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July 22, 1994

To: Members of the Executive Board

From: The Acting Secretary

Subject: Regional Trading Arrangements

The attached companion paper to the Comprehensive Trade Paper (SM/94/192, 7/19/94) provides a review of recent developments and issues in regional trading arrangements. It is proposed that this paper be discussed sometime after the Annual Meeting, on a date to be announced, unless Directors wish to discuss it along with the Comprehensive Trade Paper.

Ms. Kirmani (ext. 38721), Mr. Harmsen (ext. 38531), or Mr. Leidy (ext. 38435) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

Regional Trading Arrangements

Prepared by the Policy Development and Review Department
(In consultation with other departments)

Approved by Jack Boorman

July 15, 1994

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I. Introduction and Summary 1/

1. Introduction

Regional trading arrangements (RTAs) 2/ have become an increasingly important element of relations among Fund members. Executive Directors have frequently expressed their interest in following regional developments more closely. This paper reviews recent developments and issues in RTAs.

Given the very large number of existing RTAs, a detailed review of each one is beyond the scope of this paper. Rather, the paper provides an overview (Section II) highlighting the main developments in RTAs in different regions, factors contributing to their recent proliferation, and conceptual issues for evaluating RTAs. The overview is supported by the comprehensive catalog in Appendix I of existing RTAs, and by the examination in Appendices II-IX of selected agreements (the EU's trading relations with transition and Mediterranean economies, the Southern Cone Common Market (MERCOSUR), the Central African Customs and Economic Union (UDEAC), the Cross-Border Initiative (CBI), the ASEAN Free Trade Area (AFTA), the Asia-Pacific Economic Cooperation Forum (APEC), the Gulf Cooperation Council (GCC), and the Economic Cooperation Organization (ECO)). Sections III and IV cover the most prominent regional initiatives--EU and NAFTA, respectively.

2. Summary

Beyond the descriptive material on RTAs, this paper examines the compatibility of regional trading arrangements with multilateral liberalization. Below are the key conclusions of the paper, which Directors may wish to address in their interventions.

- Since the second half of the 1980s, some important new RTAs emerged, and many others were reactivated, in particular in Europe and the Western Hemisphere. The trend toward increased regional integration was due partly to frustration with slow progress in the Uruguay Round (UR), but mainly to factors beyond the Round. While the completion of the Round may lessen some of the impetus toward regionalism, indications are that interest is expected to remain strong in the future.

- As regionalism emerges as an integral part of the trading environment, it should not be allowed to divert attention from the fact that the first-best policy is most-favored-nation (MFN) liberalization, and the ultimate goal global free trade. Hence, it is important that regional

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1/ The principal authors of this paper are Mr. Harmsen, Mr. Leidy, Mr. Shiells, and Ms. Alonso i Terme.

2/ As used in this paper, the term "regional trading arrangements" need not imply geographic proximity of member countries.

initiatives be implemented in a manner that would harness them securely to the long run goal of multilateral liberalization and that RTAs develop as "building blocks" to such liberalization. The Fund's policy advice should be actively supportive of such an objective.

- RTAs are most likely to contribute to global trade liberalization and minimize trade diversion if they satisfy a number of conditions. These include coverage of all sectors (without exception), transparent rules of origin, liberal rules of accession, and strengthened disciplines on the use of antidumping action against third parties. Most importantly, MFN liberalization should precede or accompany new RTAs, especially in those cases where protection against non members is high. Deeper forms of integration (including, e.g., services trade) can enhance potential gains from efficient resource allocation within the bloc.

- Fortunately, many of the major regional initiatives in the recent past have been associated with outward-orientation, as evidenced by MFN liberalization that preceded or accompanied regional liberalization (in Latin America, for example).

- Measured by the scope of integration and the number of countries involved, the EU is the most advanced RTA; some of the forces behind its integration are unique and not easily replicated. In the manufactured goods sector, in the aggregate there has been substantial net trade creation as a result of European integration. Earlier concerns by trading partners of "Fortress Europe" as a result of the Single Market program have not materialized. Nonetheless, there continue to be pockets of discrimination within the manufacturing sector where trade diversion has affected specific sectors and countries, and the level of subsidies to the manufactured goods industry is high. In the agricultural sector trade diversion effects were clearly predominant as a result of the Common Agriculture Policy, with significant negative implications for welfare in the EU and third countries. Given the major impact of the EU on the world economy, and prospects for its further expansion, the Fund needs to continue to press for liberalization in areas still subject to significant protection.

- NAFTA is unique in that it attempts integration among economies at very different income levels. The potential for trade diversion in the aggregate as a result of NAFTA appears to be limited. However, there may well be more significant effects in selected sectors or individual countries, which need to be carefully monitored in the future. The Fund needs to encourage NAFTA members to pursue an open door policy that spreads the benefits of liberalization to a wider group of countries and eventually globally.

II. Overview of Recent Developments and Issues

1. Recent developments in RTAs

During the 1990s, some important new RTAs emerged, and many existing ones were reactivated (Appendix I). This sub-section describes the main developments.

Developments in Europe were numerous and rapid. Progressive implementation of the Single Market program aimed to provide an important stimulus to expansion of trade and growth within Europe (Section III). The EEA was formed between the EU and Austria, Finland, Iceland, Liechtenstein, Norway, and Sweden. 1/ Negotiations for the accession to the EU of Austria, Finland, Norway, and Sweden have been completed; they are expected to accede in 1995 if referenda are passed in these countries. The EU entered into association agreements with several central and east European countries, negotiated cooperation and partnership agreements with several Former Soviet Union (FSU) states, free trade agreements with the Baltics, a customs union with Turkey, and is in the process of negotiating agreements with some Mediterranean countries (Appendix II). Central and east European countries are negotiating similar agreements with the European Free Trade Association (EFTA); the Visegrad countries (Hungary, Poland, the Czech Republic, and the Slovak Republic) concluded a free trade agreement among themselves; and the Baltic states also did so. Hungary and Poland have applied for EU membership.

In the Western Hemisphere, too, the trend toward RTAs accelerated. In addition to NAFTA (Section III), a substantial number of new arrangements were formed, most notably the Southern Cone Common Market (MERCOSUR) (Appendix III), and existing regional integration schemes such as the Andean Pact and the Central American Common Market (CACM) were revived. Many of the new arrangements tended to be bilateral, in most cases taking the form of free trade agreements (FTA), and were typically formed by countries already in one or more RTA. 2/ A number of countries (Colombia and Venezuela, for instance) recently formed trade partnerships with several other countries. Additional agreements are under negotiation (e.g., the Group of 3 FTA among Colombia, Mexico, and Venezuela; a Caribbean Community (CARICOM)-Colombia FTA; and a CARICOM-Venezuela FTA). A number of countries

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1/ Parties to the agreement will have virtually complete access to each other's markets for manufactured goods, services, capital, and labor. Also, non-EU parties accept all the existing EU rules and legislation (except those pertaining to the Common Agricultural Policy and the Common Fisheries Policy) and make certain financial contributions.

2/ New arrangements include the Mexico-Chile FTA (1991), Chile-Venezuela FTA (1993), Chile-Colombia FTA (1993), Colombia-Venezuela FTA (1992), El Salvador-Guatemala FTA (1991), MERCOSUR (1991), Mexico-Central America FTA (1992), Nueva Octepeque FTA (1992); Mexico-Costa Rica FTA(1994). These are listed in Appendix I.

in Latin America have expressed interest in acceding to the NAFTA, including notably Chile. Within the set of existing arrangements recently revitalized, the Andean Pact and the CACM agreed on a common external tariff, and the CARICOM became more active.

While there was not much change in the status of the many long-standing RTAs in Africa, there were some new developments toward greater integration. With the recent devaluation of the CFA franc, the Central African Customs and Economic Union (UDEAC--see Appendix IV) moved forward on a number of fronts, including implementation of a common external tariff, replacement of quantitative restrictions (QRs) with tariffs, and phased elimination of intra-UDEAC duties. In eastern and southern Africa, there is a new CBI (Appendix V), sponsored by the World Bank, the European Commission, the African Development Bank, and the Fund (SM/94/91, April 8, 1994). The CBI is intended as a pragmatic step toward economic integration in the sub-region, including cross-border trade, investment, payments and exchange systems, and institutional development.

Economic integration in East Asia principally reflected private market forces; institutional arrangements tended to play more of a supporting than a leading role. Recent developments include the establishment of AFTA (Appendix VI), and increased activity within the Asia-Pacific Economic Cooperation (APEC) forum (Appendix VII). Elsewhere in Asia, a decision was reached in 1992 to draft a preferential trading arrangement for the South Asian Association for Regional Cooperation (SAARC) with the recommendation that all formalities for operationalizing this arrangement, including the finalization of schedules of concessions, be completed before 1995. 1/

There was also increased interest in regional initiatives in the Middle East, although the scope for gains from further intra-regional trade is limited by the orientation of the countries toward exports of natural resources. The Gulf Cooperation Council (GCC) liberalized movements of capital and labor, worked toward establishing a common external tariff, and held discussions with the EU concerning the possibility of an economic cooperation agreement (Appendix VIII). Ambitious plans for integration within the Arab Common Market (ACM) and the Arab Maghreb Union (AMU), both established in the 1960s, remained largely unimplemented. The Economic Cooperation Organization (ECO) made efforts to improve cooperation, and recently added as members a number of states of the former Soviet Union (Appendix IX).

2. The impetus for regionalism

Regional trading arrangements are pursued for a variety of reasons which may differ across arrangements and across participating countries within a given RTA. While it is not always possible to identify a single

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1/ The contracting states include Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka.

overriding motivation underlying a RTA, several factors seem to have played significant roles in regional initiatives of the 1990s. This sub-section reviews the principal factors contributing to the increase in RTAs.

a. The economic effects of regionalism

The growth-related aspects of regional integration (particularly the opportunity to exploit scale economies, regional specialization and learning-by-doing as well as attracting investment by expanding the regional market) is a motivation that is present in virtually all RTAs, between both industrial and developing countries. The realization of scale effects was a major consideration underlying the Single Market program in the EU. In Africa, possibly the most important reason for regional integration is the belief that individual economies need to overcome the barriers of small size and poor human and physical capital endowments which limit economic growth (Foroutan, 1992, for example, identifies this consideration as the key factor underlying regional integration in sub-Saharan Africa 1/). It is also an explicit goal of AFTA and MERCOSUR to exploit scale economies, deepen the division of labor across the region, and attract foreign direct investment (FDI) by presenting the region as a stable and prosperous single market (USITC, 1993b; Cárdenas, 1992). The dynamic growth effects expected by Mexico, especially the anticipated surge in FDI, were also a key motivation for Mexican interest in NAFTA (Ramirez de la O, 1993, Hufbauer and Schott, 1993).

b. Non-economic objectives

Regional initiatives may be viewed as a means to promote a broad range of non-economic objectives, from enhancing regional political cohesion to various foreign policy considerations such as managing immigration flows and promoting regional security. The formation of the EU has strong political roots, as did the formation of ASEAN. MERCOSUR is perceived as a means of fostering cooperation between its member states. 2/ In Africa and the Middle East, RTAs have been motivated by similar cooperative impulses. 3/ The promotion of political and economic stabilization and control of

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1/ Throughout this paper, references to sub-Saharan Africa do not include South Africa.

2/ Cárdenas (1992) views the non-economic goal of strengthening political relations among the members of MERCOSUR as very important in motivating the RTA.

3/ See, for instance, Foroutan's description of the importance of cultural ties and institutions dating back to colonial times in influencing the shape of regionalism in sub Saharan Africa, the political considerations in Nigeria leading to ECOWAS, or the non-economic goal of SADC members of lessening dependence on South Africa (Foroutan, 1992). Regarding the Middle East, see Fischer (1992).

immigration flows were also important elements underlying both NAFTA and the association agreements of the EU with east European countries. 1/

c. Uruguay Round-related reasons

The Uruguay Round (UR) played an important role in fostering interest in RTAs. Regionalism was sometimes perceived as an alternative to multilateral trade liberalization under the Uruguay Round in view of its slow progress. In other cases it reflected a desire to strengthen negotiating positions in the Round and in the international trading system as a whole. One or both of these elements were present in the formation of RTAs in North America, South East Asia, and most of Latin American RTAs. 2/

d. Regional "safe havens"

Regional initiatives at times have been viewed as an instrument to pre-empt future restrictions on market access--access that appeared not to be sufficiently guaranteed by emerging developments in the Round--and to help create a more stable and predictable trading environment. Smaller nations may seek such safe-haven trade arrangements with larger countries when future market access appears uncertain (Srinivasan, Whalley, and Wooten, 1993). This seems to have been a key element in CUSFTA, NAFTA and MERCOSUR as well as an important motivation in the interest of some EFTA countries (most notably Sweden) in joining the EEA (Hindley and Messerlin 1993) and the EU. In North America, Mexico was partially motivated by fear of changes in U.S. trade policy toward a more "managed" or "strategic" trade orientation (Nogués and Quintanilla, 1992). Canada's pursuit of the CUSFTA was significantly motivated by a desire to discipline the use of antidumping and countervail in the United States (Wonnacott, 1987, Schott, 1988 and Hart, 1989), and this issue arose again in the context of NAFTA.

e. Locking in domestic policy reforms

RTAs have been perceived as enhancing the prospects for sustaining domestic policy reforms, including unilateral trade liberalization, as well as fostering an environment conducive to the maintenance of macroeconomic

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1/ Hufbauer and Schott (1993) emphasize the US foreign policy dimension of NAFTA, according to which it serves the key US policy objective of enhancing the prosperity and stability of its neighbor to the South.

2/ For the impact of the lack of progress on the UR in Latin American RTAs, see Lustig and Braga (1994); on South East Asia, see de la Torre and Kelly (1992).

stabilization, in particular in developing and transition countries. 1/ This view suggests that a RTA may complement and solidify domestic policy shifts toward privatization and market-oriented reform (World Bank, 1994). East European countries view their association agreements with the EU as very important in enhancing and cementing their economic reforms. "Locking in" domestic reforms was also a motivation of considerable importance in many Latin American initiatives. MERCOSUR is viewed by Argentina as complementing domestic deregulation, and in Paraguay it has supported market-based policy reform and trade liberalization. Recent attempts to revive the Andean Pact and CACM are seen by member countries as an attempt to capture and lock in the outward orientation of the economic reforms initiated by individual countries during the past decade (Nogués and Quintanilla, 1992). NAFTA was particularly attractive to the United States as a means of accelerating and encouraging domestic policy reforms in Mexico. In Asia, the AFTA initiative was motivated in part by a desire to lock in the unilateral domestic liberalization programs pursued during the 1980s.

f. Demonstration effect

The widespread perception that European integration has produced significant economic benefits has had an important impact on the impetus for regionalism. The EU is often viewed as an example of how regional integration can lead to enhanced internal competition, scale economies, and technological advancement, while also establishing a framework for successful macroeconomic coordination in the region. The demonstration effect of European integration is perhaps clearest as a motivation for the expansion of the EU itself. The most important single factor in the increase in petitions for accession to the EU by EFTA and, even more, east European and southern Mediterranean countries is the economic success of the EU.

g. The domino effect 2/

As new RTAs form, or existing RTAs expand or deepen, the opportunity cost of remaining outside a RTA rises. Nonmember exporters could experience costly reductions in market shares if trade is diverted to members. This may be sufficient in some nonmember states to tip the political balance in favor of accession, as exporting interests begin to dominate import-competing interests. In turn, as new members join the RTA, trade diversion from other outsiders may lead to a second round of accessions. The "domino

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1/ Up to the late 1980s, developing countries tended to be less successful in implementing agreed RTAs than industrial countries were. For a detailed discussion of the reasons, see de la Torre and Kelly (1992). One might expect an improvement in the implementation record of RTAs among developing countries in the 1990s as many of them have more vigorously pursued market-based reforms and macroeconomic stabilization.

2/ See Baldwin (1993).

effect," or the anticipation of such, appears to have been prominent, for example, in the initiative of EFTA countries to apply for accession to the EU. East European countries were similarly interested in improving access to west European markets and in not being left out of the emerging Single Market.

The negotiations between Mexico and the United States to form a FTA may have started a comparable process in the western hemisphere. Canada's interest in NAFTA was strongly influenced by the potential erosion of the benefits expected from the CUSFTA were it not to join the newly emerging NAFTA. 1/ In a similar vein, the large number of bilateral trade arrangements between Mexico and several Latin American countries is viewed by Mexico's partners as a first step toward joining NAFTA (Lustig and Braga, 1994). Access to NAFTA has become an important objective of many Latin American countries as a way to correct the expected trade and investment diversion toward Mexico. Finally, Paraguay and Uruguay's interest in MERCOSUR was significantly motivated by their desire to prevent diversion of trade to Argentina and Brazil (Nogués and Quintanilla, 1992).

h. Infant industry regionalism

Sometimes support for regionalism is related to a regional infant industry argument. RTAs have often been pursued as a strategy to broaden and deepen domestic regional markets as a precursor to exposing regional industries to the full rigors of extra-regional competition. Liberalization at the regional level combined with a protectionist commercial policy toward third countries could, in this view, prepare regional industries eventually to compete beyond the RTA. This conception was behind most Latin American and Sub-Saharan African RTAs during the 1960s and 1970s, and was a regional manifestation of import substitution industrialization strategies pursued at the national level. 2/ It is noteworthy that those arrangements which in the past were most influenced by this perspective were also the least successful in expanding trade and fostering economic growth. 3/ The regionalism of the 1990s is far less influenced by regional infant industry arguments, although there are still remnants of this argument (for example, in Brazil's call for high tariffs for capital and high-technology goods in MERCOSUR).

1/ For a detailed analysis of the different national objectives for NAFTA, see Hufbauer and Schott (1992).

2/ For the link between import-substitution development strategies and early Latin American RTAs, see Cárdenas (1992) and Nogués and Quintanilla (1992).

3/ Notably the Andean Pact and most RTAs in sub-Saharan Africa.

3. Effects of increased regionalism

a. Conceptual framework

Unlike the strong case for unilateral and multilateral trade liberalization, economic theory offers neither unqualified support nor unqualified opposition to regional trading arrangements, whether free trade areas, customs unions, or deeper forms of economic integration (see Box 1 for definitions of various types of regional arrangements). The fact that many of the arrangements identified above fail in significant ways to satisfy textbook definitions of FTAs or customs unions adds to the difficulty in reaching definitive conclusions on a case-by-case basis. Theory does, however, offer several general guidelines for assessing the welfare implications of such arrangements.

This sub-section covers economic effects of RTAs and their compatibility with the multilateral trading system (see Box 2 on Article XXIV of GATT/WTO). It enumerates the principles characterizing desirable RTAs. Finally, it reviews trends in regional trade flows.

(1) Static effects 1/

Viner's (1950) distinction between trade diversion and trade creation delineated the static trade-offs implied by preferential moves toward free trade. The tendency of regional trading arrangements to induce a shift from less efficient to more efficient producers within the RTA (trade creation), together with opportunities to exploit economies of scale, imply a regional expansion in real national income, other things equal. However, the tendency of RTAs also to induce some substitution of relatively inefficient regional suppliers for relatively efficient suppliers in nonmember countries (trade diversion) tends to reduce regional national income, other things equal (see Box 3 for numerical examples). The real income of the regional grouping, therefore, tends to rise when trade creation dominates trade diversion. 2/

The incentives for trade diversion are minimized when the RTAs external barriers were relatively low. Alternatively, relatively high MFN tariffs generally set up greater pressure for trade diversion. Regional groupings between countries that are already major trading partners (and have

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1/ The static and dynamic effects of RTAs are discussed at greater length in de la Torre and Kelly (1992).

