

I TRADE AND TRADE POLICY DEVELOPMENTS

A RECENT TRENDS

1. THE GLOBAL ECONOMIC SITUATION IN 2002 AND PROSPECTS FOR 2003

International trade rebounded in 2002 from its contraction in the preceding year, growing at about 2.5 per cent in volume terms, which was faster than the growth of global output. The rebound occurred despite the weakness of the global economic recovery, greatly reduced capital flows, major changes in exchange rates, increased restrictions on international trade transactions to mitigate risks from terrorism, and rising geopolitical tensions. Trade growth was strong in Asia and the transition economies, largely reflecting better economic performance in those regions. However trade was stagnant in Western Europe, and contracted in Latin America as a result of economic turmoil in a number of countries in the region. North America's imports recovered in line with stronger domestic demand, while exports continued to decrease in 2002.

The trade policy environment benefited from the momentum generated by the Doha Ministerial Conference and the start of WTO negotiations. An important step in support of the negotiations was taken when the US congress approved trade promotion authority for the US President after a lapse of eight years. While the US safeguard measures on steel contributed to a rise in international trade tensions, the case was referred to a WTO panel. However, the passage of the US farm bill and the continuing disagreement over the reform of the EU common agricultural policy (CAP) cast a shadow over the agricultural negotiations.

Regional trade arrangements continued to proliferate with agreements being negotiated or concluded by countries in all corners of the world. Even countries that had long avoided regional agreements began to move in this direction. Many countries seem to be taking the multilateral trading system for granted, while pursuing their commercial interests on a preferential basis in the belief that this will not jeopardize multilateral, non-discriminatory trade relations. But there is a danger that regionalism will distract trade policy makers' attention from multilateral negotiations precisely at the moment when energy and resources need to be marshalled to shepherd these negotiations to a successful conclusion. Developments in regional trade arrangements and their implications for the WTO are discussed in more detail in Section IB.3 of this Report.

The recovery in a number of commodity prices in 2002 provided an important lift to commodity exporting developing countries. But since prices of non-oil commodities have been falling for much of the last decade, the recovery still leaves prices at historically depressed levels. An important part of the development challenge for commodity exporters is to diversify their export structures. But given that this shift in production and export structures cannot be effected immediately, continuing reform in agricultural trade leading to fewer distortions would be of particular benefit in the short and medium term. Commodity price issues are taken up in Section IB.2 of the Report.

The strong expansion of developing Asia's trade augured well for the continued expansion of South-South trade. This is because developing Asia trades proportionally more with developing countries than other developing regions. Over the last decade, developing countries' economies have grown much faster than those of the developed and transition countries. The liberalization of the trade and investment regimes of a large number of developing countries has played a significant role in this expansion. Intra-developing country trade was the main beneficiary of the higher economic growth and more liberal trade regimes in the developing countries. As a result, the share of intra-developing country trade in world merchandise exports rose from 6.5 per cent to 10.7 per cent in 2001 representing a historic peak in the last 50 years. South-South trade trends are discussed in Section IB.1 of this Report.

The global economic recovery in 2002 turned out to be less sustained than expected at the beginning of the year. The momentum of the output expansion remained moderate in the first three quarters and faltered in the last quarter of 2002 in the major industrial economies. The most prominent explanations, often interrelated, for the retardation in the global economic recovery included erosion of trust in institutional pillars such as public and corporate governance, weakening consumer and investor confidence and rising geopolitical risks.

The weakness of fixed investment expenditure – particularly pronounced for non-residential investment – contributed significantly to sluggish overall growth in the industrial countries. Investment expenditures play a critical role in the business cycle. Last year, they failed to sustain the recovery once inventory levels had been re-established. Investment activity generally picks up when prospects for profitable investment opportunities increase and the utilization of existing production capacities reaches a level that calls for a further increase of these capacities. In the first half of 2002, capacity utilization rates in the manufacturing sector of the industrial economies were still too low to warrant large scale capital expenditures. Perhaps even more important was the deterioration in business confidence as a result of growing appreciation of the poor profit prospects of large segments of the economy in addition to the IT sector or the internet economy. Confidence and credibility were further dented by the discovery of serious accounting irregularities in the financial statements of companies which had been used to inflate business expectations and reported profits. These irregularities, combined with doubtful practices by management in the mergers and acquisitions boom of the preceding years, shattered the trust in corporate governance and led to a flight out of stocks into investments considered to be safer – thereby aggravating further the downturn in stock markets. Falling stock values increased the strains on financial intermediaries, such as banks and insurance companies.

