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<sup>20</sup> In 1997, South Africa’s simple average most-favoured-nation (MFN) import tariff for industrial products was estimated at 15.6%, with a range of 0 to 72%. See WTO (1999b).

<sup>21</sup> Thanks to the South African Customs Union (SACU), this market comprises, in fact, Botswana, Lesotho, Namibia, and South Africa.

restore a “level playing field”. The prime example is Mexico, where access of EU products has doubly suffered: from discrimination in favour of NAFTA partners,<sup>22</sup> and from tariff increases against non-NAFTA countries following economic downturns in 1994 and 1998.<sup>23</sup> Mexico is also interested in a RTA with the EC, because this would reduce the potential trade diversion of NAFTA, and somewhat counter-balance its economic (and political) relation with its giant neighbour. The discussions about a possible RTA between the EU and MERCOSUR also derive, partly, from the fear of EU producers to be discriminated into an important market.<sup>24</sup>

## Conclusion

Leaving aside intra-European RTAs, which fit into a completely different logic than pure trading agreements, EC regionalism has recently taken a new direction: full-blooded regional trade arrangements with countries outside the European continent. As a result of parallel initiatives by the United States, the world trading system clearly finds itself, at the beginning of the new millennium, in a *terra incognita*.<sup>25</sup>

The EU and the US have both implemented regional trade agreements with neighbouring developing countries designed to “lock in” their economic reforms and foster regional stability: the Southern Mediterranean and Mexico, respectively. Both have also taken important steps towards preferential trading agreements with countries outside their vicinity, that offer important market potential: South Africa and Latin America<sup>26</sup>, respectively. At the same time, the EU is also considering establishing a series of regional trade agreements with its traditional African, Caribbean and Pacific partners, with a view to foster economic reforms, while also reinforcing traditional ties with potentially significant markets.

Hence, if the Free Trade Area of the Americas (FTAA) initiative and the idea of EC/ACP free trade areas are implemented, we could witness, by the end of the current decade, the emergence of two major ‘hegemon-centred’ trading blocs<sup>27</sup>: one, focused on a European Union of 25-plus members, encompassing most non-EU European countries (including, perhaps at some stage, countries like Russia and Ukraine), African countries from the North to the South of the continent, and some countries in

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<sup>22</sup> In 1999, EU exports faced an average duty of 8.7% to enter the Mexican market, with tariffs as high as 35% for some products. In contrast, the tariff paid by Mexico’s FTA partners was approaching zero, as tariff phaseout periods came to an end.

<sup>23</sup> See Krueger (1999). The problem derives from the fact that, in many developing or emerging economies, applied MFN tariff rates are far below MFN bound rates. This allows countries, like Mexico, that become members of free trade areas, to raise their external tariff protection, without having to compensate third countries.

<sup>24</sup> There is disagreement in the literature as to whether MERCOSUR has been detrimental to non-members. See Yeats (1998) and Nagarajan (1998) for opposite views.

<sup>25</sup> It is worth noting that, although the EU has far more partners in goods RTAs than the US (28 versus 3), the weight of RTA partners is the same for the EU and the US. In both instances, RTAs cover about 30% of international trade values.

<sup>26</sup> The Free Trade Area of the Americas (FTAA) initiative seeks to unite the economies of the Western Hemisphere into a single free trade arrangement. It was launched at the Summit of the Americas in 1994. The Heads of State of the 34 participating countries in the region agreed to complete negotiations by 2005.

<sup>27</sup> This concept is borrowed from Bhagwati and Panagariya (1996).

the Near East; the other, centred on the United States, comprising the entire American continent. The EU-centred bloc is, and would continue to be, a hub-and-spoke system of bilateral FTAs; by contrast, the US-centred bloc is, under NAFTA, and would continue to be under the FTAA, a single FTA. The crucial point is that both blocs are, and would remain, free trade areas rather than customs unions, which entail costly systems of origin rules.<sup>28</sup>

The two emerging trade blocs need not, but could, become closed, or even antagonists. On-going negotiations between members of the two entities suggest that the two blocs are likely to be relatively open to each other. Discussions to establish an EC/Mexico FTA, and perhaps EC/MERCOSUR and EC/Chile FTAs,<sup>29</sup> clearly indicate that neither the EU nor Latin American countries would fancy a closed FTAA. Similarly, efforts by the United States to establish closer economic ties with African countries,<sup>30</sup> indicate that the US is also keen to preserve its access to EC RTA partners. Hence, countries outside the two blocs are more likely to suffer from the current spread of regionalism than those inside, which explains why countries like Australia, Japan and Korea are the most active participants to the WTO discussions on the systemic implications of regional trade agreements for the multilateral trading system.

There is no doubt that regional trade agreements have greatly expanded in the past decade, nor that they will continue to grow in importance in the years ahead. Ethier (1998) has recently argued that the “new regionalism” - involving one or more small countries linking up with the EU or the US – reflects the success of multilateralism, not its failure. This optimistic view reflects the belief that the new regionalism helps the entry of small developing countries into the multilateral system. On the other hand, there are reasons to be concerned about the detrimental effects of RTAs on excluded countries. The best way to lay aside those worries would be to undertake an ambitious agenda of “global free trade in our time”. In the meantime, it is of the utmost importance that the European Union and the United States, the two “hegemons” of the system, agree to strengthen GATT/WTO rules on regional trade agreements, in order to minimise the discrimination they entail, and maximise their liberalisation potential.