2/ The income-reducing effect of trade diversion need not occur when changes in relative prices and the resulting substitution effects in consumption enter the analysis (Lipsey, 1960). Basically, because the pre-union MFN tariff distorts both production and consumption, by focusing on the production effects alone, Viner neglected the possibility that eliminating the price distortion within the union might improve welfare through adjustments in consumption patterns.

Box 1. Types of Regional Trading Arrangements

Free Trade Area

In principle, a free trade area (FTA) entails the full elimination of tariff and nontariff trade barriers between the partner countries, while each partner's trade barriers with third countries are left intact. Rules of origin establish conditions under which an item qualifies for preferential access within the FTA. Some FTAs have recently included provisions to liberalize investment rules, services trade, government procurement, and other steps to achieve greater economic integration. Typically, provisions for factor mobility are not included, except perhaps in the context of facilitating services trade. The GATT's Article XXIV (see Box 2) defines an FTA as an arrangement that eliminates duties and other restrictions on "substantially all the trade" between members. In practice, however, arrangements that are referred to as FTAs typically include a number of sectoral exceptions in which intra-regional trade barriers remain in place (for example, in sensitive sectors such as agriculture, textiles and clothing). Further, FTAs typically include provisions for contingent protection through, for example, one or more safeguards clauses and the maintenance of antidumping provisions.

Customs Union

A customs union is an FTA that also adopts a common external tariff against third countries. GATT's Article XXIV defines a customs union essentially as an FTA that applies "substantially the same duties and other regulations of commerce" to trade with countries not included in the union. It also requires that duties and other regulations of commerce applicable to non-members "shall not on the whole be higher or more restrictive than the general incidence of these prior to the formation of the union."

Common Market

A common market is a customs union with provisions to liberalize regional factor movements.

Economic Union

An economic union is a common market with provisions for the harmonization of certain economic policies, particularly macroeconomic and regulatory policies. It is sometimes argued that the practical distinction between a common market and an economic union will disappear over time since factor mobility within a common market will create pressures for a high degree of policy harmonization (OECD, 1993, p. 23).

Box 2. Regional Arrangements under the GATT and the WTO

Article I (General Most-Favored-Nation Treatment) of the GATT requires contracting parties not to treat the trade of any country more favorably than that of any other contracting party. In other words, improved conditions of market access granted to one must also be made available unconditionally to all. A principal exception to non-discrimination is embodied in GATT Article XXIV (Customs Unions and Free Trade Areas), which explicitly sanctions the formation of FTAs and customs unions. Preferences in the context of customs unions or FTAs, or "interim arrangements" leading to these, may be granted as long as barriers are eliminated on "substantially all" trade in goods between members, and provided extra-regional trade barriers are not raised.

In practice, the disciplines intended to limit regional trading arrangements to bona fide FTAs and customs unions have not materialized (see, for example, the discussions in Jackson (1969, chapter 24) and Bhagwati (1991, pp. 66-69). At times, this has been due to the granting of waivers (Jackson, 1969), but more often it has occurred because regional arrangements are notified to the GATT as interim agreements with a significant transition period before the formation of an FTA or customs union. GATT Article XXIV was imprecise in the language governing interim agreements, saying only that they must lead to the formation of an FTA or customs union "within a reasonable length of time."

The Uruguay Round Understanding on the Interpretation of Article XXIV provides for clarification. First, the "reasonable length of time" for the completion of transitional arrangements is not to exceed 10 years, except under exceptional circumstances. Second, any notification of a new or enlarged regional arrangement shall be examined by a working party, and the working party will submit a report to the Council for Trade in Goods which will make subsequent recommendations to the WTO. Further, in the case of interim arrangements, the working party may make recommendations concerning the timeframe and measures required to complete the transition to a customs union or FTA. This reaffirms, and appears to strengthen, the previous notification and review commitments under GATT. Third, the Understanding includes explicit reference to the applicability of the WTO dispute-settlement procedures to any matters arising from the application of Article XXIV. Finally, the Understanding also clarifies the technical procedures appropriate to an assessment of the stance of a customs union's external trade barriers.

The Uruguay Round Understanding on Article XXIV does not significantly alter the multilateral rules governing the formation of regional trading arrangements. Nevertheless, it may lead to greater attention to the intent of Article XXIV--which is to limit regional trading arrangements to bona fide FTAs and customs unions--through enhanced oversight and tighter enforcement.

Box 3. Static Trade Diversion and Trade Creation: Simple Numerical Examples

The distinction between trade diversion and trade creation in the formation of a customs union or other preferential trading agreements can be illustrated with the help of several numerical examples in the Ricardian tradition. 1/

Opportunity Cost (at existing exchange rates) of a Single Commodity (X) in Three Countries

Country	A	B	World
Opportunity cost	35	26	20

Case 1 (High MFN Tariffs). Suppose countries A and B both have a MFN tariff of 50 percent. Before the formation of the CU, country A would be importing from the world market--the least-cost source--while country B would source domestically. With the formation of the CU, country A's imports of X would be shifted from the world market to producers in country B. Production would expand in B but contract in the rest of the world (ROW). Country A had been sourcing from the world market at an opportunity cost of 20 and following the formation of the union it sources at 26 per unit. This is a case of trade diversion and national income is reduced both within the union and in ROW. The problem of trade diversion illustrated here is due to the relatively high MFN tariff. 2/

Case 2 (Low MFN Tariffs). A sufficiently low MFN tariff would have eliminated this effect. Suppose, for example, the MFN tariff is 10 percent in both countries A and B. Both countries would import commodity X from the world market before and after integration. Thus the MFN tariff in this case was sufficiently low to avoid the trade diversion of Case 2.

Case 3 (Low and High MFN Tariffs). Consider the case in which MFN tariffs are quite different between the parties to a preferential trading agreement. Suppose that the pre-integration MFN tariffs are 10 percent and

1/ This discussion draws on Lipsey (1960).

2/ If a country's MFN tariff structure is prohibitively high, so that the country is in virtual autarky, preferential liberalization would, of course, improve resource allocation without diverting any trade, simply because there is no trade to divert. But this extreme case is of no practical interest since it is difficult to identify any single country, let alone several, that are sufficiently close to autarky to make this theoretical possibility relevant.

40 percent in A and B respectively. In this case, before integration, country A imports commodity X from the world market, but country B sources commodity X domestically. If a customs union is formed, and the lower tariff is adopted by the union, trade is created between country B and ROW. In this case, of course, it is the MFN liberalization in country B that produces the positive outcome. This example points to the simple observation that customs unions that adopt the tariff structure of the most liberal member create additional pressures for trade creation, other things equal, due to the implied MFN liberalization.

This one-commodity, constant-cost example yields certain elementary propositions about the trade-diversionary effects of customs unions that apply more generally. First, countries with high trade barriers that are nevertheless integrated into the world economy (Case 1) stand to divert more trade than otherwise due to the extreme nature of the post-union preferences. Second, (Case 2) countries with low MFN tariffs stand to *divert less trade than otherwise due to the relatively minor* nature *of post-*union preferences. To the extent that these countries are also natural trading partners and were thus trading substantially with each other before the union, the preferential trading arrangement would also create more trade than otherwise. Third, a customs union that adopts the least restrictive tariff structure of the member countries (Case 3) is likely to create trade with the rest of the world because of the associated MFN trade liberalization.

relatively open trade regimes) suggest less pressure for trade diversion, and a greater opportunity for trade creation. This is because, before regional preferences are introduced, trade flows are generally consistent with least-cost sourcing. If prospective union partners are trading heavily with each other, it is because each offers the other the least-cost source for a large set of goods. Thus the likelihood is reduced that a large number of items will be diverted from least-cost suppliers outside the union to higher cost suppliers within the union. In the case of the Canada-U.S. Free Trade Agreement, for example, MFN tariffs were already quite low in both countries, suggesting that pressures for trade diversion were minimal. Further, each had long-established close trading ties and were natural trading partners, also indicating less pressure for trade diversion, while opportunities for trade creation--although limited by the already low tariffs--were also greater than otherwise.

As a regional grouping moves from minimal trade preferences toward regional free trade, there is a tendency for the incremental regional gains from trade creation to decline while the likelihood of trade diversion increases (Meade, 1955). While this appears to call into question the economic rationale for GATT Article XXIV, which requires regional trading arrangements to liberalize "substantially all" trade (see Box 2), this requirement is compatible with the long-term goal of full multilateral liberalization, and helps to preclude the kinds of partial preferential trading schemes that prevailed throughout the 1930s.

An important proposition helped to clarify the potential welfare effects of customs unions. Kemp and Wan (1976) showed that it is always possible to select a common external tariff so that the formation of a customs union will have no adverse effect on nonmembers while improving the welfare of members. While Kemp and Wan supplied the theoretical proof that these Pareto superior 1/ customs unions could be devised, there is no reason to believe that actual customs unions are devised so as to satisfy the Kemp-Wan criteria. Nevertheless, the insight of Kemp-Wan might be used to assess welfare effects of actual RTAs by looking at indicators of the volume of extra-regional trade (McMillan, 1993). In a static sense, if the volume of imports into a RTA is at least as great as the net volume imported prior to the regional grouping, this suggests that the Kemp-Wan criteria have been met and that the grouping is welfare improving (see below). 2/

(2) Other Effects

Trade liberalization may also give rise to effects which may produce a sustained increase in economic growth through information transfers,

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1/ A Pareto superior policy change is one that leaves at least one party better off without making anyone worse off.

2/ Of course, McMillan's approach fails to capture what extra-regional trade might have been in the absence of regional integration. It must thus be regarded as a rough rule of thumb.

increased competition, accelerated technological change, and the perception of improved investment opportunities. 1/ These spillover effects are occasionally cited among the reasons for pursuing RTAs (see above). To the extent that a RTA stimulates regional growth, this may offset static trade diversion effects and produce an expansion of trade both inside and outside the arrangement. There is, however, the additional risk for outsiders that improved investment opportunities, combined with restrictive and/or nontransparent rules of origin, 2/ may divert direct investment flows from nonmembers. This effect is likely to be less significant from a worldwide perspective when a regional grouping maintains relatively low MFN tariffs, or the grouping is economically small. Further, the stronger the conviction that multilateral trade liberalization will proceed apace, the less the incentive to alter longer-term investment plans in response to current regional trading arrangements.

(3) Regional arrangements and the multilateral trading system

Apart from the above conceptual issues, an assessment of the welfare effects of regional arrangements must also consider possible policy linkages to the process of multilateral trade liberalization. Are regional trading arrangements likely to be "building blocks" or "stumbling blocks" to the

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1/ Recently, a number of theorists (see, for example, Helpman and Krugman, 1985) have integrated elements of monopolistic competition under increasing returns into trade theory. In this "new" trade theory the positive effects of trade liberalization are even more pronounced as free trade leads to greater variety of products, increased competition and lower costs, in addition to the gains from specialization. The welfare implications of imperfect competition and increasing returns for RTAs are not clear-cut. This remains an area of ongoing research.

2/ Rules of origin establish the conditions under which a product will be eligible for preferential access within a FTA or customs union. An item must establish origin within the region in order to qualify for preferential treatment. In the case of a FTA, in which members maintain separate external tariffs and NTBs, rules of origin are used to prevent the deflection of trade through the point of least resistance; i.e., the least protected market. Highly liberal, or unrestrictive, rules of origin tend to transmit some of the benefits of internal liberalization to nonmembers by effectively granting them access to each country in the union under the terms existing in the least protective member country. Strict, or nontransparent, rules of origin may confer protection on certain processing industries by making it more difficult/costly for processed goods within the union to establish local origin. When rules of origin are applied so as to increase the local demand for some inputs, this may end up taxing certain downstream industries by diverting demand to less efficient regional suppliers.

multilateral trading system? 1/ During the Uruguay Round discussion there was concern in some official and academic circles that preoccupation with regional initiatives might divert attention from the multilateral trade negotiations. There was also concern that if the UR discussions did not succeed, regionalism might prove to be inward looking and thus antithetical to the multilateral trading system.

If properly conceived and implemented, RTAs can be supportive of the goal of multilateral liberalization. Blackhurst and Henderson (1993) argue that RTAs are neither inherently destructive of, nor inherently favorable to such a goal. They point out that RTAs involve a liberalizing process, and unless they are combined with protectionist elements or clearly disregard multilateral rules set out under GATT Article XXIV, they contribute to the long-run goal of global free trade. They recall that concerns over the rise of regionalism are not new, and figured prominently also in several earlier rounds of multilateral trade negotiation (also see Preeg, 1970).

Bhagwati (1992, 1993) generally agrees, but warns that certain measures are needed in order to secure a complementary relationship between regional initiatives and the multilateral trading system. Bhagwati expresses concern that countries may attempt to present regionalism as an alternative to multilateralism in order to attempt to strengthen future negotiating positions. Also, the current rise of regionalism may gain further strength because the United States, previously a strong countervailing voice against regionalism, is now a major advocate. Together, these factors risk reinforcing the mistaken belief that multilateralism and regionalism are always antithetical, even those RTAs sanctioned under Article XXIV, which could lead to inward looking policies. In this view, "confidence-building" measures are called for--e.g., pronouncements by the major players and institutions that regionalism and GATT/World Trade Organization (WTO) can be fully compatible--and institutional reforms are desirable in order to firmly harness new regional initiatives to the goals of multilateralism. 2/

Another concern that has been raised is that enhanced competition within RTAs may induce increased resort to antidumping actions toward firms outside the arrangement (Bhagwati, 1993). This endogenous use of antidumping actions might lead to considerably more trade diversion than otherwise. Hindley and Messerlin (1993), using the example of the EU, offer

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1/ Bhagwati (1991, p.77) first suggested this language. See also Lawrence (1991) and Bhagwati (1993) for a detailed discussion of the possible linkages between regionalism and multilateralism.

2/ Bhagwati (1991, p.77-79) has recommended that Article XXIV of the GATT be modified so that: (i) any countries seeking to form a FTA (or join an established FTA) should be required to simultaneously reduce their MFN tariffs, or, in the case of customs unions, the lowest MFN tariff prevailing among members on each item should be adopted as the common external tariff of the union; and (ii) it builds in a commitment that such RTAs be open to the acceptance of new members.

casual empirical support for this proposition and call for a strengthening of multilateral rules in this area.

Krugman (1993) has pointed out that as a trading bloc increases in economic size, there may be an incentive to increase external tariffs in order to exploit expanding market power, thereby improving its terms of trade. If this were so, the formation of regional trading blocs would appear to threaten the goals of multilateralism. 1/ But this observation may not reflect how trade policies are actually formed (as Krugman acknowledges). It ignores the existence of multilateral rules--including GATT tariff bindings and GATT Article XXIV restrictions--that constrain such choices. Moreover, successful efforts toward multilateral cooperation have repeatedly taken place over past decades, and governments rarely act according to unidimensional motives (such as achieving optimal tariffs). Krugman's observation does, however, reinforce the significance of strict adherence to the multilateral rules governing the formation of RTAs if regionalism is to complement multilateralism.

(4) Principles for assessing RTAs

Two fundamental points are suggested by the above discussion. First, the best RTAs are those that divert the least trade and create the most. Minimizing trade diversion is beneficial for both members and nonmembers. It also avoids introducing friction into the multilateral trading system. This suggests that, particularly in those cases where the problem of trade diversion would be more pronounced (e.g., among countries with relatively high MFN tariffs), MFN tariffs should be reduced as preferential tariffs proceed toward zero. 2/ Second, adhering to a strict interpretation of GATT Article XXIV should be regarded as essential if RTAs are to be complementary to the multilateral trading system. Indeed, surpassing the conditions of GATT Article XXIV would more securely harness the impetus toward regionalism to the goal of multilateral trade liberalization.

1/ Krugman's (1991, 1993) theoretical model suggests the best outcome in terms of world welfare occurs when there are either very few or very many trading blocs. He points out that the intuition is that with very few trading blocs (particularly one) one moves toward free trade; with many such blocs, there is an incentive to set low external tariffs (because each has limited market power).

2/ The fact that trade taxes are a prominent source of revenue in many developing countries need not conflict with this prescription. Regional arrangements are typically negotiated over an extended period of time and implementation of these agreements also typically proceeds over more than five years. This provides an ample window of opportunity during which offsetting nondiscriminatory revenue measures could be developed and implemented--preferably a broad-based value-added tax--thus assuring revenue neutrality. Nonetheless, there is a risk that temporary fiscal problems may induce tariff increases that may fall on non-members, given the requirements of an RTA.

These principles suggest general guidelines that characterize aspects of preferred RTAs. 1/ These guidelines go beyond the obligations set out in GATT Article XXIV: 2/

- RTAs should cover all sectors without exception. 3/

- The transitional phase should not be overly long (preferably less than the maximum period of 10 years set out in the Uruguay Round agreement), and should include well-defined liberalization schedules at the sectoral level.

- MFN liberalization should precede or accompany every new FTA. This is particularly important when MFN tariffs are initially high.

- Customs Unions in setting their common external tariff should strive for adopting either the tariff code of the least restrictive member *in its entirety (as is contemplated, for example, in Africa's* CBI), or--a more demanding standard--the lowest prevailing MFN tariff among members for each product (Bhagwati, 1991).

- RTAs should include liberal rules of accession so that regional liberalization can spread to new members (Bhagwati, 1991). 4/

- Rules of origin should be designed with a high degree of transparency and minimal scope for influence by protectionist interests within the union (Krueger, 1993).

- Deeper forms of integration, other things equal, are preferred since the potential gains from efficient resource allocation within the bloc are maximized; deeper forms of integration would include liberalization also of services trade, investment, some regulatory coordination and harmonization (without rejecting the legitimacy of regional diversity in, for example, areas such as labor standards,

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1/ These guidelines do not imply encouragement of discriminatory exchange arrangements that are inconsistent with the Fund Articles of Agreement.
2/ These points draw on Bhagwati (1991 and 1993), Blackhurst and Henderson (1993), and World Bank (1994).
3/ If a government can credibly precommit to pursuing a RTA without sectoral exceptions, it can avoid both the costs of rent seeking and the patchwork of special exceptions that would otherwise accompany a final agreement.
4/ This condition may also help to lessen possible trade friction by giving outsiders, including especially those hurt by trade diversion, the option to accede.

environmental protection, and tax policy), and liberalization of factor flows including labor. 1/

- The use of antidumping laws should no longer apply among members of RTAs (as occurred, for example, in the Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA) and the EU, and has been sought by Canada in the Canada-US Free Trade Area (CUSFTA) and NAFTA), and disciplines should be strengthened on use of antidumping against countries outside the RTA (Bhagwati, 1993 and Hindley and Messerlin, (1993).

b. Intra- and extra-regional trade flows

Whether or not a given RTA leaves participants better off while leaving others no worse off, is essentially an empirical matter that could be investigated on a case-by-case basis. Although there are many empirical studies of the costs and benefits of various regional arrangements for members, few studies attempt the more difficult task of assessing the effects on countries excluded from the arrangement, or on the world trading system as a whole. An indication of the overall economic effects of the trend toward regional arrangements can be drawn from developments in intra- and extra-regional trade shares. Such indices are an imperfect measure of the effects of RTAs, because intra- and extra-regional trade flows evolve also in response to other factors such as changes in comparative advantage, technology, multilateral liberalization, relative prices, regional economic size and diversity, and various non-economic events unrelated to regional trading arrangements. Nevertheless, these descriptive statistics offer a broad indication of whether RTAs are associated with greater regional concentration in trade flows (Box 4). Tables 1-3 are based on World Bank and GATT sources: Table 1 presents extra-regional trade as a share of GDP for selected RTAs, and Tables 2 and 3 provide trends in intra-regional and extra-regional trade-to-GDP ratios for geographic regions. Box 4 discusses these regional trade developments. The general conclusion is that the increased emphasis on regional trading arrangements has not apparently occurred at the expense of ongoing integration between regions. This implies that thus far the trend toward regionalism appears to have been broadly compatible with the goal of deeper multilateral economic integration.