Consumer confidence in the major industrial economies improved only temporarily in the first quarter of 2002 and declined or stagnated thereafter. Marginal employment gains in some countries and rising unemployment rates in others led to only moderate increases in wage incomes and depressed private consumption expenditure. In some countries this led to an increase in precautionary savings.¹ The deterioration in the labour markets of industrial economies with rapidly aging populations rendered their already fragile social security systems even more precarious. The general public is increasingly aware that profound adjustments are needed to restore financial sustainability to social security systems and that these adjustments can have a significant impact on future contributions and benefits. The clouded prospects of social security, and in particular pensions systems, contributed to the erosion of consumer confidence and exerted a negative impact on private consumption expenditure. Consumer confidence was also negatively affected by the wealth effect of continuing falls in stock prices, although in some countries (e.g. the United States and the United Kingdom) this was compensated for by rising house prices.

Government expenditure was the most dynamic component of domestic demand for the second year in a row in the developed countries stimulated by anti-cyclical budgetary policies. Despite supportive fiscal and monetary policies, the recovery of domestic demand remained moderate in the developed world.

The sluggish economic performance of the EU(15) and Japan proved a major drag on global recovery. Domestic demand shrank or continued to stagnate in 2002. US domestic demand, however, expanded by 2.5 per cent despite a further contraction of US fixed investment. Among the large industrial economies, only Canada and Australia stood out with strong GDP growth in 2002 (both in excess of 3 per cent).

In marked contrast to the industrial economies, the recovery in the advanced developing economies in Asia was strong. With the two most populous countries in the world – China and India – growing very rapidly, the gains in output experienced by developing Asia exceeded that of all other regions.

¹ In the United States the personal savings ratio recovered from its record low of 2.3 per cent in 2001 to 3.7 per cent in 2002.

Economic growth in the transition economies in 2002 was second only to developing Asia and continued to exceed the global average. Nevertheless, there was a deceleration in the region's economic growth, which can be largely attributed to developments in the Russian economy. Economic growth in Africa and the Middle East remained roughly unchanged in 2002, at about 3 per cent. The moderate gains in regional per capita incomes are unlikely to have a significant impact on poverty levels in the region and one should not lose sight of the large variations in the economic performance of individual African countries. Latin America was the weakest part of the global economy in 2002, recording a decline in output and a steep contraction in imports. Unsustainable, large public sector debt, political instability, sizeable external account imbalances and a reduction in private sector net-capital inflows have contributed to severe slumps in output in a number of South American countries.

During the course of 2002, the US dollar depreciated against major currencies like the euro and the yen. However, this did not seem to have materially affected the US trade deficit, nor current account surpluses being accumulated by the euro zone countries, Japan and developing Asia. In the case of Latin America, though, the steep decline in the nominal and effective exchange rates of several crisis countries may have contributed to the sharp reduction of the region's current account deficit.

Total foreign direct investment (FDI) flows fell by about one quarter in 2002, to roughly \$500 billion, with both developed and developing regions suffering sharp reductions. Only China and Central/Eastern Europe attracted larger FDI inflows than in the preceding year. Given the strong correlation between FDI flows and current and future trade flows, this development contributed to the weakness in trade growth in regions other than China and Central/Eastern Europe.

The threat of terrorism has led many governments and companies to take various measures to enhance security and to limit the risks of future terrorist attacks. Some of these measures have resulted in restrictions on the movement of persons and goods. The cost not only involves the direct expenditures for these security measures which governments and companies must put in place, but the indirect impact on trade in the form of more cumbersome procedures and delays. The increase in geopolitical risks and tensions have also taken their toll on international trade through the recent run-up in oil prices in the course of 2002. Heightened concerns about the security of oil supplies have lifted oil prices by about one third, reaching their highest level for 13 years in early 2003. The increased number of security measures, higher oil prices and the heightened perception of international uncertainty has had a large negative impact on air transportation and long-distance travel.

In March 2002, the United States imposed temporary safeguard measures on imports of key steel products. There was initially some apprehension about a tit-for-tat response from other trade partners. Although a number of countries (e.g. EU, China, Hungary) also imposed safeguard measures on imports of various steel products, the general level of restraint shown, the efforts of the United States to mitigate the effects of the measures on some trading partners, and the establishment of a WTO dispute settlement panel to hear the case, alleviated fears of retaliatory trade actions.

Global economic activity was strengthened by developments in China and the transition economies. The maintenance of stability combined with substantial market reforms culminating in China's accession to the WTO have contributed to the exceptional output and trade growth recorded by China in the 1990s. One factor contributing to this outstanding performance was the high level of FDI inflows driven by the relocation of labour-intensive manufacturing sectors from Japan and other advanced economies in Asia into China's coastal areas. WTO membership has supported these FDI inflows, combining increased access to Chinese consumers with an easing of restrictions on foreign investment.

As a consequence of these developments, China's role in international trade has been further enhanced, with its trade expansion last year accounting for more than one-fifth of the increase in world merchandise exports (and imports). China has not only become a major supplier but also a prominent market for many countries.² Having overtaken the United Kingdom in 2002, China now ranks as the world's fifth largest merchandise trader. Concerns sometimes expressed about the effects on other economies of China's dynamism as an exporter should be tempered by the realization that Chinese import demand is also growing at a remarkable pace.