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<sup>28</sup> Some authors have suggested discouraging, or even banning, FTAs, while allowing customs unions. While such a move might be desirable as a way to eliminate rules of origin, it seems hardly practical among countries that have no intention of surrendering sovereignty over trade policy.

<sup>29</sup> A Canada/Chile FTA has entered into force in July 1997.

<sup>30</sup> The second Clinton administration has appointed the first-ever Assistant US Trade Representative for Africa, who is in charge of co-ordinating negotiations of Trade and Investment Framework Agreements with countries in the region.

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Table 1  
Regional Trade Agreements (RTAs) Between the European Community (EC) and Third Countries  
in Force in January 1990 and in December 1999\*, and Planned for or Foreseeable in 2000

Type of RTA	Parties to EC Agreements			
	In force in January 1990	In force in December 1999	Planned for 2000	Foreseeable in 2000
Customs unions	Cyprus, Malta	Andorra, Cyprus, Malta, Turkey	Andorra, Cyprus, Malta, Turkey	Andorra
Free trade areas				
• In goods and services	None	Bulgaria, Czech R., Hungary, Iceland, Liechtenstein, Norway, Poland, Romania, Slovak R.	Bulgaria, Czech R., Estonia, Hungary, Iceland, Latvia, Liechtenstein, Lithuania, Norway, Poland, Romania, Slovak R., Slovenia	Faroe Is., Iceland, Liechtenstein, Norway, Switzerland
• In goods only	Austria, Finland, Iceland, <b>Israel</b> , Liechtenstein, Norway, Sweden, Switzerland	Estonia, Faroe Is., <b>Israel</b> , Latvia, Lithuania, Slovenia, Switzerland, <b>Tunisia</b>	Faroe Is., <b>Israel</b> , <b>Morocco</b> , <b>Palestinian Authority</b> , <b>South Africa</b> , Switzerland, <b>Tunisia</b>	<b>ACP countries</b> , <b>Algeria</b> , <b>Egypt</b> , <b>Israel</b> , <b>Jordan</b> , <b>Lebanon</b> , <b>Mexico</b> , <b>MERCOSUR</b> , <b>Morocco</b> , <b>Palestinian Authority</b> , <b>South Africa</b> , <b>Syria</b> , <b>Tunisia</b> ,...
Cooperation agreements (i.e. non-reciprocal free trade areas)	<b>Algeria</b> , <b>Egypt</b> , <b>Jordan</b> , <b>Lebanon</b> , <b>Morocco</b> , <b>Syria</b> , <b>Tunisia</b> , Turkey	<b>Algeria</b> , <b>Egypt</b> , <b>Jordan</b> , <b>Lebanon</b> , <b>Morocco</b> , <b>Syria</b>	<b>Algeria</b> , <b>Egypt</b> , <b>Jordan</b> , <b>Lebanon</b> , <b>Syria</b>	None

\*Agreements notified to GATT/WTO under GATT Article XXIV and GATS Article V.

Note: non-European countries are in **bold letters**.

Table 2  
Work Progress by the Committee on Regional Trade Agreements (CRTA) on  
WTO-Notified Agreements between the European Community and Third Parties

Regional Trade Agreement	Status in			
	1996	1997	1998	1999
EC/Czech R. FTA	Under examination	Under examination	Consultations on draft report	Consultations on draft report
EC/Hungary FTA	Under examination	Under examination	Consultations on draft report	Consultations on draft report
EC/Poland FTA	Under examination	Under examination	Consultations on draft report	Consultations on draft report
EC/Slovak R. FTA	Under examination	Under examination	Consultations on draft report	Consultations on draft report
EC/Bulgaria FTA	Under examination	Under examination	Consultations on draft report	Consultations on draft report
EC/Romania FTA	Under examination	Under examination	Consultations on draft report	Consultations on draft report
EC/Estonia FTA	Under examination	Under examination	Consultations on draft report	Consultations on draft report
EC/Latvia FTA	Under examination	Under examination	Consultations on draft report	Consultations on draft report
EC/Lithuania FTA	Under examination	Under examination	Consultations on draft report	Consultations on draft report
EC/Turkey CU	Under examination	Under examination	Under examination	Under examination
EC/Faroe Is. FTA		Under examination	Under examination	Under examination
EC/Hungary-Services		Under examination	Under examination	Consultations on draft report
EC/Poland-Services		Under examination	Under examination	Consultations on draft report
EC/Slovak R.-Services		Under examination	Under examination	Consultations on draft report
EC/Slovenia FTA			Under examination	Under examination
EC/Andorra CU				Under examination
EC/Tunisia FTA				Under examination
EC/Palestinian Authority FTA				Under examination

Source: Annual draft reports of the Committee on Regional Trade Agreements to the WTO's General Council.