1/ It is noteworthy that deeper forms of integration are subject to the same caveats as preferential tariff cuts more generally. That is, deeper integration is both trade creating and trade diverting.

Box 4. Intra- and Extra-Regional Trade Developments

In western Europe intra-regional trade as a percentage of GDP has grown steadily, increasing from 14.8 percent in 1948 to 33.0 percent in 1990 (Table 2). Extra-regional trade as a percentage of GDP fell between 1948 and 1963, but has been roughly constant since then at about 13 percent. In the EU in particular, extra-regional imports as a share of GDP have stayed at around 9 percent since 1970 (Table 1). Thus, notwithstanding increasing integration, EU imports from third countries have generally kept pace with the growth in GDP. Eastern Europe and the FSU's intra-regional trade as a share of GDP expanded quickly between 1948 and 1968 (due partly to the creation of the CMEA), but it has been falling since then. Extra-regional trade as a share of GDP had fallen to 9.7 percent by 1958 (Table 3), but has been on an upward trend since then.

In the NAFTA region, intra- and extra-regional trade have increased. Extra-regional imports as a share of the region's GDP have grown from 2.9 percent in 1970 to 7 percent in 1992 (Table 1). Both intra- and extra-North American regional trade as a share of GDP were considerably greater in 1990 than they had been in 1948 (Tables 2 and 3). In contrast, Latin American regional trade shares fluctuated, but there was a trend toward decline in intra-regional trade shares, while extra-regional trade shares were roughly constant.

In the ASEAN countries, extra-regional imports as a share of GDP have been growing at a very fast pace (in 1990 they reached 26.9 percent, compared to only 9 percent in 1970) (Table 1). Much of Asia experienced rapidly expanding intra- and extra-regional trade (as a share of GDP) due to the region's dynamism and growing openness. Japan's intra-regional and especially extra-regional trade as a share of GDP increased between 1948 and 1958 reflecting the country's export-led growth. Both shares remained roughly constant since the 1960s. In ANCZERTA a mild increase in extra-regional imports as a share of GDP can be traced between 1970 and 1992.

Africa's intra-regional trade as a share of GDP followed a downward trend from 1948 through 1979 and it increased slightly during the 1980s, while extra-regional trade as a share of GDP fell from 1948 until 1968, and has been on a mildly upward trend since then. In the Middle East, intra-regional trade decreased sharply between 1948 and 1968 and roughly stabilized thereafter. Extra-regional trade varied widely from 1948 through 1979, then stabilized at about 50 percent of GDP.

Trade weighted averages for the world show that intra-regional trade as a share of GDP has more than doubled since 1948 (it grew from 7.3 percent in 1948 to 17.4 percent in 1990). While the path of extra-regional trade as a share of world GDP has been less clear, it moved to its highest post world war levels in the last decade. Thus, intra-regional integration has been important throughout the postwar era, but it does not appear to have precluded inter-regional trade expansion.

Table 1. Regional Arrangements: Extra-Regional Imports as a Share of GDP, 1970-92

(In percent)

RTA (year founded/ entry into force)	1970	1980	1990	1991	1992
EU-12	9.0	12.5	9.7	9.7	9.1
EFTA (1960)	17.2	22.3	20.0	18.8	19.0
CACM (1958/60)	17.2	23.5	25.0	23.0	...
LAIA (1980; LAFTA, 1960/61)	6.8	10.6	6.8	8.0	...
ANDEAN PACT (1969)	11.2	14.3	12.6	14.6	...
CARICOM (1973)	52.3	104.8	...	...	...
CUFSTA (1988/89)	3.0	7.6	7.7	7.4	7.7
NAFTA (1992/94)	2.9	7.0	7.0	6.7	7.0
MERCOSUR (1991)	5.7	10.6	4.0	4.8	5.3
ASEAN (1967)	9.0	19.7	26.9	...	...
ANCZCERTA (1983)	11.7	13.0	13.4	12.9	14.3
ECOWAS (1975)	13.0	17.1	...	...	...

Source: World Bank, "The New Regionalism and Its Consequences", SEC-M94-23, March 1994.

Table 2. Intra-Regional Trade as a Share of GDP, 1/ 1948-90

(In percent)

Region	1948	1958	1968	1979	1990
Western Europe	14.8	17.7	21.3	31.5	33.0
Eastern Europe and FSU	11.6	15.3	25.4	21.6	18.8
Total Europe	17.2	19.1	24.5	33.4	34.3
North America	2.9	2.9	3.5	5.8	6.0
Latin America	6.0	5.0	4.0	5.4	3.8
Total America	7.9	6.6	5.7	9.7	9.2
Japan	5.2	6.7	5.0	6.1	6.2
Australasia	6.6	7.7	7.7	14.3	15.0
Developing Countries: Asia	11.0	13.3	11.0	17.8	26.2
Total Asia	9.6	10.8	7.8	11.2	14.0
Africa	4.2	3.7	3.5	2.7	3.1
Middle East	10.2	7.0	3.0	3.6	3.3
Total World	7.3	8.8	10.3	15.9	17.4

Source: K. Anderson and R. Blackhurst, eds., Regional Integration and the Global Trading System, (London: Harvester-Wheatsheaf for the GATT Secretariat, 1993).

1/ Intra-regional merchandise exports plus imports as a percentage of GDP.

Table 3. Extra-Regional Trade as a Share of GDP, 1/ 1948-90

Region	1948	1958	1968	1979	1990
Western Europe	20.6	15.8	12.5	16.1	12.8
Eastern Europe and FSU	13.4	9.7	14.6	18.4	22.7
Total Europe	16.5	12.4	10.2	12.8	11.1
North America	7.8	6.3	6.0	13.6	13.2
Latin America	24.0	24.8	17.4	21.3	23.7
Total America	6.0	5.2	5.2	11.2	11.2
Japan	2.8	11.8	11.5	13.8	11.6
Australasia	44.7	29.0	23.2	27.2	28.0
Developing Countries: Asia	15.8	18.9	20.4	28.1	31.2
Total Asia	15.1	15.5	13.5	16.1	15.2
Africa	45.8	42.2	34.8	45.5	45.6
Middle East	40.0	51.0	34.2	52.5	50.0
Total World	14.9	12.9	11.6	18.8	16.1

Source: K. Anderson and R. Blackhurst, eds., Regional Integration and the Global Trading System, (London, Harvester-Wheatsheaf for the GATT Secretariat, 1993).

1/ Extra-regional merchandise exports plus imports as a percentage of GDP.

III. European Union

With the adoption of the Treaty of Rome in 1957 the six original member states of the EU laid the basis of a process of continuous political and economic integration in Western Europe that has resulted in one of the largest internal markets in goods and services in the world economy. Three different stages of integration can be distinguished. The first, transitional period (from 1958 to 1969) was marked by the phased elimination of internal tariffs, the dismantling of quantitative restrictions on imports from other member states, and the introduction of a common external tariff. The transition period also saw the establishment of the Common Agricultural Policy (CAP) aimed at the introduction of free trade in agricultural goods within the Community. The second period of integration, covering the seventies and the years up to the mid-eighties was marked by the introduction of a number of important institutional changes (such as an enhanced political role for the European Council) and by two enlargements of the Community, first with the accession of Denmark, Ireland, and the United Kingdom in 1973, followed by Greece, Portugal, and Spain in the 1980s. The third period (from 1986 onwards) was dominated by the adoption and subsequent implementation of the Single Market program and the Treaty on the European Union, which brought further important institutional changes and a road map for the establishment of an Economic and Monetary Union. This period was also marked by closer cooperation with surrounding countries (notably the member states of EFTA and countries in eastern Europe and the FSU) and accession talks with Austria, Finland, Norway and Sweden. 1/

This section reviews the present status of EU integration with respect to trade and trade-related issues. Sub-section 1 contains a description of the Single Market program and its status of implementation. This is followed in sub-section 2 by a concise review of existing empirical work on the trade and aggregate real income effects of European integration since the establishment of the Community. Finally, sub-section 3 draws conclusions about the implications of European integration from the point of view of multilateral trade liberalization.

1. Completion of the Single Market program

The progressive implementation of the Single Market program can be seen as the most important European initiative directed toward stimulation of trade and growth since the establishment of Community. The formal deadline of the program was December 31, 1992. Although the imposition of a deadline was of great significance for the negotiation process within the EU, the implementation of the Single Market program is in effect a continuous process that started soon after the adoption of the White Paper on the

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1/ For an overview of the history of European integration and community institutions, see Swan (1992).

program in 1985 and is not yet fully completed. The creation of the Single Market brought inter alia the following changes: 1/

a. Removal of physical controls on cross border shipments of goods. This required a change in the administration of indirect taxes, which was strongly dependent on customs declarations. This change and the removal of controls became effective on January 1, 1993.

b. Elimination of remaining national restrictions on imports of industrial products from third countries, and their replacement in some cases with EU-wide restrictions. Member states still maintained a large number of QRs and voluntary export restraints (VERs) on cars from third countries with implications for intra-Community trade. In some cases, national restrictions were replaced by Community-wide restrictions, notably the VER on Japanese cars, the tariff quotas on bananas, and QRs on imports of toys, ceramics and footwear from China.

c. The definition of essential minimum requirements with respect to technical regulations on product standards (mainly in the interests of health, safety, and the environment), the promotion of harmonized industry standards and the mutual recognition of testing and certification.

d. Elimination of barriers to cross-border services, notably transportation and financial services. The Single Market program provided for minimum harmonization of prudential and technical rules, where appropriate, and the elimination of discriminatory restrictions on trade in services between member states.

e. The opening of public procurement markets. Public procurement of goods and services has been made subject to rules providing for transparency and free market access.

f. The full liberalization of capital movements. All restrictions on capital movements between member states are eliminated.

As noted above, the implementation of the Single Market program is still going on. There were some delays in the legislative work at the Community level and in the implementation of EU legislation by member states. An example of delays in the adoption of Community legislation are offered by the liberalization of road haulage, which was adopted only after the formal deadline of the program. Also, some liberalization measures provide for relatively long implementation periods, such as in the case of road and air transportation. Some areas were not covered by the program, notably leasing services, services which are subject to private regulation (legal services, accountancy), energy, and some areas of telecommunications

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1/ For a detailed description of the Single Market program, see "European Union: Common Policies and Recent Institutional Developments," SM/94/120 and Supplement 1 to this document.

and postal services. Most of these sectors are currently subject to a more active application of the principles of competition policies, including new legislative initiatives.

Although delays in the transposition of EU legislation do not seem to be a reflection of a reduced willingness to carry out the program fully, private enterprises continue to face trade barriers from time to time related to the practical implementation of the rules. This is especially the case where the introduction of EU legislation on a national level has been combined with specific national regulations, notably in the area of technical product standards. The effectiveness of the enforcement of Single Market rules is also receiving increased attention. For instance, in the field of public procurement there are problems with the monitoring of the vast range of public contracts. The European Commission has drawn up a "strategic program" of priorities which aims to improve the functioning of the Single Market, providing, inter alia, for better enforcement of rules and calling for faster transposition of EU rules into national legislation.

2. Trade and real income effects of European integration

This subsection gives a brief overview of empirical work on the trade diversion and trade creation effects of European integration and the third country effects of the Single Market. The conclusion can be drawn that in the manufactured goods sector, trade creation exceeded trade diversion by a wide margin, and that the Single Market program likely has net positive effects on third countries. A clear exception is the agricultural sector, where trade diversion dominated as a result of the CAP.

a. Trade creation and trade diversion

The trade creation and diversion effects of European integration have been subject to a large number of studies, covering different periods between the establishment of the Community and the beginning of the nineties. Mayes (1978) reviews estimates from studies of the trade effects of integration during the 1960s and the 1970s. The various estimates in the survey are not strictly comparable due to differences in coverage and methodology, and in any case quantitative estimates in this area have a number of drawbacks (see El-Agraa, 1985). Nevertheless, the broad conclusion can be drawn that trade creation in the manufactured goods sector in this period was significant (10 percent to 30 percent of total EU imports of manufactured goods), and that it exceeded trade diversion by a wide margin (estimated at 2 percent to 15 percent). This development likely can be explained by at least two factors, namely the process of multilateral trade liberalization that was making progress during the same period, and the different structure of intra and extra Community trade in manufactured products. The impact of the elimination of internal tariffs on the size of the resulting trade diversion was mitigated by the more or less simultaneous reduction of external tariffs in the context of various GATT rounds. Average external tariff rates declined from 13 percent in 1958 to 6.6 percent after the implementation of the Kennedy Round agreement. As concerns the structure of intra EU trade, computations of Balassa (1975) and Buigues et al. (1990) show that the share of intra-industry trade in total EU trade steadily increased since the establishment of the Community, reflecting continued product differentiation and scale effects. 1/ Trade with third countries, however, is more based on inter-industry specialization related to diverging factor endowments.

The above mentioned studies on trade creation and diversion in general did not cover trade in services and agricultural products. Balassa (1975) made a first attempt to measure trade creation and diversion including trade in agricultural products, and he came to the conclusion that the Common Agricultural Policy had resulted in significant trade diversion, although the overall effect--including manufactured and agricultural products--remained positive. A computation by Jacquemin and Sapir (1988) for the period 1975-1982 also showed that total trade creation effects outweighed trade diversion effects in four large member states of the Community. A study by Sapir (1992) covering nine member states confirms this picture for the period 1980-1991 (see Table 4). The calculations are based on a decomposition of expenditure on consumption into three shares: domestic production, intra-EU imports, and extra-EU imports. Table 4 shows that the share of domestic supplies of all processed goods (including processed agricultural products) steadily decreased since 1980, whereas the shares of intra and extra-Community imports increased. This points to trade creation both within the Community and in relation to third countries. However, the trade figures on food, drink, and tobacco indicate that in the agricultural sector trade diversion effects occurred since 1985.

b. The implications of the Single Market program for the multilateral trading environment

The Single Market program was primarily directed toward the creation of the conditions for free trade in goods and services within the European Union. However, the Single Market also had implications for third parties. In this connection, two observations should be made.

First, the positive demand effects of the Single Market program are a likely contributor to the growth of world trade in goods and services. The European Commission is still working on an evaluation of the economic effects of the program. The Commission initially estimated the eventual permanent effect of the program on the level of real income at 4.25 percent

1/ The strongest increase was recorded in Germany, where intra-industry trade in manufactured products grew from 47 percent (1958) to 76 percent (1987) of total EU trade in manufactured products.

Table 4. Sources of Apparent Consumption: EU-9 1/

(In percent)

	All processed products				Food, drink and tobacco			
Year	Domestic production	Intra-EU Imports	Extra-EU Imports	Total	Domestic production	Intra-EU imports	Extra-EU imports	Total
1980	66.7	19.1	14.2	100.0	82.1	11.1	6.7	100.0
1981	65.3	19.6	15.1	100.0	81.4	11.6	7.0	100.0
1982	64.3	20.5	15.2	100.0	81.1	12.0	6.9	100.0
1983	63.8	20.7	15.5	100.0	81.4	11.7	6.9	100.0
1984	61.6	21.5	16.9	100.0	80.6	12.1	7.3	100.0
1985	60.6	22.6	16.9	100.0	79.9	13.1	7.0	100.0
1986	61.2	22.6	16.2	100.0	81.1	12.9	6.1	100.0
1987	60.5	23.2	16.4	100.0	81.0	13.1	5.9	100.0
1988	58.8	23.5	17.7	100.0	80.0	13.8	6.2	100.0
1989	57.1	24.6	18.3	100.0	79.9	14.0	6.1	100.0
1990	57.4	24.5	18.1	100.0	80.5	13.7	5.8	100.0
1991	56.1	25.0	18.9	100.0	80.1	14.2	5.7	100.0

Source: Sapir (1992).

1/ Belgium, Denmark, France, Germany, Italy, Ireland, Luxembourg, Netherlands, United Kingdom.

to 6.5 percent of GDP for the Community as a whole (European Commission, 1988). The trade diversion effects at the cost of foreign suppliers were estimated at 2.5 percent of imports. If an average income-elasticity of EU demand for imports from the rest of the world of 2 and a GDP growth rate of 5 percent is assumed, the net positive impact of the program on extra-EU imports would reach 7.5 percent. The Commission also estimated that this increase would be compensated by lower extra-EU imports due to improved competitiveness of European industries as a result of the program. Similar conclusions with respect to the third country effects were reached by Haaland and Norman (1992). The information on trade and income that has become available since these studies were prepared give only partial support to their conclusions. Preliminary estimates suggest that the permanent real effect of the program was 2.4 percent to 3.4 percent of GDP, somewhat less than initially expected, although still considerable (Buigues and Sheehy, 1993, Harrison et al., 1994). 1/ At the same time, the progressive implementation of the program was associated with a strong increase in both intra and extra EU-imports (see Table 4).

Second, the elimination of remaining national quantitative restrictions and technical barriers to trade, and liberalization in the financial sector (services and capital movements) have implications for suppliers outside the EU. The elimination of trade barriers resulting from the harmonization of technical product standards do not only promote trade between member states, but also with third countries. The same holds, mutatis mutandis, for liberalization of financial services and capital movements. The second banking directive grants to foreign bank subsidiaries established in a member state the same benefits as EU banks. New foreign establishments are subject to the principle of reciprocity in national treatment. As U.S. legislation is considered by the EU to satisfy this principle, the implementation of the second banking directive has in practice created full market access for U.S. subsidiaries. Further, the elimination of restrictions on capital movements also covers capital transactions between the EU and third countries. All restrictions are prohibited, with the exception of any restrictions on direct investment, the right of establishment, the provision of financial services or the admission of securities which existed on December 31, 1993. In this area, new measures which constitute a step back as regards the liberalization of capital movements to or from third countries require a unanimous Council decision. Thus the new regime on capital movements implies a standstill on restrictions on direct investment and the right of establishment from third countries.

At the same time, some Single Market rules are associated with limited access for third countries. In one well-documented case, notably the replacement of national quantitative restrictions on imports of bananas from

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1/ These estimates do not take into account that the program is not yet fully implemented and that output effects are likely to be realized over a significant period.

Latin American countries with a Community-wide tariff quota, there is a risk that efficient Latin American producers may lose market shares in the EU. Another example is the replacement of national quotas and VERs on Japanese cars with a Community-wide VER. Also, provisions in public procurement directives leaving the possibility for national authorities to maintain a 50 percent EU content requirement and a 3 percent price preference for EU suppliers reduce market access for third countries, although the liberalization of public procurement markets in the EU may still have a net positive impact on suppliers in third countries.