(a) Prospects for 2003

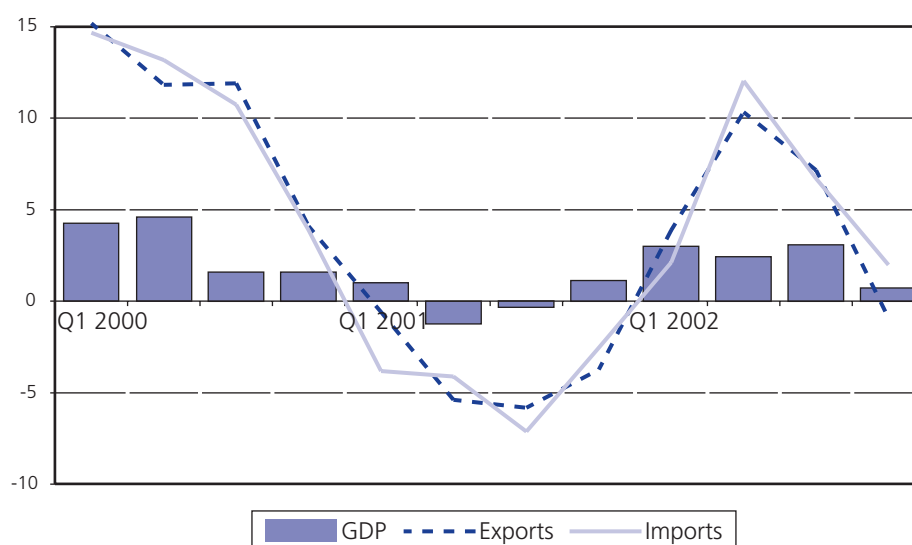
Considerable uncertainty clouds trade growth prospects for 2003. The expectations of a war in Iraq caused a sharp increase of oil prices in the first quarter of 2003 and had a detrimental effect on business confidence and global stock markets. Oil prices started to weaken in the second half of April but remained above the preceding year's level. Information on economic activity in the industrial countries in the first months of 2003 has led to a marked downward revision of output growth in 2003, in particular for Western Europe. As Western Europe accounts for more than 40 per cent of world merchandise and commercial services trade, global trade will suffer accordingly. The outbreak of Severe Acute Respiratory Syndrome (SARS) and the possibility of its continued spread will affect economic growth in developing Asia, which was one of the motors of the global trade expansion in 2002.

The slowdown in economic expansion in the industrial economies in the last quarter of 2002, continued sluggishness of business and consumer confidence in the first months of 2003 (reflected also in weak stock markets), together with the higher oil prices, call for a downgrading of the economic projections made in late 2002. Predictions then were for a moderate acceleration in global output growth and a significant rise in global trade on a year to year basis. In the light of the recent exchange rate developments – in particular the strong appreciation of the euro and yen vis-à-vis the US dollar – growth projections need to be lowered for the EU and Japan and increased for the United States, thereby increasing further the projected gap in output growth among these economies.

Chart IA.1

Expansion of trade and output of OECD countries slows in fourth quarter 2002

(Percentage change on a quarter to quarter basis)



Source: OECD, Olisnet

² For eight developing countries China was the principal export market in 2001 and for five other economies, the second largest market.

Global trade flows are projected to expand by 3 per cent or less in 2003. In the last quarter of 2002, trade expanded only marginally from the third quarter (see Chart IA.1). On the assumption that trade will stagnate during the first months of 2003 and pick up at a moderate rate thereafter – as economic activity strengthens on a world-wide basis – the year-to-year expansion of trade would be a disappointing rate of 3 per cent or less. Trade growth in 2003 would thereby be markedly lower than the average growth rate recorded in the 1990s.

This bleak short-term outlook for the world economy and world trade in particular calls for government policies which strengthen business and consumer confidence and which refrain from the introduction of trade restrictive measures. The forthcoming Ministerial Meeting in Cancún provides an opportunity to make progress in the current round of trade negotiations. Such progress would represent an important signal that governments are able to come together to conclude mutually beneficial agreements, boosting confidence in the world economy and strengthening the foundations of the multilateral trading system.

(b) The economic background

The global economic recovery was uneven in 2002 and lost steam in the second half, limiting full-year growth to only 1.5 per cent. The main driving forces in global economic activity in 2002 were the recovery in domestic demand in the United States and the advanced economies in East Asia. The expansion of world GDP was also sustained by both China and the transition economies which continued to record much faster economic growth than the world economy. In sharp contrast, Japan and Western Europe continued to experience stagnant or declining domestic demand growth, and Latin America's economy plunged into a recession largely brought about by the crises in Argentina and Venezuela. The per capita income in the region declined for the second consecutive year.