3. European Union: a model for integration?

A question often raised is whether the EU provides a model for integration that other countries could emulate. Some of the forces behind European integration are unique and not easily replicated in other regions.

a. First, and most importantly, European integration in the context of the EU, although predominantly economic in nature, should also be seen in the light of the geopolitical considerations of its founding fathers. The European Economic Community and its sister organization, the European Coal and Steel Community, were established to create a multilateral framework for cooperation between industrial countries which were previously engaged in two world wars, and faced with the pressures of the east-west conflict after the war. The establishment of the European Communities was a unique attempt to create an area of political stability in Europe, and this objective has not lost its value since then. The closer cooperation with countries of eastern Europe and the FSU and recent applications for EU membership by Hungary and Poland should also be seen in this light.

b. Another relatively important distinction is the structure of trade in manufactured goods. As noted earlier, a large and growing share of trade within the EU consists of intra-industry trade, reflecting increasing product differentiation and narrowing differences in the economic development of EU member states. Product specialization within a certain industry typically requires less structural change than inter-industry specialization which may be associated with the closure of whole enterprises and substantial new investments. As a result of the specific circumstances in Europe, the adjustment costs of economic integration have remained relatively small.

c. Third, European integration goes beyond the creation of an internal market in goods and services. EU member states have agreed to establish an economic and monetary union including a single currency, in accordance with the provisions of the Maastricht Treaty. The EU also aims at the enhancement of economic cohesion, requiring substantial financial transfers by the wealthier member states to the economically weaker regions in the EU (total resources committed for the period 1995-1999 are set at Ecu 176 billion).

d. Another point to note is that the process of integration and liberalization took place over a prolonged period, which has unnecessarily reduced its benefits. The transition period (1958-1969) was unduly long, and before 1985 integration was confined to only a few--albeit important--areas of economic activity, mainly agriculture, coal and steel, and trade in goods. Progress in the field of trade in services, liberalization of capital flows, and the enforcement of competition policies (including those directed toward the reduction of distortive state aids) were hampered by wide differences of policies and practices between member states. The Single Market program gave an important impetus to further liberalization, but even today, after the nearly full implementation of the program, some important areas of economic activity (such as the production and distribution of energy) are not yet completely liberalized.

Notwithstanding these qualifications, most computations of the trade creation and diversion effects of European integration indicate that the aggregate real income effects have clearly been positive, notably in the manufactured goods sector. Given the limited gross trade diversion effects measured in this sector, and the positive impact of higher income in the EU on imports, industrial producers in third countries are in general likely to have benefitted from European integration, especially because internal integration was associated with external liberalization in the context of the GATT. The harmonization and liberalization under the Single Market program probably have added to these positive effects. Also, European competition policies may have contributed to some reduction in state aids during the eighties, and possibly have prevented harmful subsidy wars between European countries. However, the present level of subsidization is still very high and it has proved difficult to reach agreement on faster reforms.

A clear exception to the positive real income effects is the CAP, which has effectively closed EU markets for temperate zone products and seriously distorted world markets in agricultural commodities. The costs for consumers within the EU and for more efficient foreign producers (including many developing countries) are high and it has proved very difficult to introduce necessary reforms. 1/ Although computations of trade diversion and creation indicate that the negative trade effects in the agricultural sector were smaller than the positive effects in the manufactured goods sector, the interests of those developing countries which have weak industrial sectors and are heavily dependent on exports of temperate zone products are seriously damaged by these policies.

1/ For a description of the 1992 CAP reform, see "European Union: Common Policies and Recent Institutional Developments," SM/94/120 and Supplement 1 of that document.

IV. North American Free Trade Agreement

The North American Free Trade Agreement (NAFTA) liberalizes barriers to trade and investment between Canada, Mexico, and the United States, while leaving barriers to countries outside the NAFTA unchanged. Its provisions include improved market access as well as changes in trade rules and new issues; these are briefly summarized in sub-section 1. Subsequent to signature of the NAFTA, two supplementary agreements were negotiated in the areas of environmental and labor standards, as discussed in sub-section 2. The NAFTA is expected to stimulate trade and raise living standards within North America, as described in sub-section 3. Existing studies indicate that the NAFTA will not have substantial adverse effects on nonmembers in the aggregate--trade diversion is estimated in most studies at less than 1 percent of non-NAFTA partner country exports to North America; these studies are discussed in sub-section 4 below. It is important to note, however, that these studies provide, at best, rough orders of magnitude of the full economic effects and they typically do not capture the distribution of adverse effects at the level of individual nonmember countries.

1. Main provisions

The NAFTA was signed by the Governments of Canada, Mexico, and the United States on December 17, 1992, and entered into force on January 1, 1994. 1/ The agreement provides for improved market access in many sectors, including agriculture, the automotive sector, energy, financial services, telecommunications, textiles and apparel, and transportation. Additionally, there are provisions governing the rules for international trade within North America, including dispute settlement, government procurement, intellectual property, and investment.

a. Market access in selected sectors

Improvements in market access are provided for in the NAFTA in the form of phased tariff reductions, liberalization of NTBs, relaxed investment restrictions, and harmonization of standards. Main market access provisions in the NAFTA are briefly summarized below for a selection of key sectors.

The NAFTA has separate bilateral agreements concerning agricultural products for U.S.-Mexico trade and Canada-Mexico trade. The rules of the Canada-U.S. Free Trade Agreement (CUSFTA) will continue to apply to U.S.-Canada trade. On U.S.-Mexico trade, tariffs will be reduced over a 15 year period (over half of bilateral trade will be duty free as of January 1, 1994) and both countries will immediately eliminate all NTBs by converting them into regular tariffs or tariff-rate quotas, to be phased out over 10 to 15 years. Mexico and Canada will phase out all tariffs over 10 years (over

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1/ Details of the NAFTA's provisions and an assessment are found in Hufbauer and Schott (1993) and USITC (1993).

85 percent of Canadian agricultural imports from Mexico already enter duty-free) but most nontariff barriers (NTBs) on sensitive products such as dairy, poultry, and eggs will remain intact.

The NAFTA will eliminate all of Mexico's tariffs on cars and most of its NTBs over a 5 to 10 year transition period; the United States will immediately eliminate its tariffs on automobiles imported from Mexico and reduce its tariff on Mexican light truck imports from 25 percent to 10 percent, phasing out the light truck tariff over 5 years. Mexican domestic content and trade balancing provisions will be phased out over 10 years. The rule of origin specifies that finished automobiles must contain at least 62.5 percent North American content, as compared to 50 percent in the CUSFTA.

In the energy sector, the NAFTA contains provisions in the areas of investment, tariffs and NTBs, and procurement. The Mexican enterprise Pemex retains a monopoly on oil exploration and development in Mexico, and on gasoline and fuel oil sales; investment restrictions will be substantially eased on 14 of the 19 basic petrochemicals and entirely eliminated on 66 secondary petrochemicals. Mexico will open up Pemex and CFE (the State Electricity Commission) procurement contracts to foreign participation. The CUSFTA limits on energy trade restrictions will not apply to Mexico. 1/

Mexico agreed to phase out restrictions on foreign ownership and participation in its banking, insurance, and brokerage industries but with long phase-out periods and interim caps on the market share that can be controlled by foreign firms. The NAFTA partners are only required to allow subsidiaries of North American firms in their countries rather than branches. Subsidiaries, unlike branches, are subject to the minimum capital and reserve requirements of the host country on their own.

The NAFTA eliminates all tariffs on telecommunications equipment within five years and removes most controls on trade and investment in enhanced or value-added services. Most tariffs and NTBs will be eliminated immediately; tariffs on central office switches and certain mobile equipment will be phased out over five years.

The NAFTA immediately eliminates U.S. import quotas on Mexican textiles and apparel trade that meet the strict NAFTA rules of origin. Quotas on Mexican goods that do not meet these rules will be phased out within

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1/ The U.S.-Canada FTA confines energy trade restrictions to special circumstances (national security protection, conservation of depletable resources, shortages, or to implement a price stabilization plan). Dislocation caused by energy trade is shared by domestic and foreign users under the U.S.-Canada FTA. These norms are not extended to Mexico under the NAFTA.

10 years. 1/ All tariffs on textiles and apparel trade will be eliminated within 10 years; tariffs on most U.S.-Mexico textile trade will be eliminated within 6 years.

Under the NAFTA, cross-border access for trucking companies carrying international cargo will be permitted and foreign investment in bus and trucking services will be allowed. Prior to the NAFTA, U.S. truckers were prevented from carrying cargo across the border, and Mexican truckers were allowed limited access to the United States. There is no change in the restrictive cabotage requirements of the U.S. Jones Act and parallel restrictions by Canada and Mexico.

b. Trade rules and new issues

In the area of dispute settlement, the NAFTA parallels and augments the dispute settlement provisions in Chapters 18 and 19 of the CUSFTA. The NAFTA establishes a trilateral Trade Commission, composed of ministerial level representatives from each country, to administer the agreement and adjudicate disputes. Dispute resolution procedures contained in Chapter 19 of the CUSFTA, involving final determinations in antidumping and countervailing duty cases, are extended to Mexico in the NAFTA. Panel decisions effectively substitute for judicial review and are binding on the respective governments; Mexico will undertake significant legal and judicial reforms to provide due process guarantees and effective judicial review for disputing parties. In addition, the NAFTA includes new provisions to ensure that a country complies with panel procedures and rulings, and strengthens existing extraordinary challenge procedures of the CUSFTA. 2/

In the area of government procurement, Mexico will phase out its procurement regulations within 10 years. For Pemex, CFE (the State Electricity Commission), and construction contracts, procurement will be opened to Canadian and U.S. bidders progressively over 10 years. For pharmaceuticals, Mexico will open procurement of patented drugs immediately and nonpatented drugs in 8 years. Subnational governments are encouraged but not required to enter into the obligations of the NAFTA.

In the intellectual property area, the NAFTA commits Canada to eliminate its compulsory pharmaceutical licensing practices and Mexico to adhere to the GATT accord on intellectual property. The NAFTA also strengthens Mexico's protection for patents, copyrights, trademarks, and

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1/ To qualify for NAFTA preferential treatment, textiles and apparel must be produced from yarn spun in North America or from fabric made from North American fibers (the "yarn forward" and "fiber forward" rules); these rules are much more strict than the rules of origin under the U.S.-Canada FTA.

2/ Once a panel decision has been made, either country may request a 3-person extraordinary challenge committee. If any of the grounds of the extraordinary challenge are met, the panel decision will be overturned and a new panel set up.

trade secrets, largely along the lines set out in the Uruguay Round Agreement. Canada will maintain its cultural exemption, and biotechnology inventions are excluded from patentability.

The NAFTA commits all three countries to provide national treatment to investors from NAFTA partners and contains a most-favored nation (MFN) obligation ensuring that NAFTA investors are treated as well as any other investor. Mexico agreed to phase out export and production-based performance requirements. In addition, private investors may seek binding arbitral rulings in an international form, directly against the host government. In parallel negotiations, the United States and Mexico signed a tax treaty that significantly reduces tax rates on interest, dividends, and royalties flowing in both directions. The NAFTA's investment provisions do not apply to Mexico's energy and rail sectors, Canada's cultural industries, or to U.S. airlines and radio communications.

2. Supplementary agreements

Subsequent to negotiation and signature of the NAFTA, the three countries embarked upon a series of parallel negotiations, culminating in supplementary agreements on labor, the environment, and import surges. These supplementary agreements were implemented along with the main NAFTA with effect from January 1, 1994. The labor and environmental side agreements are briefly summarized below. The agreement on import surges reaffirms the right to emergency protection provided in the safeguards clause (Chapter 8) of the NAFTA, and includes provisions to facilitate its effective use. It establishes a "early warning system" for responding to import surges, and also establishing a Working Group on Emergency Action. The Working Group will assess how well NAFTA's safeguards provisions are working and make recommendations for revisions, as appropriate.

a. Environment

The North American Agreement on Environmental Cooperation creates a new Commission on Environmental Cooperation, commits the NAFTA partners to work toward improving their environmental protection laws and to enforce existing laws, and establishes a dispute-settlement procedure to address complaints of a persistent failure to enforce domestic laws (monetary fines as high as $20 million may be assessed).

If an environmental issue cannot be resolved through consultations, and it concerns whether a country has persistently failed to enforce its own environmental laws, in an area related to the production of goods or services traded between the two parties, then any party may request an arbitration panel. If it is impossible for the disputing parties to agree on a mutually satisfactory action plan to remedy the situation, the panel may impose a monetary fine. If the party fails to pay the fine or continues to fail to enforce its environmental laws, then in the case of Mexico and the United States, the complaining party may suspend NAFTA benefits based on the assessed fine. In the case of Canada, enforcement assessment would be handled by its own courts. The process provides for a 60-day interval between the panel ruling and the monetary assessment, during which the violator could begin to enforce its laws.

b. Labor

The North American Agreement on Labor Cooperation sets forth shared objectives and obligations in the area of labor standards and sets up a dispute resolution mechanism similar to that established in the environmental side agreement, including establishment of a tri-national Commission for Labor Cooperation. The Commission provides a forum for consultations and, in addition, has the authority to form dispute resolution panels. If a country shows a persistent pattern of failure to comply with enforcement of mutually recognized, trade-related labor law, the panel may assess monetary fines (up to $20 million). If the fines are not paid within an established time frame then, in the case of the United States and Mexico, NAFTA benefits may be removed temporarily; in the case of Canada, enforcement shall be handled by Canadian courts.

The first two complaints were filed under the labor side agreement during February 1994. 1/ It is unclear, however, whether the National Administrative Office can rule on cases that began last year, since the NAFTA and supplementary agreements only took effect from January 1, 1994.

3. Effects on member countries

Implementation of the NAFTA is expected to result in a broad-based expansion of trade within North America, especially between Mexico and the United States, and in increased real incomes in all three member countries. Substantial rationalization and gains from trade are expected in the areas of agriculture, automobiles and auto parts, machinery, chemicals, textiles and apparel, and services (banking and insurance, pharmaceuticals, and telecommunications). While there has been considerable debate concerning the effects of NAFTA on aggregate employment and/or real wages for low-skilled workers in Canada and the United States, available evidence is mixed--some studies showing increases and others decreases--, but in most cases the effects are small (real wages change by less than 2 percent). Effects of the NAFTA on member countries have been extensively analyzed in the literature, using a variety of modeling methods. 2/ It is important

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1/ Two unions accused General Electric Company and Honeywell Inc. of firing Mexican employees for attempting to organize workers into labor unions. The unions, together with an independent Mexican labor federation (Authentic Labor Front), filed the cases with the U.S. Department of Labor's newly created National Administrative Office, and have asked for public hearings and for the fired workers to be reinstated and allowed to choose unions without reprisals.

2/ See Brown (1992), Francois and Shiells (1994), and USITC (1993) for surveys.

to note that these studies were conducted without full information as to the exact nature of the agreement, and therefore may be subject to a larger margin of error than otherwise.

a. Aggregate effects for member countries

The economic effects of the NAFTA flow from the relative magnitudes of trade flows between the partner countries as well as the relative sizes of the economies. The Canadian economy is about one tenth the size of the U.S. economy, whereas the Mexican economy is less than half the size of the Canadian one (measured in terms of GDP). The CUSFTA has already liberalized trade between the two partners, so the FTA is unlikely to have important effects on U.S.-Canada bilateral trade (or investment) flows. Canada-Mexico bilateral trade flows are currently very small. It is unlikely that the NAFTA would lead to a substantial increase in trade between them. Mexico is a significant trading partner for the United States, but the U.S. economy is large so that Mexico only accounts for about 7 percent of U.S. exports and imports. In contrast, trade with the United States is very important for Mexico; around 70 percent of its trade occurs with its Northern neighbor. Given these facts, it is to be expected that Mexico will reap most of the gains, and bear much of the adjustment burden, from the NAFTA.

Existing studies show just this. Although the studies indicate that the NAFTA is likely to lead to an increase in aggregate real income for all partner countries, estimated increases in aggregate real income for Canada range from 0.03 to 0.07 percent and, for the United States, they range from 0.07 to 0.3 percent. 1/ Real income gains for Mexico are more substantial; they range from 0.1 percent to 5.0 percent, with the range depending upon whether the studies incorporate gains due to rationalization of production in the presence of scale economies, and whether the NAFTA induces substantial capital flows into Mexico (USITC, 1993a, pp. 2-1 to 2-7).

Notwithstanding the insignificant nature of estimated aggregate effects for the United States, there has been considerable attention given to the possibility that low-skilled U.S. workers may suffer reduced earnings or lose their jobs as a result of the NAFTA. While some studies do distinguish

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1/ The static CGE models used to generate these numbers describe the one-time impact on real national income achieved upon full implementation of the agreement. The CGE methodology first solves for the level of national income (and other endogenous variables like prices, employment, and production by sector) under the initial conditions of the trade regime (the status quo including existing tariff levels, quotas and other NTBs). Next, the model is re-calculated under the conditions characterizing the post-agreement preferential trade regime (e.g., regional tariffs are set at zero). Endogenous variables, such as national income, in the pre-agreement state are then compared to those under full implementation of the agreement to obtain the kinds of estimates cited above.

low-skilled workers from other workers, their findings are inconclusive; regardless of the direction of the estimated change in earnings, however, "the preponderance of evidence indicates an almost indiscernible effect on U.S. wage rates for both low-skilled and high-skilled groups" (USITC, 1993a, p. 2-3).

b. Effects on selected sectors

As described above, the NAFTA liberalizes imports of fresh fruits and vegetables into the United States and imports of grains (principally corn) into Mexico. On the U.S. side, this is expected to reduce domestic production especially in certain horticultural products such as asparagus, avocados, fresh and canned tomatoes, oranges and orange juice, and sugar. 1/ On the Mexican side, liberalization of corn trade is expected to lead to substantial displacement of domestic production and, in turn, to migration into urban areas of displaced farmers (Levy and van Wijnbergen, 1994, and Robinson et al., 1993).

The effects of liberalization of North American trade in cars will depend crucially on decisions by the large multinational producers. Currently, there are five auto producers operating in the Mexican market, all of which are wholly foreign owned: Chrysler, Ford, General Motors, Nissan, and Volkswagen. On the demand side, the income elasticity for autos is very high in Mexico, hence strong economic growth there (due to the NAFTA) would lead to a substantial increase in car sales (Berry et al., 1994, forthcoming). On the supply side, existing domestic content and trade balancing provisions under the Auto Decrees have led to uneconomical investment in parts production, and to production at too small a scale for efficient operation. The NAFTA would be expected to lead to substantial rationalization in the Mexican auto industry, but to only slight production and employment changes in Canada and the United States (Lopez-de-Silanes et al., 1994).

The NAFTA liberalizes tariffs and quotas on North American trade in textiles and apparel. Safadi and Yeats (1993) show that Mexico has consistently underutilized its MFA quotas with the United States over the 1980s, Mexico's market share is low, and the NAFTA incorporates a strict "triple transformation"-based rule of origin. This makes it unlikely that Mexico would experience a major expansion in its textiles and apparel industry as a result of the NAFTA, especially as quotas under the MFA are phased out as a result of the Uruguay Round. 2/

1/ The latter two are subject to agreements that effectively limit surges in imports of orange juice and sugar.