In the industrial countries, the main expenditure categories of GDP differed markedly in behaviour during the cyclical slowdown and recovery. The run down in inventories and their replenishment in 2002 was the most outstanding factor in last year's cyclical recovery. Inventory changes in the OECD reduced GDP growth by 0.8 per cent in 2001, but added 0.2 per cent to GDP growth in 2002. In the United States, public consumption expanded by 3 per cent and was also the fastest growing component of demand in the industrial countries. Private consumption in the OECD area rose by 2 per cent in 2002 as the acceleration of consumer demand in the US was balanced by the slowdown in both Japan and Western Europe. A major element in the weakness of the recovery was the continuing contraction of non-residential investment, which was even more pronounced last year than in 2001. The recent decline in non-residential investment was also much more marked than the last downturn in the early 1990s, which can be attributed to the steeper contraction in the United States. Residential investment, however, recovered in the OECD, in particular in North America and the European Union.

The sluggishness of economic activity and widespread excess capacity in the manufacturing sector contributed to a further decline in inflation rates.³ Inflation decreased slightly in Western Europe, North America and Asia. While consumer prices in the transition countries receded markedly, from what were sometimes double digit rates, they increased in South and Central America under the impact of currency devaluations. As global economic growth lagged behind both productivity and labour force growth, unemployment and underemployment worsened in most regions. Recorded unemployment rates rose in North America, Western Europe and Japan. In the latter country, the unemployment rate reached a historic record level of 5.5 per cent in 2002, more than twice the level reported in the early 1990s. In Latin America, the steep decline in output has led to a sharply worsened employment situation. According to CEPAL (Comisión Económica para América Latina y el Caribe), the average urban unemployment rate in the region increased to 9.1 per cent, the highest rate observed in the 1990s.⁴

³ In mid-2002, capacity utilisation rates in the manufacturing sector in the US, Japan and the euro zone were still well below the average utilization rates recorded on average in the 1990s.

⁴ UNECLAC (2003).

Marked differences in domestic demand growth between the United States, developing Asia and the transition economies on the one hand, and Japan, Western Europe and Latin America on the other, contributed to major shifts in trade and current account balances. Japan and Western Europe recorded an expansion in net exports. Consequently, the trade and current account surpluses of Japan and the EU widened with increases equivalent to 1 per cent and 0.7 per cent of GDP respectively. Under the impact of sharply lower capital inflows, Latin America had to cut its imports, which led to a trade surplus and reduced the region's current account deficit. The US current account deficit widened to more than \$500 billion or 5 per cent of GDP, which was a historic peak in absolute and relative terms. Given that the aggregate deficit for the OECD area remained almost unchanged in relative terms in 2002, this implied that the level of net imports from developing areas also stayed unchanged. Developing Asia again recorded a substantial current account surplus. Japan, the four advanced developing Asian economies (Hong Kong, China; Korea, Rep. of; Singapore; Chinese Taipei) and China all reported large current account surpluses, indicating that these economies have become the principal suppliers of capital to the rest of the world.⁵

International capital flows had risen throughout the 1990s and peaked in 2000. Since then there has been a drastic contraction. This can be illustrated by the pronounced rise and fall in FDI. Total FDI flows surged from about \$200 billion in the early 1990s to almost \$1.2 trillion in 2000. In 2001, the value of these flows collapsed by about 50 per cent, and in 2002, by another 25 per cent, falling back to about \$500 billion, a level first reached five years ago. Both developed and developing regions have been affected by the reduction in FDI flows. Only FDI inflows to China and to Central/Eastern Europe continued to increase. China's FDI inflows rose by 19 per cent, to \$ 52.7 billion, and those to Central/Eastern Europe increased by 9 per cent, to \$30 billion.⁶ The sharp decline in nominal terms of global FDI flows can be attributed to the end of the frenzied boom of mergers and acquisitions and the lower market values of corporations listed on global stock markets. Between the end of 2000 and the end of 2002, the valuation of global stock markets decreased by about 40 per cent, which automatically lowers the transaction value of FDI flows for buying corporations listed on equity markets.⁷

In the course of 2002, the real effective exchange rate of the US dollar depreciated while those of the euro and yen appreciated. In the medium term, the depreciation of the US dollar, after its rise of nearly 20 per cent between 1995 and 2001, could contribute to arresting the steady increase in the US trade deficit. For the euro zone and Japan, however, the net contribution of foreign demand to GDP will decrease if real effective exchange rates remain at the level attained at the end of 2002 and the beginning of 2003. A number of countries in Central/Eastern Europe who are in the process of accession to the EU as well as some economies in developing Asia also felt upward pressure in their exchange rates with respect to the US dollar. The nominal and effective exchange rates of several countries in Latin America affected by the financial crisis in 2002 decreased sharply thereby helping to reduce the region's current account deficit. One aspect of the dollar decline vis-à-vis the currency of major traders is the "inflationary" impact on world trade prices measured in dollar terms. Although intra-EU trade stagnated in 2002 in euro terms, it recorded an increase of nearly 5 per cent measured in dollar terms. The overall impact of exchange rate developments on trade values in 2002 contrasts with the tendency prevailing between 1995 and 2001, when the dollar's appreciation had the impact of "deflating" world trade prices measured in dollar terms.

For the first time since 1995, the dollar prices of internationally traded agricultural and manufactured goods showed an annual increase. Oil prices recovered from their trough in early 2002, with annual average prices for 2002 marginally exceeding those of the preceding year. Prices for metals continued to decline, particularly for aluminium, the most heavily traded metal. The recovery in food prices was the net outcome of higher prices for all types of cereals, soybeans and vegetable oils, which outweighed the price reductions in meat,

⁵ The foreign exchange reserves of the five Asian developing economies increased by about \$50, while Japan's international reserves increased by \$30 billion in 2002.

⁶ The Vienna Institute for International Economic Studies, press release, February 2003: FDI in CEECs in 2002: Record Inflow Concentrated in a Handful of Countries. At <http://wiiw.ac.at>.

⁷ Estimates based on the average decrease of four major stock market indices: NYSE-Composite, FTSE 100, Frankfurt DAX and Tokyo Topix. Source: World Federation of Exchanges at <http://www.world-exchanges.org>.

seafood, sugar and tropical fruits. Prices for cereals, in particular wheat, rose as droughts in four of the five traditional exporting regions caused a decline in production for the second year in a row.

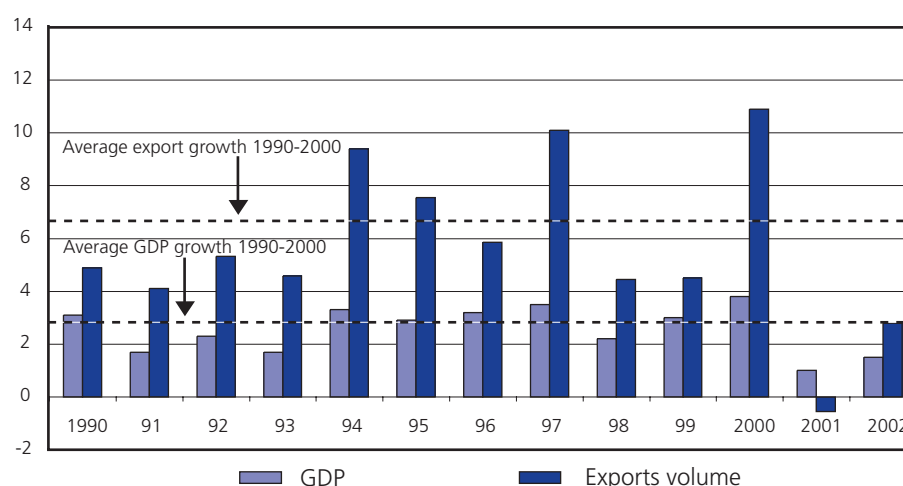
Given the steady recovery of prices for fuels and non-fuel commodities in the course of the year, the price levels attained in the fourth quarter of 2002 exceed those of the corresponding quarter in 2001 by 30 per cent and 12 per cent respectively. However, the annual averages for 2002 remained almost unchanged from those in 2001.

The price increase for manufactured goods can be largely attributed to European price developments as the export and import prices for manufactured goods of the United States and Japan continued to decrease in 2002. Among manufactured goods, prices of iron and steel products and automotive products recorded above average increases, while those for office and telecom equipment decreased further. Prices for internationally traded chemicals and clothing showed only marginal increases.

Chart IA.2

Merchandise trade recovers more strongly than output in 2002

(Annual percentage change)



Source: WTO, International Trade Statistics.

The pick up in global economic activity went together with a rebound of international trade flows. Based on preliminary estimates, world merchandise exports rose in volume terms by 2.5 per cent in 2002 after the contraction in the preceding year. Although global trade recovered faster than output, the expansion was less than half the average rate recorded in the 1990s (see Chart IA.2). The annual average growth rates conceal the steep decrease of global trade in the course of 2001 and its rapid recovery between the last quarter of 2001 and the third quarter of 2002. In the fourth quarter of 2002, there was a notable flattening of trade growth for both the United States and Western Europe.

A major element in the more subdued expansion of trade in the last quarter of 2002 was the continued sluggishness of investment in the major developed markets and in Latin America. The continued contraction of new investment in machinery and equipment in 2002 can be linked to low capacity utilisation rates in the manufacturing sector, and in particular, in information technology and telecommunication equipment. Worldwide expenditures on electronic equipment, IT hardware and semi-conductor plants continued to shrink worldwide.⁸ The repercussions of the decline of investment expenditure on trade flows can be illustrated by

⁸ According to industry sources, global sales of electronics equipment and IT hardware decreased by about 5 per cent while sales of semi-conductor plant equipment decreased by more than 20 per cent in 2002.