2/ See, however, Trela and Whalley (1994), who do find that Mexican exports to the United States will expand significantly, although they assume that quotas on Mexican exports to the United States are binding.

4. Effects on nonmembers

Given the preferential trade liberalization, there is the potential for trade diversion, as NAFTA member countries shift their purchases to other countries within North America and away from countries excluded from the NAFTA. Additionally, there is potential for investment diversion; firms may relocate operations within North America to serve the North American market. Rules of origin in the NAFTA are particularly strict in the cars, computer, and textiles sectors, and this may exacerbate the exclusionary tendencies the agreement. However, available studies, though tentative, suggest that the adverse economic effects of the NAFTA on excluded countries in aggregate are likely to be quite small. Caution is warranted, however, in interpreting such results, as disruption at the level of individual countries, or specific sectors within countries, may be significant. Because such studies typically model the rest of the world as a single entity, significant effects for individual nonmember trading partners are not captured. One might expect that potentially significant trade diversion may take place within a limited range of items--for example, in certain agricultural sectors and labor-intensive manufactures such as textiles and apparel where MFN protection is high--, for selected countries whose trade is concentrated in these items. The conclusion to draw from these studies is that trade diversion due to NAFTA is not likely to appreciably disrupt the pattern of aggregate world trade, but that individual trading partners might still experience a nonnegligible adverse trade shock.

a. Aggregate effects

Using partial equilibrium methods, Laird (1990) finds that removing tariffs completely within North America would reduce exports of other countries in the Western Hemisphere to the United States by less than 0.8 percent; for all industrial countries, the NAFTA would reduce their exports to the United States by 0.5 percent. Erzan and Yeats (1992) also use partial equilibrium methods to show that trade diversion from preferential tariff elimination within North America (together with liberalization in NTBs just sufficient to accommodate the trade expansion due to tariff cuts) would be limited, 94 percent of total trade diversion would affect countries outside the Western Hemisphere, and total trade diversion would amount to about 0.5 percent of U.S. imports from non-members.

While a large number of computable general equilibrium (CGE) models constructed to analyze the economic effects of the NAFTA concentrate mainly on the NAFTA members themselves, a few do provide some results for the rest of the world. Generally speaking, non-North American countries suffer losses in trade shares and in welfare as a result of the NAFTA, albeit extremely small losses. 1/ Estimated trade diversion effects of the NAFTA based on these CGE models depend importantly on the manner in which foreign investment flows are incorporated, if at all, and on the way in which the model's structure influences terms-of-trade changes in response to preferential trade liberalization within North America. 2/

b. Effects on selected sectors

In the agricultural sector, more highly aggregated analyses generally show very minor trade diversion for non-North American countries from the NAFTA. The picture changes, however, in moving to specific agricultural items, notably frozen orange juice concentrate and sugar. Regarding orange juice, there is potential for trade diversion from Brazil (on the order of 5 percent of Brazilian citrus production) if the NAFTA stimulates significant new investment in Mexican citrus (Spreen et al., 1992). Clearly, the Caribbean is also vulnerable to changes in U.S. sugar quotas.

The North American automobile market would experience substantial rationalization and reorganization but there would be little effect on producers currently operating outside the North American market. Prospects for non-North American firms in the automobile sector are complicated by the multinational nature of existing operations, by NAFTA's strict rules of origin in the auto sector, and by existing local content and trade balancing provisions in Mexico. Although there is much uncertainty regarding the implications of the NAFTA for the North American automobile market, given the high trade barriers within the Mexican automobile market prior to implementation of the NAFTA, much of the restructuring may take place there (Lopez-de-Silanes et al., 1994). While foreign firms operating within North America may experience substantial production declines, especially in their Mexican operations, consumers in countries excluded from the NAFTA are unlikely to experience any significant change in real income.

Textiles and apparel trade with the United States, which is the largest market in North America, is governed by bilateral quotas under the Multi-Fiber Arrangement (MFA). While Mexico's access to the U.S. market for textiles and apparel will increase under the NAFTA, Mexico currently

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1/ Brown et al. (1992), for instance, find that the NAFTA would improve the terms of trade of its members vis-a-vis the rest of the world, thereby leading to trade diversion and a reduction in real income (albeit less than 0.1 percent) for countries outside North America. Cox and Harris (1992) find that U.S. import volumes from countries outside North America decline (but by less than 1 percent), while Canadian imports from outside the NAFTA increase (again by less than 1 percent).

2/ See Sobarzo (1992) for an example; changes in Mexico's trade balance with countries outside North America, estimated to result from the NAFTA, range from 0.0 to 17.1 percent, depending on the set of assumptions made regarding international capital mobility, exchange rate determination, and factor price flexibility.

underfills its existing quotas by about 25 percent and many of the items Mexico exports to the United States do not overlap with exports from other countries (Safadi and Yeats, 1993). In view of this, trade diversion due to the NAFTA in textiles and apparel is unlikely to be significant. 1/ In any event, Mexico's margin of preferential access to the Canadian and U.S. markets in the textiles and apparel area will be eliminated in terms of QRs, (but remain in terms of tariffs) over time due to the eventual phase-out of the MFA under the Uruguay Round agreement.

c. Effects on selected regions

East Asian countries generally face the highest tariffs and hard-core NTBs on exports to the United States (their largest North American market) in labor-intensive manufactures such as textiles and apparel and footwear; China, Korea, Malaysia, and Singapore also face significant trade barriers on exports of iron and steel as well as electronic equipment (Primo Braga et al., 1992). Diversion of East Asian exports induced by the NAFTA is estimated to be in the range of \$380 to \$700 million based on partial equilibrium and gravity equation methods as employed by Primo Braga et al. (1992); this amounts to less than 1 percent of East Asian exports to the United States in 1989. Partial equilibrium estimates constructed by Kreinin and Plummer (1992), however, suggest somewhat greater trade diversion for ASEAN (\$434 million, 4 percent of exports to North America, or less than 1 percent of their global exports in 1988) and South Korea (\$1,015 million, 5 percent of Korean exports to North America, or just over 2 percent of Korea's global exports in 1987). 2/ Noland (1994) obtains estimates of trade diversion for Korea ranging from 1 to 3 percent of Korea's global exports in 1991, using a variety of partial equilibrium models. Accounting for stringent rules of origin may reduce these figures. There is only anecdotal evidence on the likelihood of investment diversion from East Asia to Mexico as a result of the NAFTA, in particular regarding the rules of origin; this remains an open and potentially important question. Countries in East Asia are also concerned about the implications of additional countries in Latin America joining NAFTA, and the potential trade-diverting effects of future accessions to NAFTA will have to be carefully monitored and assessed.

Countries in South Asia mainly compete with Mexico for sales of textiles and clothing in the U.S. market and are subject to tariffs in the 15 to 30 percent range and quotas under the MFA; India has by far the

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1/ Since apparel assembly operations in Mexico already use a high proportion of U.S. inputs such as cut cloth, rules of origin contained in the NAFTA are unlikely to lead to substantial production losses for Mexico but may lead to investment diversion away from Mexico by non-North American firms, who may wish to use a lower proportion of U.S.-made inputs in their Mexican operations than U.S. firms. See Bannister and Low (1992).

2/ Pomfret (1993) argues that the estimates of trade diversion in Kreinin and Plummer (1992) are upper bounds.

largest share of South Asian exports to the United States. Diversion of exports from South Asian countries due to the NAFTA is expected to be minor (about 1 percent of South Asian exports to the United States) based on partial equilibrium simulations of preferential removal of tariffs and NTBs on textiles and apparel within North America (Safadi and Yeats, 1993). It is noteworthy that diversion of South Asian exports due to the NAFTA is much less than (about 1 percent of) the expected gains from the Uruguay Round.

Latin American and Caribbean countries compete with Mexico in certain agricultural products (frozen orange juice concentrate from Brazil and sugar from Caribbean Basin countries, for instance) and in labor-intensive manufactures such as textiles and apparel and footwear. 1/ Trade diversion is likely to be minor (1 percent) for Latin America and the Caribbean as a whole, although there may be some exceptions in certain product groups vis-à-vis particular countries (Primo Braga et al., forthcoming, *USITC, 1992*).

Estimates of trade diversion for each region may overstate the actual trade diversion in view of the aforementioned capacity constraints in the Mexican economy (as evidenced by the small Mexican share of the U.S. market), substantial underfilling of MFA quotas, and tight rules of origin that may reduce the value of preferential trade barrier reductions in the NAFTA. Phase-out of the MFA (and other improvements in market access) contained in the Uruguay Round agreement will erode the margin of preference in textiles and clothing, thereby lessening trade diversion in this area. Nevertheless, despite these assurances at the aggregate level, it will be important to monitor country-specific developments as NAFTA implementation proceeds.

1/ Beneficiary countries of the U.S. Caribbean Basin Initiative expressed concern that their benefits might be eroded by the NAFTA, particularly due to possible investment diversion to Mexico in the area of textiles and apparel. In response, the U.S. administration recently prepared an Interim Trade Program for the Caribbean Basin (ITPCB). The program outlines mutually beneficial measures to allay these concerns. The U.S. is offering new NAFTA-like preferences in textiles and apparel for beneficiaries of the Caribbean Basin Initiative in return for commitments on trade-related intellectual property rights, trade-related investment measures, environmental protection, labor standards, and adherence to GATT/WTO trade rules. The ITPCB proposal is at an early stage and would require completed negotiations and Congressional approval before entry into force.

Regional Trading Arrangements 1/

Name	Membership	Objectives	Progress to Date
AFRICA:			
CBI (Cross-Border Initiative) (1993)	Burundi, Comoros, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Tanzania, Uganda, Zambia, Zimbabwe.	Economic union. Promoting cross-border trade, investment and payments. Facilitating factor mobility. Removing intra-regional trade barriers as well as lowering external tariffs. Liberalizing administration and other controls relating to investment.	The framework agreement for the treaty was under discussion at the end of 1993. It calls for immediate abolition of NTBs and removal of tariffs on trade in goods and services among reciprocating countries by 1996 and for moving towards a CET by lowering external tariffs at least to the level of the member with the lowest tariffs by 1998.
CEAO (Communauté Economique de l'Afrique de l'Ouest) (1974). Abolished 1994.	Benin, Burkina Faso, Côte d'Ivoire, Mali, Mauritania, Niger, Senegal.	Customs Union. Ultimate objective is to establish an economic union (now within the framework of WAEMU).	Moderate Progress. Only 428 products receive regional preferences. Some sucess in achieving labor mobility and regional cooperation.
CEPGL (Communauté Economique des Pays des Grands Lacs) (1976)	Burundi, Rwanda, Zaire.	Free trade area. Free factor mobility and sectoral regional cooperation.	Limited progress. No progress towards trade liberalization, and factor mobility has not yet been achieved. Industrial projects in agriculture and energy.
COMESA (Common Market for Eastern and Southern Africa) (1993), formerly PTA (Preferential Trade Area for Eastern and Southern African States) (1982)	Angola, Burundi, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Rwanda, Somalia, Sudan, Swaziland, Tanzania, Uganda, Zambia, Zimbabwe.	Common Market. A common market is to be established by 2000. Ultimately an economic union. Sectoral cooperation in industrial, agricultural and inter-State transport and communications development, environment, natural resources, energy and the development of economically depressed areas. Cooperation in monetary and financial matters.	Moderate progress. PTA tariff reform calls for an initial set of tariff cuts ranging from 10% to 70%, followed by a 10% tariff reduction every two years between 1988 and 1996. The remaining 50% would be eliminated in two steps: 20% in 1998 and 30% in 2000. NTBs are to be eliminated during that period as well. This schedule is being implemented by most PTA members. To facilitate intra-regional transactions, checks denominated in UAPTA (PTA Units of Account) were introduced in 1988. To ease inter-country flow of merchandise trade, the Road Customs Transit Declaration (RCTD) was introduced; it has replaced diverse documents previously required by member states. In 1987 the PTA Motor Vehicle Insurance scheme was introduced to obviate the need to take out separate insurance in every country.
ECCAS (Economic Community of Central African States) (1992)	Burundi, Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon, Rwanda, Sao Tome & Principe, Zaire.	Common market. Coordinating and expanding efforts at regional cooperation in Central Africa.	Limited progress. A framework agreement is being discussed.

1/ This table includes only regional trading arrangements of a reciprocal nature. Unilateral preferential agreements such as, for example, arrangements under the Generalized System of Preferences, are not included.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
ECOWAS (Economic Community of West African States) (1975)	Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo.	Common market. Fiscal and monetary harmonization. Joint development projects. New target to eliminate NTBs by 1995.	Limited progress. Negligible trade liberalization, no formation of CET, no allocations to the Fund for Compensation and Development. A protocol on labor mobility was signed in 1979, but it has not been implemented.
IOC (Indian Ocean Commission) (1984)	Comoros, Madagascar, Mauritius, Seychelles.	Economic cooperation. Promote cooperation in economic, commercial, and industrial development.	Limited progress. Functional cooperation in a number of sectors: fishing, transport and communications and information gathering.
Lagos Plan of Action (1980)	*All countries in sub-*Saharan Africa.	*Economic union. Providing a* unifying framework for existing arrangements.	*Moderate progress. The ECCAS was* created under its auspices in order to coordinate economic integration in Central Africa.
MRU (Manu River Union) (1973)	Guinea, Liberia, Sierra Leone.	Economic Union.	Considerable progress. Intra-MRU trade is tariff-free and a CET is in place. However, progress towards integration and intra-regional trade has been slowed by pervasive NTBs and political unrest.
SACU (Southern African Customs Union) (1910)	Botswana, Lesotho, Namibia, South Africa, Swaziland.	Common market. Free movement of goods and right of transit among members.	Considerable progress. Goods and labor markets are relatively well integrated. A CET is in effect. With the exception of Botswana, all SACU countries are also members of the Common Monetary Area or Rand Monetary Area.
SADC (Southern African Development Community) (1992), former SADCC (Southern African Development Coordination Conference) (1980)	Angola, Botswana, Lesotho, Malawi, Mozambique, Namibia, Swaziland, Tanzania, Zambia, Zimbabwe.	Economic cooperation. Foster economic cooperation among members, initially with a view to reducing economic dependence on South Africa; promote balanced regional development; and secure and coordinate support from foreign donors. SADC members have expressed their willingness to welcome a democratic South Africa into the organization. Since 1988 the SADCC included trade as an additional area for cooperation.	Limited progress. Some success in undertaking joint development projects in transport and communications, food and agriculture and industrial rehabilitation.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
UDEAC (Union Douanière des Etats de l'Afrique Centrale). (1966)	Cameroon, Central African Republic, Chad, the Congo, Equatorial Guinea, Gabon.	Common market; policy harmonization. Members of the UDEAC are also members of the Franc Zone, with a common central bank, BEAC.	Moderate progress. QRs among member countries have been eliminated. A preferential tariff equal to 20% of the CET is to be applied as of 1994 to member states. Also since 1994 a CET with four rates (5%, 15%, 35% and 50%) is being implemented. UDEAC countries signed a treaty establishing the Economic and Monetary Community of Central Africa (CEMAC) (1994).
WAEMU (West African Economic and Monetary Union) (1994)	Benin, Burkina Faso, Cote d'Ivoire, Mali, Niger, Senegal, Togo.	Economic union. Adding a common market to the existing monetary union through the BCEAO. Harmonizing taxing systems and coordinating sectoral policies.	Agreement signed in January 1994. Main goals in the agreement: coordination of macroeconomic policy, fiscal convergence, harmonization of budget procedures, public finance statistics, indirect taxation and business law.
ASIA:			
AFTA (ASEAN Free Trade Arrangement) (1992)	Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand.	Free trade area. Regional industrial cooperation. The FTA is to be achieved in 2008, 15 years after the start of the phasing down of tariffs in 1994. The goal is to reach a 0 to 5% preferential tariff on manufactured goods by 2008. QRs are to be eliminated upon enjoyment of initial concessions and other NTBs are to be phased out over five years from the date of initial concessions on an item. Raw agricultural products and services are not included. 1/	Moderate progress. The starting date for implementation was moved forward from January 1993 to January 1994. An average of 25% of member country tariff lines are covered in the program of tariff reduction with effect from 1994. According to the present schedule, roughly 88% of these tariff lines will reach the target level of 0 to 5% tariff by 2003.
ANZCERTA (Australia-New Zealand Closer Economic Relations Trade Agreement) (1983)	Australia, New Zealand.	Free trade area. Harmonization of business law and cooperation in the area of standards, customs procedures. Elimination of antidumping within the FTA.	Considerable progress. Since 1990 all intra-area trade in goods and services is free of tariffs, QRs, anti-dumping measures and production subsidies.

1/ Motor vehicles and mineral fuels are also excluded from the liberalization scheme. Member States may temporarily exclude sensitive items. The exclusion lists will be reviewed in the eighth year with a view to bringing the covered items back into the liberalization process and achieving the 0 to 5% tariff by 2008.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
APEC (Forum for Asia-Pacific Economic Cooperation) (1989)	Australia, Brunei Darussalam, Canada, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Republic of Korea, Singapore, Taiwan Province of China,Thailand, United States	Economic cooperation. Promoting the multilateral trade system and intensifying regional consultation and cooperation. Representing member countries' views in multilateral negotiating fora.	Limited progress. No comprehensive blueprint exists for a liberalization agenda. Exploratory work is under way on reviewing member countries' customs procedures and investment regimes and prospects for mutual recognition of standards.
ASEAN (Asia-Pacific Economic Cooperation Forum) (1967)	Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand.	Economic cooperation. Initially especially concerned with regional peace and security. Since 1977, when the ASEAN Preferential Trading Arrangement was signed, the goals became more economic in nature. Mainly enhancing regional trade, maintaining the area's competitive position and exploiting economies of scale.	Moderate progress. Under the auspices of ASEAN's PTA preferences for a limited range of products were implemented; no agreement on reducing NTBs; liberalization process hindered by strict rules of origin; some joint ventures. Regional trade liberalization plan now formally codified in AFTA (1992).
Bangkok Agreement	Bangladesh, India, Korea Rep., Lao PDR, Sri Lanka. 1/	Free trade area.	Moderate progress. Tariff preferences established for 237 products.
EAEC (East Asian Economic Caucus) (1990)	Brunei, China, Hong Kong, Indonesia, Japan, Republic of Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, Thailand.	Economic cooperation. Regional grouping to represent members' views in multilateral negotiating fora and to expand regional cooperation.	Limited progress.
EUROPE:			
Baltic FTA (1993)	Estonia, Latvia, Lithuania	Free trade area. The agreement does not apply to agricultural goods, for which a special protocol will be signed at a later date. Customs duties and QRs to be abolished upon entry into force of the agreement. No new tariffs or NTBs are to be introduced among the three countries in future. During a transitional period export restrictions on some specific goods will be maintained by each republic.	The agreement went into effect on April 1, 1994.