⁹ US Department of Commerce, Commerce News FT-900-12, Exhibit 11, p. 16.

the continuing decline in the volume of US imports of capital goods in 2002, while US imports of all other products recovered by 6 per cent.⁹

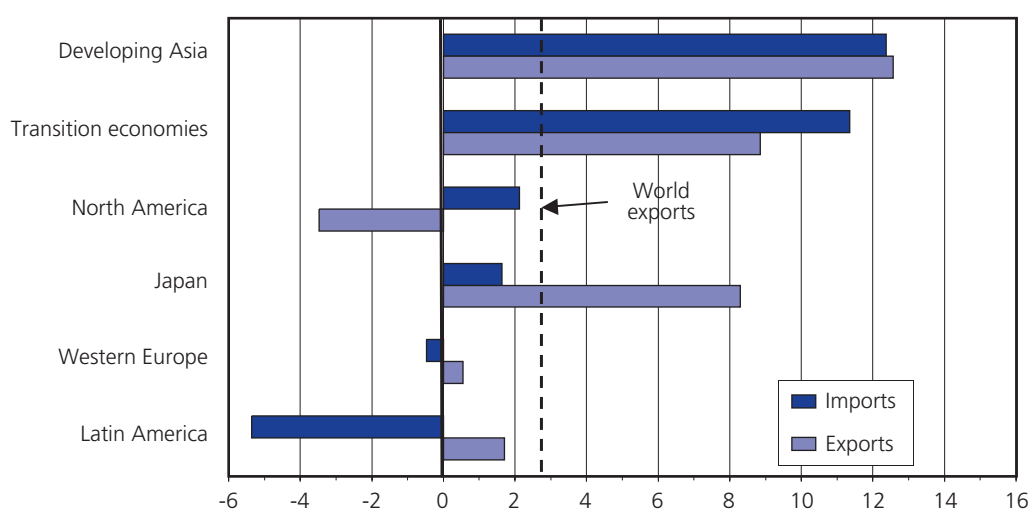
Largely due to sluggish investment expenditures, trade expansion (average of exports plus imports) in both North America and the Western Europe lagged behind their GDP growth. In Asia and the transition economies, however, trade expanded at least two times faster than output, which was in each case well above the global average. The strength of these regions' trade growth, which was around 10 per cent in 2002, stemmed largely from the vigorous expansion of domestic or intra-regional demand. The performance of these two regions explains why global trade expanded faster than output in 2002. In contrast, Latin America's output decline caused a contraction of its imports by 5.5 per cent, while exports continued to grow despite shrinking intra-regional trade because of the expansion of trade with countries outside the region. On the whole, both trade and output declined in Latin America, with trade decreasing more than output.

An important element in the global trade recovery of last year was North American, and in particular, US import growth. United States merchandise imports account for one-fifth of world trade and expanded by 3 per cent in volume terms, which was faster than the global trade expansion. Relatively buoyant private and public consumption growth continued to stoke US import demand. Developing Asia and the transition economies, which were the regions with the highest GDP growth, also contributed strongly to the growth in imports. Developing Asia's imports rebounded by 12.5 per cent following a contraction in the preceding year (see Chart IA.3). Two factors can be singled out for this dramatic reversal. First, the surge of FDI inflows in the aftermath of China's accession to the WTO resulted in a jump in China's real imports by nearly a quarter. Second, was the recovery of imports in the developing East Asian IT traders of nearly 9 per cent (after a decline of 8.5 per cent in the preceding year). As regards the transition economies, most of the strength was contributed by Russian demand, although import growth was broad-based, with more than half of all transition economies experiencing double digit growth.

Chart IA.3

Large variations in trade volume growth by region in 2002

(Annual percentage change)



Source: WTO

The recovery of global trade was retarded by the stagnation of Western Europe's imports and a contraction of Latin America's imports. Among the West European countries, imports shrank or stagnated in France, Germany and Switzerland while Belgium and Denmark recorded a relatively vigorous import expansion. A reduction of net capital inflows into Latin America forced the region to cut back its current account deficit. This was achieved primarily by a fall in imports in the order of 4 per cent and a rise in extra-regional exports.

(c) Price and exchange rate changes contribute to the increase in global trade values

The recovery in the volume of trade combined with a moderate increase in prices of internationally traded goods resulted in a rise in the value of world trade. Merchandise and commercial services exports rose by 4 and 5 per cent respectively in 2002. However, these rates of nominal trade expansion remained below the average recorded in the 1990s (see Table IA.1). For merchandise trade, the expansion in 2002 offset the decrease reported in the preceding year, while commercial services trade reached a new peak level. For world merchandise exports, available data point to an above average rise in the exports of manufactured goods and a below average increase for both mining and agricultural products. Among the categories of commercial services, exports in the largest category – other commercial services – expanded significantly faster than those of travel and transportation services.

Table IA.1

World exports of merchandise and commercial services, 1990-2002

(Billion dollars and percentage)

	Value	Annual percentage change				
	2002	1990-2000	1999	2000	2001	2002
Merchandise	6240	6	4	13	-4	4
Commercial services	1540	7	3	6	-1	5

Source: WTO

As inflation and exchange rates evolved quite differently by region, developments in nominal merchandise trade differed from those in volume terms. This is most evident in the case of Western Europe, whose exports in volume terms stagnated at 0.6 per cent while its exports in value terms increased by 5.5 per cent. The difference can be attributed almost entirely to the 5 per cent depreciation of the dollar against the euro and other western European currencies. Asia and the transition economies had the strongest export value growth of all regions, followed by Western Europe. North America reported the largest export contraction among regions, while imports recovered by 1.5 per cent. The double digit import growth of the transition economies contrasts with the contraction in Latin American imports of 6.5 per cent, the worst of all regions. Latin America's exports rose moderately despite a steep contraction in intra-regional trade, which was balanced by a rise of shipments to other areas. Africa's exports and imports achieved small positive gains. Middle East exports are estimated to have decreased further in 2002, although at a lower rate than in 2001. As the region's imports continued to grow, the large trade surplus of the Middle East eroded somewhat.

2. TRADE AND TRADE POLICY DEVELOPMENTS BY REGION

A notable feature of North America's trade in 2002 was the poor performance of its merchandise exports, which decreased by 4 per cent (see Table IA.2). A major reason for this was reduced demand from some of its key trading partners because their economies were either hardly growing, such as Western Europe and Japan, or in outright contraction, as in Latin America. Despite the recent depreciation of the dollar, lack of price competitiveness might have also played a major role as US exports decreased even to those regions whose imports grew strongly. Exports from the United States lost market share not only in developing Asia, the transition economies, Western Europe and NAFTA, but also in the developing economies of Latin America, the Middle East and Africa. However, imports continued to grow, driven by consumer spending and

an increasingly expansionary fiscal stance. Consumer spending, particularly on durables, remained healthy because of low inflation, strength in the US housing market, which partly offset stock market losses, and tax relief.¹⁰ The federal budget deficit rose to \$158 billion in fiscal year 2002, which is about 1.5 per cent of GDP. The widening deficit was due to the slowdown in economic growth, increased expenditures on homeland security and the tax cut of 2001. North America's export and import prices decreased slightly in 2002 and contributed to sluggish growth in merchandise trade in value terms. On the other hand, commercial services trade recorded a better performance, as exports rose by 3 per cent and imports by 11 per cent (see Table IA.3).¹¹ Once again, there were big differences in the performance of the three major services sectors. While travel and transportation services shrank, other services saw double-digit import and export growth.

Table IA.2
Growth in the value of merchandise trade by region, 1990-2002
(Billion dollars and percentage)

	Exports				Imports			
	Value	Annual percentage change			Value	Annual percentage change		
	2002	1990-2000	2001	2002	2002	1990-2000	2001	2002
World	6240	6	-4	4	6500	6	-4	3
North America	946	7	-7	-4	1431	9	-6	2
United States	694	7	-7	-5	1202	9	-6	2
Latin America	351	9	-3	1	355	12	-2	-7
Mexico	161	15	-5	1	176	15	-4	0
MERCOSUR	88	6	4	1	62	12	-6	-26
Other Latin America	102	6	-7	0	116	7	3	-3
Western Europe	2648	4	0	5	2644	4	-2	4
European Union (15)	2441	4	0	5	2438	4	-2	3
Excl. intra-EU trade	939	5	1	6	931	5	-4	1
Intra-EU trade	1502	4	-1	5	1507	4	-1	5
Transition economies	309	10	5	8	297	8	11	10
Central/Eastern Europe	145	10	12	12	176	12	9	10
Russian Federation	107	-	-2	4	60	-	20	12
Africa	139	3	-6	1	133	3	2	1
Middle East	236	6	-7	-2	183	5	4	2
Asia	1610	8	-9	8	1457	8	-7	6
Japan	416	5	-16	3	336	5	-8	-4
Developing Asia	1114	11	-7	10	1033	9	-7	9
China	326	15	7	22	295	16	8	21
IT traders (6) ^a	618	10	-13	7	561	9	-13	6

^a Chinese Taipei, the Rep. of Korea, Malaysia, Philippines, Singapore and Thailand.

Source: WTO

¹⁰ The passage of the Economic Growth and Taxpayer Relief Reconciliation Act of 2001 (EGTRRA) was estimated to have resulted in a reduction of \$78 billion in federal tax liabilities in 2002.

¹¹ Most of this increase is linked to the rise in US imports of insurances services which recovered from the fallout of insurance payments linked to the damage caused by the terrorist attacks of 11 September 2001.

Intra-North American trade declined marginally while exports to crisis-ridden South America and stagnating Western European economies decreased at double-digit rates. Imports from these regions, however, increased slightly in 2002. Imports from Asia rose largely due to higher shipments from China. United States imports from China increased by 20 per cent, but decreased from Japan and the NICs(4). The steep decline of US exports to and imports from Japan, Hong Kong, China and Singapore point to structural shifts in US trade with Asian countries. For the first time, China replaced Japan as the principal Asian supplier of merchandise to the United States. Although US exports to China also rose rapidly, the bilateral trade deficit widened sharply and reached almost \$103 billion, the largest with any country.