1/ Afghanistan and Papua New Guinea are negotiating accession.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
Belarus-Russia Economic Union (1994)	Belarus, Russia	Economic union. A full economic union is to be built by stages between the two countries. The first stage includes monetary union as well as unification of tariff and NTBs towards third countries on the basis of the system of the Russian Federation. The final stage features the complete elimination of barriers to trade between Belarus and Russia.	Considerable progress. The first stage of the economic union started being implemented on May 1, 1994. Both Belarus and Russia are working on reaching full monetary union--meanwhile Belarus continues to use its ruble as a means of payment. Common rules regarding trade with third countries should start to be implemented in July 1994. Intra-area trade barriers are being eliminated.
BENELUX (1948) *(Belgium-Netherlands-*Luxembourg Economic Union)	Belgium, Netherlands, *Luxembourg*.	Economic union.	Considerable progress. Closely *integrated common market. Close* tax policy coordination.
Bilateral FTA Agreements between individual Baltic Republics and Finland, Norway, Sweden and Switzerland (1992) (1993)	Estonia, Finland, Latvia, Lithuania, Norway, Sweden, Switzerland	Free trade area. Agriculture is not included and restrictions apply to textiles. A separate agreement between Sweden and Latvia grants Latvia lower import duties on agricultural exports to Sweden.	Considerable progress. Most agreements have come into force throughout 1992 and 1993.
CEFTA (Central European Free Trade Agreement) or Visegrad Agreement (1992)	Czech Republic, Hungary, Poland, Slovak Republic.	Free Trade Area. Liberalization of trade in "normal" goods over a period of 3 to 4 years and in "sensitive" products (textiles, steel, agriculture) over 8 years. Exceptions remain, for example, QRs in agriculture will remain indefinitely.	Considerable progress. Implemented as of March 1993.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
CIS Economic Union (1993)	Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.	Economic union. Gradual deepening of integration through the establishment of a free trade zone, a customs union, a common market and monetary coordination. Customs procedure to be harmonized and legal provisions and policies for inter-state contracts, investment and joint ventures to be coordinated. The treaty envisages the coexistence of countries belonging to a renewed ruble area with countries with national currencies. Regarding national currencies the treaty calls for limiting exchange rate fluctuations between currencies. The treaty also provides for the harmonization of national fiscal policies, to be specified in a future agreement.	Limited progress. No deadlines have been specified regarding implementation. Several supplementary agreements are being negotiated. As of May 1994 all CIS republics except Tajikistan had introduced interim or permanent national currencies to be used alongside rubles.
EEA (European Economic Area) (1994)	European Union, Austria, Finland, Iceland, Liechstenstein, Norway, Sweden. 1/	Free trade area plus factor mobility. It excludes agricultural products.	Considerable progress. Just entered in force.
EFTA (European Free Trade Association) (1960)	Austria, Finland, Iceland, Liechtenstein, Norway, Sweden, Switzerland.	Free trade area. Agricultural products are excluded.	Considerable progress. All tariffs on manufactures eliminated by 1967. QRs eliminated by the late 1970s.
EFTA-Turkey FTA (1991)	EFTA, Turkey.	Free trade area. Most agricultural products are excluded.	Considerable progress. By 1994 EFTA countries had abolished all customs duties on most imports from Turkey. For textiles and apparel they will be completely phased out by end of 1995. Turkey had by 1993 reduced the tariff rate on EFTA imports by 70-80%
EU (European Union) (EC) EC (1957) EU (1993)	Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, U.K. 2/	Economic union. Economic and Monetary Union to be achieved by 1997 or 1999 at the latest. Coordination of fiscal and socio-economic policies.	Considerable progress. By the end of 1993 the Single Market project had almost been completed. Some barriers remain in areas such as energy, telecommunications and transportation. Free capital mobility has been achieved. Labor movement is almost completely liberalized. Exchange rate coordination through the European Exchange Rate Mechanism. 3/

1/ As of 1995 Austria, Finland, Norway and Sweden will accede to the European Union, if so agreed under national referendas.
2/ Austria, Finland, Norway and Sweden completed their negotiations for accession to the EU in 1994. Cyprus, Hungary, Malta, Morocco, Poland and Turkey have applied for membership.
3/ The Greek dracma, the Italian lira and the United Kingdom's pound are not part of the ERM at the moment.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
Europe Agreements: EU Association Agreements (bilateral) with:	Bulgaria, Czech Republic, European Union Hungary, Poland, Romania, Slovak Republic. Bulgaria (Interim Agreement 1993) Czech Republic (Interim Agreement 1992) Hungary (Interim Agreement 1992) Poland (Interim Agreement 1991) Romania (Interim Agreement 1993) Slovak Republic (Interim Agreement 1992) 1/	Free trade area. Liberalization of trade in manufactured goods. Ultimately, the goal is accession to the European Union. The agreements include provisions on political dialogue and trade-related issues, such as competition law. Commitment to negotiate the liberalization of trade in services. Approximation of legislation of East European countries to European Union law.	Considerable progress. Most tariffs and QRs on industrial goods were eliminated after the coming into effect of the agreements. Substantive restrictions remain in steel, textiles and clothing, and coal, but are due to be phased out over a four-to-five-year period after the entry into force of the agreements. Concessions were made by East European countries, although more limited, with longer phase-in periods for implementation (with a maximum of 10 years).
EU-Baltic Republics FTA (1994)(bilateral)	EU, Estonia, Latvia, Lithuania.	Free trade area.	Considerable progress. Negotiations are on their final stage. Under these agreements the EU will liberalize imports from the Baltic republics on industrial goods and services. The same sensitive areas which receive special treatment in the Europe Agreements will be protected in the EU agreements with the Baltic Republics. Estonia will eliminate all QRs upon entry into force of the treaty. Latvia and Lithuania will be granted a five-to-six year period to do so.
EU-FSU Cooperation and Parnership Agreements (1994) (bilateral)	EU, Former Soviet Union (Belarus, Kazakhstan, Russia, Ukraine)	Free trade area. In the medium run, the "cooperation and partnership agreements" of the EU with the FSU republics provide for MFN treatment of merchandise trade and certain services. The agreements also schedule a revision in 1998 with the possibility of creating a free trade area.	Moderate progress. Negotiations with Russia and the Ukraine were concluded in 1994 and they are still in process with Belarus, and Kazakhstan. The EU had already signed a treaty on commercial and economic cooperation with the USSR in 1989. Under the auspices of that treaty, specific EU QRs were removed in 1989 and 1990.
EU-Turkey Association Agreement (1963)	EU, Turkey.	Customs union. To be achieved by 1995.	Considerable progress. Industrial products of Turkish origin have been exempt from customs duties and QRs in the EC since 1971. By 1993 Turkey had brought the cumulative rate of tariff reductions on EU imports to 70-80%. Very significant tariff reductions are also being implemented in Turkey with regard to non-EU countries in anticipation of the implementation of the CET in 1995.

1/ Association agreements are being negotiated at present with the Baltic Republics.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
Intra-CIS Bilateral Trade Arrangements (1992) (1993)	CIS member states.	Securing traditional markets and supplies, especially raw materials and oil from Russia, and offsetting the effect of the trade restrictions imposed by the newly independent countries. Overcoming payments problems through barter. Softening the adverse impact on terms of trade resulting from the move to world market prices for energy and raw materials. The agreements typically included three sections: one on "obligatory trade" on "strategic goods," such as energy and key inputs for which prices were fixed and governments were obliged to ensure delivery; a second section with "indicative lists" of enterprise-to-enterprise trade in which the government was only obliged to issue the necessary licenses; thirdly, in all other goods trade was left freely to enterprises and export quotas applied if they did in the rest of the world.	Moderate progress. The agreements were implemented throughout 1992. However, deliveries often fell short due to contractions in output and the inability of governments to compel enterprises to fulfill state orders. The absence of efficient payments mechanisms also affected implementation. The agreements were renegotiated during 1992 and new bilateral trade agreements were signed in late 1992 and early 1993. The new agreements reduce the volume of government-to-government trading to a few "strategic" products, provide for quotas and tariff-quotas for enterprise-to-enterprise trade and, in general, give preferential treatment to the signatory countries. These agreements are being implemented with the same shortcomings as their predecessors.
MIDDLE EAST:			
ACM (Arab Common Market) (1964)	Egypt, Iraq, Jordan, Libya, Mauritania, Syria, Yemen.	Customs union.	Moderate progress. Tariffs on manufactured goods had with a few exceptions been removed by 1992. Considerable QRs remain. No progress on CET.
AMU (Arab Maghreb Union) (1989) (Former Maghreb Customs Union)	Algeria, Libya, Mauritania, Morocco, Tunisia.	Economic Union. In its 1991 meeting the AMU agreed to a fourt-stage economic integration process. The announced deadlines were: end-1992 for a FTA, end-1995 for a CU and end-2000 for a common market. There was no set deadline for the stage of monetary union, which should be established "some time thereafter".	Limited progress. Some multilateral trade liberalization agreements have been signed but remain largely unimplemented. An agreement was signed by the five central banks of the AMU in 1991 to help facilitate interbank payments and it has been implemented since April 1992. Some joint projects in the energy and industrial sectors have been reached and are being carried out under the aegis of the Union.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
BSEC (Black Sea Economic Cooperation Project) (1992)	Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russian Federation, Turkey, Ukraine.	Economic cooperation. Enhanced movement of goods, services, labor and capital. Regional economic cooperation.	Limited progress. Working groups have been established covering areas such as organizational matters, exchange of statistical data and economic information, banking and finance, trade and industrial cooperation, transport and communications, agriculture and agro-industries and free travel of the businessmen of the participating states.
ECO (Economic Cooperation Organization) (1985) (Former Regional Cooperation Development)	Islamic Republic of Iran, Pakistan, Turkey. Since 1992: Afghanistan, Azerbaijan, Kazakhstan, Kyrghyz Republic, Tajakistan, Turkmenistan, Uzbekistan.	Economic cooperation. Bilateral trade and investment promotion and sectoral economic cooperation.	Moderate progress. In 1992 a very limited system of tariff preferences among member countries was established granting a 10% reduction on specific tariff lines. The agreement was initially for a period of four years, but would be automatically extended for further periods of two years each. Several committees to coordinate sectoral cooperation have been formed. Initiatives under consideration include the establishment of a regional trade and development bank and formation of an ECO shipping company.
GCC (Cooperation Council for the Arab States of the Gulf, or, alternatively, the Gulf Cooperation Council) (1981)	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates.	Common market. Achieving "deep integration" among the member countries by establishing free movement of goods, services and factors of production.	Considerable progress. Virtual elimination of customs tariffs by 1982 and liberalization of trade in services by 1983. No CET. Free movement of factors of production has been achieved.
WESTERN HEMISPHERE:			
ANCOM or Andean Pact (Andean Common Market) (1969). Revived 1990.	Bolivia, Colombia, Ecuador, Peru, Venezuela.	Common market. Harmonization of social and economic policies, joint programs.	Considerable progress. By 1993 tariff barriers between member countries had been eliminated in almost all product categories except capital goods. A four-tier common external tariff--5, 10, 15 and 20%--has been agreed upon and should start to be implemented in January 1995 with some exceptions. Strict rules on foreign ownership relaxed significantly in 1987.
Argentina-Brazil (1990)	Argentina, Brazil.	Common market. Establishing a bilateral common market by 1994.	Moderate progress. Efforts at liberalization are being concentrated in the MERCOSUR framework.
CACM (Central American Common Market). (1961) Revived 1990.	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua.	Customs union. Agricultural goods are excluded from trade liberalization; a common price band for some key agricultural products is in place.	Considerable progress. Many restrictions to intra-regional trade were lifted in the 1960s and 70s. NTBs were reintroduced in the 1980s. CET between 5% and 20% by end 1992. The average intra-regional tariff level has been below 20% since 1991.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
CARICOM (Caribbean Community) (1973)	Antigua and Barbuda, Bahamas, Barbados, Belize, S. Cristobal, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Trinidad and Tobago.	Common market. Phasing down of the CET to reach a 5% to 20% range by 1998.	Considerable progress. Most intra-regional trade has been liberalized. The first phase of the CET, which will bring tariff rates down to a range of 0 to 35% has been implemented starting in January 1993.
CARICOM-Colombia (1991)	CARICOM, Colombia.	Free trade area. During a transition period it would work as a system of unilateral preferences for access of CARICOM products into Colombia. Eventually, CARICOM countries would reciprocate.	Limited progress. Negotiations under way and proceeding slowly due to CARICOM's demands for unilateral tariff reductions.
CARICOM-Venezuela (1991)	CARICOM member countries, Venezuela.	Free trade area. During a period of five years all duties on Venezuelan imports from CARICOM should be phased out. After five years negotiations should start on how to eliminate trade barriers on Venezuelan imports into CARICOM countries.	Limited progress. Negotiations are proceeding slowly due to CARICOM's insistence on unilateral tariff reductions.
Chile-Colombia FTA (1993)	Chile, Colombia.	Free trade area.	Considerable progress. The free trade area is operational as of January 1994.
Chile-Venezuela FTA (1993)	Chile, Venezuela.	Free trade area. The final deadline for complete trade liberalization between the two countries is 1999. Eventually a customs union.	Moderate progress. The maximum tariff to imports from Chile is scheduled to be 20% in 1994. Chile's rate is to remain at 11%. Tariffs are to reach 0 in 1999.
Colombia-Central America FTA (1993)	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Venezuela.	Free trade area. During a transitional period Colombia is to grant unilateral tariff cuts to Central American countries. Eventually these cuts should be reciprocated and result in a free trade area.	Limited progress. Negotiations under way.
Colombia-Ecuador-Venezuela FTA (1992)	Colombia, Ecuador, Venezuela.	Customs union. Elimination of tariffs and NTBs to bilateral trade and establishment of a simplified CET.	Moderate progress. An automobile trade agreement was signed in 1993 and became effective in January 1994; it includes a unified automobile industrial policy through a CET and common rules of origin. Negotiations on the harmonization of agricultural policy to stabilize prices and align them within the customs union under way.
Colombia-Venezuela (1992)	Colombia, Venezuela.	Free trade area. To be achieved by 1992.	Considerable progress. Intra-area tariffs were eliminated in 1992 and a CET was agreed.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
EAI (Enterprise for the Americas Initiative) (1990)	United States, Belize, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Antigua and Bermuda, Bahamas, Barbados, Dominica, Grenada, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent, Trinidad and Tobago, Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guyana, Mexico, Paraguay, Peru, Uruguay, Venezuela.	Free trade area. Aims to achieve a free trade zone for the entire Western Hemisphere. Reinforcing market-oriented reforms in Latin America by expanding trade, increasing investment, easing the debt burden and strengthening environmental policies.	Moderate progress. As of November 1991, the United States had signed framework agreements with 31 out of 34 Latin American countries. 1/ Framework agreements establish the agenda for bilateral negotiations as well as institutional mechanisms.
El Salvador-Guatemala FTA (1991)	El Salvador, Guatemala.	Free trade area.	Considerable progress. It entered into force in 1991.
GROUP of 3: Colombia-Venezuela-Mexico Free Trade Agreement (1993)	Colombia, Mexico, Venezuela.	Free trade area. Creating a free trade zone over a ten-year period starting in January 1995. Agricultural goods are excluded. Liberalization of the car sector will be phased-in over a 13-year period.	Moderate progress. Treaty signed in June 1994. Agreement provides for an immediate 0 tariff for some items and a 10-year transition for others. Tariff cuts will proceed more quickly for Colombian and Venezuelan exports to Mexico than vice versa. Venezuela has been granted two extra years to dismantle tariffs on textiles.
LAIA (Latin American Integration Association) (1960), formery LAFTA (Latin American Free Trade Association) (1980)	Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela.	Common market. Area of economic preferences constituted by regional tariff preferences, "regional scope agreemts" and "partial scope agreements" (among only some of the member states) on sectoral issues of economic cooperation or trade liberalization.	Moderate progress. Numerous bilateral trade agreements. In 1990 member countries doubled the level of the Regional Tariff Preference to an average of 20%. The non-extension of preferences granted by Mexico to Canada and the U.S. under NAFTA will require an amendment of the treaty.
MERCOSUR (Southern Cone Common Market) (1991)	Argentina, Brazil, Paraguay, Uruguay.	Common market. Coordinating fiscal and exchange rate policy. Accelerating economic development.	Considerable progress. Intra-regional trade is being gradually liberalized with 1995 as the final deadline for the elimination of tariffs as well as NTBs. A CET ranging from 0 to 20% has been agreed on for 85% of products. Agreement has not been reached on the CET on capital goods and high technology products.

1/ The exceptions are Cuba, Haiti and Suriname.

Regional Trading Arrangements

Name	Membership	Objectives	Progress to Date
Mexico-Chile FTA (1991)	Chile, Mexico.	Free trade area. Promoting inward investment. Phased elimination of tariffs and NTBs by 1998. Oil products and certain agricultural goods are excluded. Harmonization of taxation and investment rules.	Considerable progress. Since 1992 NTBs have been eliminated and the maximum mutual tariff is 10%. This rate is being cut by 2.5% a year until it reaches 0 in 1996 for goods in the fast track. For goods in the slow track (key among them oil and textiles) duties on bilateral trade will be reduced over 7 years.
Mexico-Costa Rica FTA (1994)	Mexico, Costa Rica.	Free trade area.	Moderate progress. An agreement was signed in 1994 and is scheduled to go into effect in January 1995.
Mexico-Costa Rica-El Salvador-Guatemala-Honduras-Nicaragua FTA (1992)	Mexico, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua.	Free trade area.	Limited progress. Deadline for achieving the FTA has been set for 1996. Negotiations in process.
NAFTA (North American Free Trade Agreement) (1994)	Canada, Mexico, United States.	Free trade area. Including goods and services, government procurement and IPRs. Canadian agricultural and Mexican petroleum products are excluded. Liberalization of investment flows and professional services.	Considerable progress. Staged elimination of tariffs and NTBs over a maximum of 15 years agreed. In phase as of January 1, 1994.
Nueva Ocotepeque Agreement (1992)	El Salvador, Guatemala, Honduras.	Customs union. Forming a free trade area by 1993, and eventually evolving to a customs union.	Limited progress. Member countries have signed Economic Complementation agreements. Little progress toward establishing a free trade area.
OECS (Organization of East Caribbean States) (1991)	Antigua and Bermuda, Dominica, Grenada, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent.	Customs union. Its main goal was to implement CARICOM's CET ahead of schedule.	Moderate progress. Only Dominica and St. Vincent have implemented the CET.
U.S.-Canada FTA (1991)	Canada, United States.	Free trade area. Eliminating bilateral QRs immediately, tariffs by 1998 and reducing NTBs to trade in goods and services. Liberalizing investment. "Cultural" industries are excluded.	Considerable progress. Implementation ahead of schedule: three rounds at accelerated tariff cuts completed. Parts of the agreement will be superseded after NAFTA. The Auto Pact, however, remains as a distinct agreement. Under the Auto Pact imports of new or used vehicles from one country into the other are duty free.
U.S.-Israeli FTA (1985)	Israel, United States.	Free trade area. Eliminating by 1995 tariffs on all products traded between Israel and the U.S.	Considerable progress. Liberalization on schedule.
Venezuela-Central America FTA (1992)	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Venezuela.	Free trade area. During a transitional period unilateral tariff cuts will be made by Venezuela. Eventually, Central American countries will reciprocate.	Limited progress. Negotiations under way.

EU's Trade Relations with Transition and Mediterranean Economies

The past several years brought important changes to trade arrangements between the European Union and countries in eastern Europe and the FSU.

In 1989, the EU concluded an agreement on trade and commercial and economic cooperation with the U.S.S.R. which gave it most-favored-nation (MFN) status and provided for a timetable for the removal of general quantitative restrictions (QRs) on exports to the EU. Specific EU quantitative restrictions were removed in 1989 and 1990. Also, in January 1993 the EU gave Russia and other republics of the FSU access to the Generalized System of Preferences (GSP). Trade relations with republics of the FSU are still governed by the agreement with the U.S.S.R. In October 1991, the Council gave a mandate to the Commission to negotiate separate "cooperation and partnership agreements" with Russia and other republics of the FSU. These agreements could be seen as a halfway house between the agreement of 1989 and the Association Agreements with east European countries (see below). Agreements with Russia and the Ukraine were signed in June 1994. They provide for MFN treatment of merchandise trade and certain cross-border services, investment protection, and rules on the free transit of goods. Definitions are brought in line with GATT definitions. The agreements also provide for a review in 1998, when the possibility of the creation of a free trade area will be examined. The European Union has a separate agreement with Russia on textiles, and the Commission has asked for a mandate to negotiate an agreement on trade in steel. It also intends to replace the recent safeguard measure against imports of aluminum with a multilateral arrangement.

Negotiations on the conclusion of Free Trade Agreements with Estonia, Latvia, and Lithuania have reached their final stage. EU concessions are expected to be comparable to those made in the trade sections of the Association Agreements. Estonia will eliminate all remaining quantitative import restrictions upon entry into force of the new arrangements. Latvia and Lithuania have a five- to six-year transition period to do the same.

The EU concluded Association Agreements ("Europe Agreements") with Bulgaria, the Czech Republic, Hungary, Poland, Romania, and Slovakia. The agreements with Hungary and Poland entered into force on February 1, 1994; the trade and some trade-related aspects covered by interim agreements became effective on March 1, 1992 for Czechoslovakia, Hungary and Poland, on May 1, 1993 for Romania, and on December 31, 1993 for Bulgaria. There are also special agreements on trade in wine and meat with most east European countries.

The Association Agreements with eastern Europe are a step toward the final objective of the associated countries to become full members of the EU, and contain provisions on, inter alia, political dialog, trade in goods and services, and trade-related issues such as competition law. The agreements provide for immediate or phased elimination of all restrictions and tariffs on trade in general industrial products. The EU abolished all

QRs and tariffs on a large number of products upon entry into force of the agreements. All remaining tariffs (including tariff quotas and ceilings) will be eliminated after a 3-year period. 1/ However, special, more restrictive arrangements apply to so-called "sensitive goods": agricultural products, clothing and textiles, coal, and steel. Market opening in agricultural trade is rather limited. The level of protection in agriculture will remain high after the full implementation of the program, and cereals are excluded from liberalization. The concessions on the other sensitive product categories are more favorable: barriers to re-exports of textiles and clothing in connection with processing activities were eliminated upon entry into force of the agreements, and remaining duties and QRs will be phased out in a five year period. Quantitative restrictions on steel were also eliminated upon entry into force of the agreements (QRs on coal one year later, with the exception of coal imports into Germany and Spain), and duties will be phased out in 3 to 4 years. Comparable concessions were made on the side of the associated countries, although they are in some areas more limited, and implementation periods are longer (up to 10 years).

Notwithstanding the maintenance of restrictions on sensitive products, the reduction of trade barriers in recent years has greatly facilitated the strong growth of trade in the region. Total trade between the EU and east European countries grew on average by about 21 percent per annum between 1989 and 1992 and further liberalization may give a new boost to trade. However, the application of other important provisions of the Association Agreements, in particular the approximation of laws by the associated countries to EU law (such as competition law, and legislation in the field of technical standards and intellectual property), remains very limited so far. Progress in this area is essential for further integration and liberalization, for instance in trade in services. Another point of concern is that the Association Agreements leave ample room for protective measures such as safeguards and antidumping measures, and for the reintroduction of trade taxes. Recent examples are available on both sides: on several occasions, the EU imposed restrictions against imports of steel from eastern Europe, and several eastern European countries (Hungary, Poland and Slovakia) increased taxes on imports after the entry into force of the agreements. 2/ Poland also introduced safeguard measures against imports of sugar and some agricultural products.

The EU has had longstanding non-reciprocal preferential trade agreements with Mediterranean countries such as the Maghreb countries (Morocco, Tunisia, Algeria) and Turkey.

Morocco has a Trade and Cooperation Agreement with the EU since 1976. Moroccan industrial exports enter the EU duty-free and virtually

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1/ The European Council of June 1993 decided to reduce this period from initially 5 years to 3 years.

2/ Poland introduced an import surcharge of 6 percent in December 1992, and Slovakia introduced one of 10 percent in March 1994.

unrestricted, with one voluntary import expansion remaining on clothing and a QR on petroleum products. The EU's regime for agricultural products is more restricted. Some agricultural products are admitted duty-free up to a certain quota and are accorded preferential treatment thereafter. The restrictions on fruit and vegetable imports are the most onerous for Morocco. The EU and Morocco are currently negotiating a new partnership agreement that includes new provisions on agricultural exports. Tunisia has a Cooperation Agreement with the EU that provides for duty-free and unrestricted access for industrial products (with the exception of textiles and clothing that are subject to a voluntary export restraint). There is also preferential treatment of some important agricultural products (olive oil, wine, citrus fruits) up to certain limits. The World Bank estimates that these QRs are mostly non-binding. Tunisia is also negotiating a new agreement with the EU. Algeria has a Cooperation Agreement with the EU similar to (but more limited in scope than) Morocco's and Tunisia's.

Turkey's Association Agreement with the EU provides, as a general rule, for duty-free and unrestricted access to EU markets for industrial products. Turkey's industrial exports to the EU are free from duties and restrictions, with the exception of textiles and clothing (that are subject to a VER) and petroleum products (that are subject to a tariff quota). Agricultural products are subject to restrictions. Turkey has embarked on a trade liberalization program that provides for the elimination of tariffs and other restrictions on imports of industrial products from the EU by the end of 1994. The aim of this project is that Turkey enters a customs union with the EU by January 1, 1995.

MERCOSUR (Southern Cone Common Market)

MERCOSUR was founded by the Treaty of Asuncion signed by Argentina, Brazil, Paraguay and Uruguay in 1991. The goal of the agreement was forming a common market among the member countries by 1995. The instruments set forth by the treaty included the free movement of goods, services and factors of production through the elimination of tariffs and non-tariff barriers, the establishment of a common external tariff (CET), the coordination of macroeconomic policy and the harmonization of the respective internal legislation as needed.

The Treaty of Asuncion was the culmination of a five-year process of efforts by Argentina and Brazil to create a customs union between them through bilateral agreements. Paraguay and Uruguay joined the process in 1991. The root of these efforts lay in the failure of the Latin American Integration Area effectively to increase intra-regional trade, the pressing need to improve the trade balance in order to be able to reduce the debt burden and the similarity of the new economic thinking in the area.

Contrary to the efforts at regional import substitution which characterized Latin American integration projects in the 1980s, the 1990s show an attempt to view regional integration as part of a more general strategy to deregulate and liberalize the economy and further multilateral trade liberalization by maintaining low external trade barriers. MERCOSUR is a good example of this new trend.

The Treaty of Asuncion mandates signatory countries to apply a progressive and automatic schedule of intra-regional tariff reduction in eight equal steps beginning in 1991 and finishing by the end of 1994. Non-tariff barriers are to be eliminated by the same date. 1/ Member countries are to agree on a common external tariff by 1995. Paraguay and Uruguay, as relatively less advanced countries within the area, are given one extra year in the phase-in period for free trade. Factor mobility should be free by 1995.

According to the Asuncion Treaty, assembled products must have a minimum of 40 percent of domestic value added in order for them to qualify for regional preferences. Rules of origin will no longer be in force after the implementation of the common external tariff. The treaty provides a few rules concerning the settlement of disputes which may arise among member countries during the transition period. On December 1991, a Protocol was signed which mandated that the mentioned disputes should be settled through

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1/ Member states submitted lists of products which were to be exempted from the general tariff-reduction schedule. They included the following number of items: 394 for Argentina, 324 for Brazil, 439 for Uruguay and 960 for Paraguay. These lists have been progressively reduced and they should reach 0 by the end of 1994 for Argentina and Brazil and by the end of 1995 for Paraguay and Uruguay.

arbitration. Also, until 1995, member countries are allowed to reintroduce tariffs and quotas as a safeguard in case of balance of payments crises or in the case of a threat of injury to domestic industry. The Asuncion Treaty allows production-sharing arrangements to be signed within MERCOSUR. These arrangements, which must be approved by the Common Market, in effect imply managed trade.

Implementation has followed the agreed schedule. As planned, by the end of 1993 member countries had reduced their intra-area tariffs by 82 percent and the elimination of NTBs was quite advanced. Anti-dumping measures, however, were often used as de facto protectionist mechanisms by all member countries except Paraguay. After 1994 export incentives will no longer be possible within MERCOSUR and the agreed common legislation on anti-dumping duties and countervailing duties will enter into force. Negotiations on the common external tariff to be established by the end of 1994 are under way. 1/ Agreement has been reached on almost all tariff lines, which will range from 0 to 20 percent. Agreement on the common external tariff for capital and high technology goods, however, is proving elusive. Argentina prefers very low tariffs whereas Brazil is calling for a 35 percent tariff. Argentina is a net importer of these products, and is interested in lowering its input costs while Brazil, who produces them, is concerned with protecting its import-competing sectors. A second key area in which an accord has not yet been reached is the list of products that will definitely be excluded from MERCOSUR. 2/ Production-sharing arrangements allocating different stages of the production process among MERCOSUR firms have been signed in almost all industries. These sectoral arrangements are included under article 5 of the Treaty of Asuncion as one of the key instruments in the constitution of the common market and they are assigned the objective of making the best use of the factors of production in the region and contributing to exploiting efficient economies of scale. In reality, they will effectively hamper the potential gains from trade creation, especially in Argentina and Brazil. In April 1992, for instance, a production-sharing arrangement was signed for the steel industry. Until it expires in December 1994, this production-sharing arrangement implies the existence of managed trade in the steel sector.

At the present time, the potential net gains from MERCOSUR seem large. Trade within the area during 1993 rose by one third to reach $8 billion. Brazil is now Argentina's largest export market and Argentina is Brazil's second biggest market. For Paraguay and Uruguay the importance of MERCOSUR is even greater, since the regional market accounts for 40 percent and 35 percent of exports respectively. Dynamic gains from trade creation may arise from the new opportunity of member countries' firms to exploit economies of scale as well as from the eventual increase in intra-industry trade if macroeconomic stabilization proceeds in the region and economic

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1/ A number of specific products will face a longer time frame for liberalization, with the final deadline being 2001.

2/ These will likely include some agricultural products as well as selected sectors of heavy industry.

growth continues. Further gains are already being reaped from foreign investment, as the region is increasingly viewed by investors as a single market. Other less tangible but nevertheless important gains will come from enhanced bargaining power of the region as a whole and from strengthening political relations among its members. The single largest benefit, however, probably resides in the role of MERCOSUR in locking the unilateral trade liberalization currently being implemented in the region.

There is, however, some potential for trade diversion. Much depends on the level of the common external tariff. The introduction of the CET for most goods, which ranges from 0 to 20 percent, will cause trade diversion for some MERCOSUR countries who have lower tariffs on some lines than those established by the CET (especially Paraguay, whose maximum tariff at present is 16 percent). The common external tariff on capital and high-technology goods will be of central importance. If it is set at the initial 35 percent level desired by Brazil, 1/ trade diversion effects for Argentina, Paraguay, and Uruguay could be considerable. At present, national positions on this question are tentative.

1/ Gradually to decline to 20 percent by 2001.

Table 5. Intra-Mercosur Trade - Exports Plus Imports, 1980;1992

(<u>In millions of U.S. dollars</u>)

Country	Argentina		Brazil		Paraguay		Uruguay	
Year	1980	1992	1980	1992	1980	1992	1980	1992
Argentina	----	----	1,933	4,907	180.62	245.88	316.4	595.5
Brazil	1,837.5	4,974.1	----	----	180.74	431.04	475	759.2
Paraguay	274	250.5	508	731	----	----	34.1	21.2
Uruguay	333.4	589.1	514	643	25.11	20.01	----	----
Total	2,444.9	5,813.7	2,955	6,281	386.47	696.93	825.5	1,375.9
Percent of total trade	13.2	20.8	6.6	10.6	46.5	38.1	30.5	37.9

Source: IMF, <u>Direction of Trade Statistics</u> (1986 and 1993).

The Economic and Customs Union of Central African States: UDEAC

The Economic and Customs Union of Central African States (UDEAC) was founded by a treaty signed in Brazzaville in 1964 and became effective at the beginning of 1966. It comprises six Central African countries 1/ which are also members of the Franc Zone, with a common currency (the CFA Franc) and Central Bank (the Banque Centrale des Etats de l' Afrique Centrale, BEAC). With the ultimate objective of establishing an economic union, the Treaty envisaged the creation of a customs union with a common external tariff (CET), the elimination of all barriers to intra-union trade, and the establishment of a "Taxe Unique" (TU) or single tax system 2/ to foster the creation of a regionally balanced industrial structure. The Treaty also provides for the establishment of a common customs administration, the creation of a UDEAC investment code, the progressive harmonization of domestic fiscal systems, coordination of transport sector issues, and the free intra-union movement of labor, services, and capital.

The performance of the UDEAC over the last thirty years of its existence has been mixed. While the UDEAC has had some success in areas such as training and research, its goal of an integrated regional market has remained elusive. This relatively poor record of the UDEAC can be traced back to two major factors.

First, buoyed by the commodity price boom of the 1970's, oil exporting members of the UDEAC (Cameroon, Congo, and Gabon) embarked on an import substitution strategy, mainly through ambitious programs of public investment and public enterprises. In order to accommodate the objectives of these countries, the UDEAC treaty was revised in 1974, and the scope of free intra-regional trade was restricted to just raw materials and unprocessed agricultural products; trade in other products originating from UDEAC was limited unless they had access to the single tax regime, which became an instrument of restricting preferential treatment on intra-UDEAC trade to only a selected number of products.

Second, the sharp decline in commodity prices and the overvaluation of the CFA franc, combined with inappropriate macroeconomic policies, resulted in a severe economic crisis in all UDEAC countries. In order to cope with the difficult economic situation, individual countries introduced several measures to circumvent the provisions of the Treaty and further their own objectives, thereby exacerbating the distorted incentive structure created by the single tax. As a result, tariffs became very high and dispersed

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1/ Cameroon, Central African Republic, Chad, the Congo, and Gabon were original signatories. Chad left the Union in 1968 and rejoined in 1984. Equatorial Guinea gained admission in 1984.

2/ The "Taxe Unique" is a complex incentive regime that favors eligible regional firms in the application of indirect taxes on their imported inputs, and their sales within the Union.

across and within countries, and non-tariff barriers to intra-union trade, but also to trade in general, increased.

Against this backdrop, in late 1991, UDEAC members, who had already embarked on structural adjustment programs, started discussing a Regional Reform Program (RRP) to reinforce their domestic adjustment efforts. At the core of the RRP is a trade reform program aimed at simplifying the trade regime, increasing its transparency, and lowering average tariffs and tariff dispersion. The main elements of the trade reform program--to be implemented by all UDEAC members between January 1, 1994 and January 1, 1995--are as follow.

On tariff reform, a CET tariff with four rates will replace all previous customs duties and related taxes and levies. The new tariff structure comprises rates of 5 percent for essential products, 15 percent for inputs and capital goods, 35 percent for consumption goods, and a temporary 50 percent for a limited number of products needing special protection. Duties on intra-UDEAC imports are set at 20 percent of the corresponding CET tariffs before being progressively eliminated over the next 5 years, starting in 1994. The single tax regime will be abolished, and individual members will regain full control of their jurisdiction on domestic taxation.

Quantitative restrictions on imports are to be eliminated over a three-year period and replaced, if necessary, by an import surcharge no greater than 30 percent. The import surcharge should be phased out over the following three years.

The new UDEAC trade regime represents a substantial trade liberalization effort, but it still provides significant protection to certain domestic industries. Over the medium-term, as the competitiveness of these industries improves following the devaluation of the CFA franc, the domestic tax base is broadened and tax administration is strengthened, UDEAC members would benefit considerably from further tariff reduction. In this regard, the decision of UDEAC members (with the exception of Equatorial Guinea) to accelerate the tariff reduction process and implement a tariff structure with lower rates (5, 10, 20 and 30 percent) than suggested by the CET, constitutes a notable step in the right direction.

The Cross Border Initiative: CBI

The CBI is a regional integration initiative among 13 Eastern and Southern African countries. 1/ It is co-sponsored by the African Development Bank, the Commission of the European Communities, the World Bank, and the Fund, and was formally established in August 1993. The broad objective of the CBI is to help reduce impediments to cross-border activity with a view to bolstering economic growth in the region. The CBI is not an "institution" for regional integration, but rather a set of commonly designed and agreed policies--to be implemented during the period 1994-96--to promote cross-border trade, investment, payments, and institutional development among participating countries. This box will briefly review trade patterns within the CBI region, and highlight the main elements of the initiative. 2/

1. Trade patterns within the CBI region

Intra-CBI trade is relatively low and involves usually one or two partners, reflecting the general lack of complementarity among participating countries, but also a poor regional infrastructure. For example, in 1992, the share of individual countries' exports to the entire CBI region varied from below 3 percent for Malawi, Mauritius, Rwanda, and Uganda to about 9-15 percent for Kenya, Tanzania, and Zimbabwe (see Table 6). Kenya and Zimbabwe (which have the most diversified export base among CBI countries), represent the dominant intra-area trading partners, and run substantial surpluses vis-à-vis the rest of the region.

Intra-CBI trade is also hampered by the relatively high level of tariffs and non-tariff barriers which still prevails in the region despite recent liberalization efforts by some participants. Many countries, including Burundi, Kenya, Mauritius, Tanzania, and Zimbabwe have average tariffs exceeding 30 percent, and in some cases (Kenya, Mauritius) tariff dispersion is quite wide (see Table 7). Quantitative restrictions (QRs) on imports vary from open general licensing in Burundi and Tanzania, to more or less restrictive licensing in Comoros, and import bans on different items in Madagascar and Mauritius.

The low level of trade among CBI participants and the differences in the degree of liberalization of their economies, make it very important for the initiative to have mechanisms to minimize the risk of trade diversion, and help those countries with the most restrictive trade regime to achieve their liberalization objective.

1/ Participants are: Burundi, Comoros, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Tanzania, Uganda, Zambia, and Zimbabwe.

2/ For a detailed examination, Initiative for Promoting Cross-Border Trade, Investment, and Payments in Eastern and Southern Africa, see SM/94/91, April 8, 1994.

2. Main elements of the CBI

The CBI rests mainly on three pillars: a trade liberalization program, an investment promotion component, and measures to liberalize members' exchange and payments systems.

The trade liberalization program emphasizes the elimination of tariffs and non-tariff barriers among participating countries in the context of an overall trade liberalization effort. Participants in the CBI agreed to eliminate tariffs on intra-regional trade by 1996, while at the same time lowering tariffs vis-à-vis third countries to the level of the member with the lowest tariffs. Quantitative restrictions affecting both intra-regional trade and trade with non-CBI members are to be removed. The elimination of quantitative restrictions applies also to trade in services. The CBI allows for technical and some financial assistance, as well as some flexibility in the pace of reduction of trade barriers for countries that are likely to be severely affected by the implementation of these measures.

The investment promotion component of the CBI consists of measures aimed at reforming the regulatory environment for investment and progressively harmonizing investment incentives. Participating countries are to take concrete steps to liberalize, streamline, expedite and publicize procedures for the approval of both domestic and foreign investment. Participants to the CBI should also enhance the incentives for cross-border investment by, inter alia, taking steps to: (i) join investment-guaranteeing agencies such as the Multilateral Investment Guarantee Agency; (ii) conclude necessary agreements to avoid the double taxation of investment profits; and (iii) facilitate labor mobility.

The CBI also seeks significantly to improve the functioning of the intra-regional payments system and liberalize members' exchange systems. In this regard, participants should take the necessary measures to: (i) strengthen the domestic payments and settlements systems; (ii) converge to a position that will allow the complete, non-discriminatory elimination of all restrictions on payments and transfers for current international transactions, and the attainment of current account convertibility; and (iii) establish a unified, inter-bank foreign exchange market by 1996.

As one of the sponsors of the initiative, the Fund has primary responsibility for guiding reforms and providing technical assistance in the area of macroeconomic, monetary and exchange rate policies. Participants are to hold discussions with Fund staff with a view to designing a framework of macroeconomic and structural policies that facilitates the attainment of the objectives of the CBI.

Table 6: Trade Between Major CBI Participants, 1992 1/

(In percent of each country's total exports or imports)

	Burundi	Kenya	Madagascar	Malawi	Mauritius	Rwanda	Tanzania	Uganda	Zambia	Zimbabwe	Total
Burundi		...	...	...	...	3.2	...	...	--	0.5	3.7
		3.3	...	--	...	0.1	8.9	...	2.9	0.9	16.1
Kenya	0.5		0.1	0.2	1.2	1.8	2.3	7.8	0.4	0.6	15.0
	0.2		--	--	0.1	...	0.5	0.1	0.3	0.8	2.0
Madagascar	...	0.2		...	2.2	...	0.5	...	...	...	3.6
	...	1.0		...	1.0	...	...	...	...	--	2.0
Malawi	--	--	...		--	...	0.2	...	1.6	1.0	2.8
	...	0.2	...		--	...	0.1	...	1.4	9.2	10.9
Mauritius	...	0.1	0.9	--		...	--	--	--	0.6	2.1
	...	1.4	0.9	--		...	--	...	--	0.1	2.4
Rwanda	0.2	--	...	...	...		--	...	...	...	0.2
	1.3	9.7	...	...	...		8.0	0.2	--	...	19.2
Tanzania	4.1	1.6	...	...	0.1	4.8		...	0.3	0.6	11.5
	...	3.0	0.1	...	--	...		...	0.1	0.5	3.7
Uganda	...	1.1	...	...	...	0.4	...		0.1	0.2	1.8
	...	28.1	...	...	--	...	...		--	0.2	29.0
Zambia	0.5	0.7	...	0.4	...	...	0.3	...		1.2	3.1
	--	0.5	7.8	0.5	...	...	0.3	--		5.6	15.1
Zimbabwe	0.1	1.0	--	3.4	0.1	...	0.4	--	3.7		8.9
	--	0.5	...	0.2	0.4	...	0.2	--	0.7		2.0

Source: IMF, Direction of Trade Statistics ,1993.

1/ The table should be read horizontally; for each country, figures on the first row indicate exports to partner countries, and figures on the second row indicate imports from partner countries.

Table 7: Current Trade Regime of Selected CBI Participants.

	Tariffs	Quantitative restrictions
Burundi	Average tariff is 40.4 percent.	OGL for imports. A few import restrictions for security reasons.
Comoros	Average tariff is 10 percent. Consumption taxes averaging 25 percent applied to imports.	Import bans on some goods. Imports outside the Franc zone require licensing. Imports of some clothing and food items are restricted. Government monopoly on rice and petroleum imports.
Kenya	Average tariff rate is 34 percent. Maximum rate of 62 percent is applied on certain goods such as TVs, finished textiles and some beers.	Short negative list for imports for environmental reasons.
Madagascar	Tariffs range is 5–40 percent. Most rates fall into 5–10 percent range. Fiscal duty of 10–50 percent on imports with a surtax of 30 percent on luxury goods.	OGL for imports except for import bans of 61 items mainly for health and security reasons.
Malawi	Average tariff rate of about 20 percent. Maximum rate is 40 percent.	Most imports are under OGL. Specific import licences are required for certain items in some cases for health and security reasons.
Mauritius	Average tariff is 52 percent. The tariff range is 5–220 percent. Fiscal duty (5–100 percent) and import levy of 17 percent are also applied to imports.	Import permits maintained for statistical and tax purposes. Import bans exist for certain items.
Tanzania	Average tariff is 30.1 percent	OGL for imports with a small negative list for health and security reasons, and for 8 luxury items.
Uganda	Tariff rates ranging from 0–30 percent for most goods. Higher rates of of 90–175 for some petroleum products.	Import bans on beer, and soft drinks.
Zambia	Tariff rates ranging from 15–40 percent for most goods. Luxury goods are at higher rates.	Negative list includes those related to security reasons, gold, silver, platinum, alcholic beverages, tobacco, electronics and passenger vehicles.
Zimbabwe	Average tariff rate is about 20 percent plus a surcharge of 20 percent.	Retention of exports earnings up to 60 percent.

Source: Various Staff Reports and RED's.

ASEAN Free Trade Agreement (AFTA)

Beginning in the late 1970s, the Association of Southeast Asian Nations (ASEAN) shifted its attention from a largely political orientation to an economic focus. 1/ This was viewed as part of an effort to maintain its competitive position in the world economy by increasing opportunities to exploit scale economies and deepen the division of labor across the region. On February 24, 1977, member states signed the ASEAN Preferential Trading Arrangement. This arrangement included provisions relating to long-term quantity contracts, preferential interest rates for purchase finance, preferences in government procurement, selective tariff preferences, and the preferential liberalization of non-tariff barriers (NTBs). The scope of regional liberalization under this arrangement was strictly limited by the request-offer approach to liberalization, extensive exclusions, relatively stringent rules of origin, and the small number of tariff lines covered by intra-ASEAN trade. As a result, the share of intra-ASEAN trade in total ASEAN trade, the direction of intra-ASEAN trade, and the product composition of intra-ASEAN trade have remained virtually unchanged.

The third ASEAN summit held in 1987 essentially paved the way for the ASEAN Free Trade Area. Member countries recognized the ineffectiveness of the ASEAN PTA and agreed in 1987 to seek new ways to increase intra-ASEAN trade. On January 28, 1992, ASEAN member countries agreed to implement the Common Effective Preferential Tariff Scheme (CEPT), with the aim of improving the PTA and with a view to moving toward an ASEAN Free Trade Area.

The stated objective of the AFTA was to increase manufacturing competitiveness in ASEAN member countries by attracting greater foreign direct investment and thereby improving the ASEAN production base from which to reach world markets.

A detailed CEPT list was submitted by ASEAN members and announced October 31, 1993. It includes the products to be liberalized--both fast track and normal track--those excluded from liberalization (both temporary exclusions and general exceptions), 2/ and a specific timetable of tariff reductions submitted by each ASEAN member to be implemented over a 15-year period from January 1, 1993. The Agreement covers manufactured products and

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1/ ASEAN was established by Indonesia, Malaysia, the Philippines, Singapore, and Thailand in 1967. Brunei Darussalem joined ASEAN in 1984.

2/ The general exclusion list includes such products as motor vehicles, mineral fuels, etc. Member States may exclude products from the CEPT scheme for reasons of national security, public morals, protection of human, animal, or plant life and health, and the protection of articles of artistic, historic or archeological value. Member States may temporarily exclude certain sensitive items from the CEPT scheme and the exclusion list will be reviewed in the eighth year with a view to bringing these items into the scheme and achieving the 0-5 percent tariff within the remaining 7 years.

processed agricultural products. Unprocessed agricultural products and services are not covered. The goal is to reach a target preferential tariff on manufactured goods of from 0 percent to 5 percent by January 1, 2008. Nontariff barriers, including quantitative restrictions, on CEPT goods are also to be eliminated; quantitative restrictions are to be eliminated upon enjoyment of initial concessions, and other NTBs are to be phased out over five years from the date of initial concessions on a CEPT product.

Member states with foreign exchange restrictions must exclude AFTA states from these restrictions in respect of payments for CEPT products (to be clarified).

Concessions apply only to goods originating in an ASEAN country and the rule of origin is set at 40 percent of local content, either within a single member country or on a cumulative ASEAN basis.

The starting date for the implementation of the AFTA was moved forward by consensus from January 1993 to January 1994. An average of roughly 25 percent of member countries' tariff lines are to be covered in the program of tariff reductions with effect from 1994. The current schedule indicates that about 88 percent of the tariff lines included in the liberalization schedule will reach the target level of 0-5 percent tariff by the year 2003.

The phasing of CEPT tariffs is divided into "fast track" and "normal track" timetables. Tariff reduction timetables are subdivided into those items with tariffs initially above 20 percent and those at or below 20 percent. Fast track items with tariffs above 20 percent will be reduced to 0-5 percent by January 1, 2003. Those with initial tariffs at or below 20 percent are to be reduced to 0-5 percent by January 1, 2000. Under the normal track timetable, items with tariffs above 20 percent are to reach a 20 percent tariff no later than January 1, 2001. Subsequently, these items are to reach tariffs of 0-5 percent by January 1, 2008. Normal track items with initial tariffs below 20 percent are to reach the 0-5 percent range by January 1, 2003.

Asia-Pacific Economic Cooperation Forum (APEC)

Established in 1989 at a ministerial conference in Canberra--under the initiative of Australian Prime Minister Bob Hawke, the Asia-Pacific Economic Cooperation forum (APEC) is a vehicle for promoting greater regional economic cooperation. The original membership included the members of ASEAN (Indonesia, Malaysia, Philippines, Singapore, Thailand, and Brunei), as well as Australia, Canada, Japan, Republic of Korea, New Zealand, and the United States. The group expanded in 1991 when China, Hong Kong and Taiwan Province of China joined the 12 original members. APEC members together account for 38 percent of world trade (in 1992), and intra-APEC trade represents 60 percent of their total trade. From the outset, the attention of the organization was devoted to trade facilitation and technical cooperation efforts carried out within ten working groups (Telecommunications, Trade Promotion, Human Resources Development, Regional Energy Cooperation, Marine Resource Conservation, Fisheries, Transportation, Trade and Investment Data Review, Investment and Technology Transfer, and Tourism). More recently, exploratory work has been underway in the areas of customs cooperation, reviewing APEC-member investment regimes (with a view to increasing transparency), and exploring the prospects for mutual recognition of standards.

APEC has not been viewed as a precursor to an eventual free-trade arrangement. Instead, cooperation efforts and trade facilitation initiatives are pursued under the banner of "open regionalism". This means that any successful efforts to facilitate trade and investment flows within APEC will be carried out multilaterally, on a most-favored nation (MFN) basis. In 1992, a permanent secretariat was established in Singapore to support Asia-Pacific cooperation in trade. Support for the multilateral trading system was reaffirmed with the November 1993 declaration of APEC ministers calling for urgent action to conclude the Uruguay Round successfully.

The November 1993 ministerial meeting established a Pacific Business Forum, an APEC Education Program, and an APEC Business Volunteers Program. In addition, several new initiatives were agreed including (i) steps to improve the competitiveness of small- and medium-sized businesses; (ii) an action program to assist in the integration of policies on economic growth, energy security, and environmental protection within APEC; and (iii) the development of a set of non-binding investment principles. With regard to the latter area, APEC countries will undertake a work program to identify barriers to trade and investment flows in the region with a view to pursuing future efforts to eliminate these. Ministers also agreed at the 1993 meeting to expand APEC membership to include Mexico and Papua New Guinea.

A vision for the future direction of APEC was recently presented in the Report of the Eminent Persons Group (EPG). Ministers endorsed the report's call for initiatives to achieve freer trade and investment flows in the region, and called for further study in some areas, including the EPG's recommendation that APEC pursue an active program of regional trade liberalization on a GATT-consistent basis.

Gulf Cooperation Council (GCC)

The Gulf Cooperation Council was established in 1981 by Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE) to integrate their economies by establishing free movement of goods, services and factors of production. Trade in goods between the GCC members is free of tariffs provided that at least 40 percent of the value added is produced in the GCC region and that at least 51 percent of the capital of the producing firm is owned by citizens of the GCC member countries. Oman, however, was permitted to levy tariffs on some products, reduced to 4 product groups in 1989, originating in the member countries. The GCC countries are to levy a common external tariff ranging between 4 and 20 percent. Tariff exemptions are allowed, and the higher range of tariffs are to be levied for protection or other special reasons.

Currently, the trade regimes of the GCC members are practically free of QRs, the tariff structure is relatively uniform, and the average tariff is low. Qatar and the UAE levy generally uniform tariffs at 4 and 1 percent respectively. Oman has a basic import duty of 5 percent on non-GCC imports, though on some goods rates of 15 to 25 percent are levied. In Saudi Arabia tariffs on most imports average 12 percent, within an overall tariff structure ranging from 0 to 20 percent. Tariffs in Bahrain range from 0 to 20 percent with an effective tariff of about 5 percent. In Kuwait tariffs also range between 0 and 20 percent. The recent agreement to proceed by applying a common external tariff on commodities on which there is accord should accelerate the formation of the common market.

Trade among the GCC members in 1992 was about 6 percent of their overall trade (about 5 percent for exports and about 7 percent for imports), and imports were significantly lower than exports. While the share of intra-GCC exports in overall trade is small, intra-GCC exports are important in total non-oil exports, varying from about 5 to about 30 percent depending on the country.

Exports are very concentrated with Saudi Arabia accounting for about 60 percent of intra-GCC exports--a significant portion of which are petroleum exports to Bahrain--while the UAE accounts for another quarter. The main importers are Bahrain with about a third of intra-GCC imports, and Oman and the UAE with about a quarter each. The main exports from Saudi Arabia are light manufactures such as garments and paper products, and agricultural goods such as dairy products, fish from Bahrain, and metal products from Bahrain, Qatar, and the UAE.

The GCC has been negotiating an economic cooperation agreement with the EU to foster trade between the two regions, and for the EU to assist the members of GCC in their economic development. At a meeting in May 1994, it was agreed to intensify cooperation between the EU and the GCC in a number of areas such as standards, environment, energy, and industry. The ultimate objective is for a EU-GCC free trade agreement. This will be discussed after completion of the common market among GCC members through the establishment of a common external tariff.

Factors of production move freely within the region and the capital markets of GCC members are integrated. Citizens of GCC member countries are allowed to move within the area for employment as well as to purchase and own shares of industrial companies in all GCC member countries. Citizens can also borrow from the specialized financial institutions of any member country providing loans for industrial development on common terms relating to maturity and charges. Steps have been taken to harmonize certain prices throughout the region--telephone rates have been unified, there is movement towards unifying water rates and prices of petroleum products--opening the way for regional enterprises. GCC companies are accorded a 10 percent preferential margin in government contracts. The Gulf Investment Corporation aims to set up private joint ventures in the region, and has been operating since 1986.

Table 8. Intra-GCC Export Trade, 1992
(in millions of US dollars)

	Destination					Total to:	
Origin	Bahrain	Oman	Qatar	Saudi Arabia	UAE	GCC	World
Bahrain	--	25.4	23.2	104.2	43.7	196.5	3,007.6
Oman	41.4	--	5.2	26.8	8.3	81.7	7,799.9
Qatar	3.7	8.5	--	56.2	129.0	197.4	3,488.1
Saudi Arabia	1,598.0	68.0	83.0	--	909.0	2,658.0	51,771.0
UAE	32.0	957.0	7.0	215.0	--	1,241.0	24,742.0
Total	1,675.1	1,058.9	148.4	402.2	1,090.0	4,374.6	90,808.6

Source: IMF, Direction of Trade Statistics.

1/ Data on Kuwait were not available and were not included in other countries' exports to the GCC area. Exports include re-exports. For some countries re-exports could be a significant proportion of exports to member countries.

Economic Cooperation Organization (ECO)

ECO aims at promoting economic, technical and cultural cooperation among its member states. Its origins are to be found in its forerunner, the Regional Cooperation for Development (RCD), which was founded in 1964 with identical goals and working procedure as ECO. The founding members of RCD were the Islamic Republic of Iran, Pakistan and Turkey. The RCD became ECO in 1985. In 1992 ECO found new strength as the newly independent Central Asian Republics of Azerbaijan, Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan and Uzbekistan as well as Afghanistan joined the organization. At the 1993 ECO summit, member states expressed their intention at a future date to take up the Russian Federation's proposal to become a member.

The activities of ECO are organized through eight working groups or technical committees in the fields of economic and commercial cooperation, transport and communications, agriculture, energy, infrastructure and public works, narcotics and educational, scientific and cultural matters.

At the 1992 ECO Summit, a very limited system of tariff preferences among member countries was agreed, establishing a 10 percent reduction on specific tariff lines. The agreement was initially for a period of 4 years, but would be automatically extended for further periods of 2 years each. The ECO summit of 1993 adopted a decision to establish the ECO Development Bank as well as a joint insurance company for shipping and airlines. Further areas discussed included the setting up of free trade and industrial zones, border trade, joint ventures in the transportation sector, and cooperation in the area of telecommunications, pipelines and railroads. A proposed World Bank-backed project to build a railway linking Baluchistan and Turkmenistan has not made progress due to the military conflict in Afghanistan.

ECO's progress in achieving regional integration has thus far been limited. The extent of regional trade liberalization is extremely limited and the projects decided upon at ECO summits are not being implemented. Participation by Afghanistan is constrained by its internal security situation. The Central Asian republics have only recently joined and their most pressing needs are internal stabilization and restructuring. Central Asian republics are naturally also desirous of maintaining their economic links to other republics of the FSU, especially the Russian Federation. Even among the original ECO members, intra-regional trade accounts for very small percentages of total trade (Table 9). The trade regimes of ECO member countries vary considerably. Turkey has few QRs and an average tariff of less than 10 percent. The Islamic Republic of Iran retains QRs on some commodities, an average tariff of 30 percent, high import registration fees and a commercial benefits tax; under its trade liberalization program, the Islamic Republic of Iran intends to cut its tariffs by half by end-1994 and incorporate the benefits tax into the tariff structure. Pakistan has the most restrictive trade regime among the three, but is currently undertaking significant liberalization.

In the long run, the region could benefit from increased trade as infrastructure is improved, economic reforms take hold, and military conflicts are resolved.

Table 9. Intra-ECO Trade of Selected Members, 1992

(in millions of U.S. dollars)

Countries	Afghanistan		Iran		Pakistan		Turkey	
	Imports	Exports	Imports	Exports	Imports	Exports	Imports	Exports
Afghanistan	--	--	--	--	6.6	16.0	.1	.5
Iran	.05	.03	--	--	184.7	89.9	269.8	502
Pakistan	17.56	5.96	99	168	--	--	46.9	41.7
Turkey	.52	.12	552	245	49.84	3.0	--	--
Intra-ECO Total	18.13	6.11	651	413	241.1	148.9	316.8	544.2
Percent of Total Imports/Exports	1.1	0.6	2.8	2.6	2.6	2.0	1.3	3.7

Source: IMF, Direction of Trade Statistics, 1993.

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