The imposition of emergency safeguard measures by the United States on specialty steel products may be expected to have reduced US steel imports, but precise estimates of these effects cannot yet be provided. However, the value of total iron and steel imports into the United States (including those not subject to restrictions) had already fallen by 22 per cent in 2001, followed by a further decrease of 2 per cent last year. As US import prices for iron and steel had risen on average by 1.5 per cent, the reduction in import volumes was greater than in import values.

Table IA.3
Growth in the value of commercial services trade by region, 1990-2002
(Billion dollars and percentage)

	Exports				Imports			
	Value	Annual percentage change			Value	Annual percentage change		
	2002	1990-2000	2001	2002	2002	1990-2000	2001	2002
World	1540	7	-1	5	1520	6	-1	5
North America	304	7	-4	3	260	7	-5	11
United States	268	7	-4	3	218	8	-5	13
Latin America	55	7	-2	-6	63	7	0	-12
Mexico	13	7	-7	0	16	5	-1	-1
MERCOSUR	13	8	-5	-13	19	10	-3	-26
Other Latin America	30	7	1	-5	28	7	3	-6
Western Europe	744	5	1	7	695	5	2	6
European Union (15)	673	5	2	8	651	6	3	6
Transition economies	58	...	7	8	63	...	11	12
Central/Eastern Europe	33	...	6	3	29	...	7	12
Russian Federation	12	...	10	18	21	...	12	13
Africa	29	5	1	-6	40	4	4	1
Middle East	32	9	-7	-4	47	4	-6	3
Asia	316	9	-1	5	354	7	-4	1
Japan	65	5	-7	2	105	3	-7	-2
Developing Asia	230	11	2	6	227	11	-1	2
China	37	18	9	13	44	24	9	13
Hong Kong, China	44	8	2	6	24	8	-1	-2
Korea, Rep. of	29	13	0	-1	34	13	0	2
Singapore	27	8	-2	3	21	10	-6	1

Source: WTO

Other US trade policy measures taken in 2002 are likely to have both short-term and long-term impacts on trade flows, but these are not always quantifiable. For the first time since 1994, Congress granted Trade Promotion Authority (TPA) to a US President. The granting of TPA in August 2002 was an important signal not only of US commitment but also its ability to advance WTO trade negotiations. But the US administration also approved the 2002 Farm Bill, which was to increase spending on US agriculture by \$82.8 billion over a six-year period. United States agricultural exports decreased slightly in 2002 in value terms, although the decline in export volumes was larger given strengthening US prices. Imports of agricultural commodities rose by 6 per cent in both value and volume terms.

In 2002, the US developed further its preferential trade policy across many regions by the conclusion of free trade agreements (FTAs) with Chile and Jordan, the acceleration of the tariff elimination process among NAFTA members agreed to in early 2002, and the extension of the list of African countries benefiting from the African Growth and Opportunity Act (AGOA). As discussed below, in relation to other regions, many countries continued to divide their attention between multilateral and preferential trade negotiations (see also Section IB.3 in this Report).

For the Latin American region, 2002 turned out to be one of the most difficult years since the debt crisis of the 1980s. Private net capital inflows to the region, which exceeded \$60 billion in 1999 and 2000, had financed large current account deficits and supported economic activity, investment and imports. But given the loss in confidence by foreign investors in the sustainability of the economic policies of some major countries, there was a curtailment of net capital inflows into the region. This reduction had already begun in 2001, and there was a sharp fall again in 2002. Even FDI inflows, which had continued to enter in large volumes in 2001, contracted last year.¹² The reductions in inflows were first compensated by a reduction in foreign exchange reserves and eventually by devaluations ranging between 50 and 70 per cent in the most affected countries. Early in January 2002, Argentina decided to abandon the 10-year-old parity link between the Argentinian peso and the US dollar and devalued the peso by 30 per cent. This decision triggered a series of further devaluations in the region. Given that the level of many commodity prices remained low in 2002, this limited the export earnings of many countries in the region, while the huge contraction in economic activity significantly dampened imports.

The financial crisis in Argentina, the economic repercussions on its MERCOSUR neighbours, and the civil unrest in Venezuela were the major factors contributing to the contraction of Latin America's merchandise imports, by nearly 7 per cent in 2002. Argentina experienced a massive cut in imports (-55 per cent), which exceeded even the worst import contractions during the Asian financial crisis. The reduction in Latin America's imports was the largest of any of the seven major regions covered in this report and contrasts with its trade performance in the 1990s, when Latin America's imports and exports expanded much faster than the global average. Merchandise exports rose slightly as falling intra-regional trade was offset by rising exports to other regions (Chart 1A.4). For the first time since 1991, Latin America's merchandise trade balance (measured on a f.o.b.-f.o.b. basis) turned positive again. Commercial services imports are estimated to have decreased by more than 10 per cent in 2002. In contrast to merchandise exports, the region's exports of commercial services experienced a contraction of about 5 per cent.

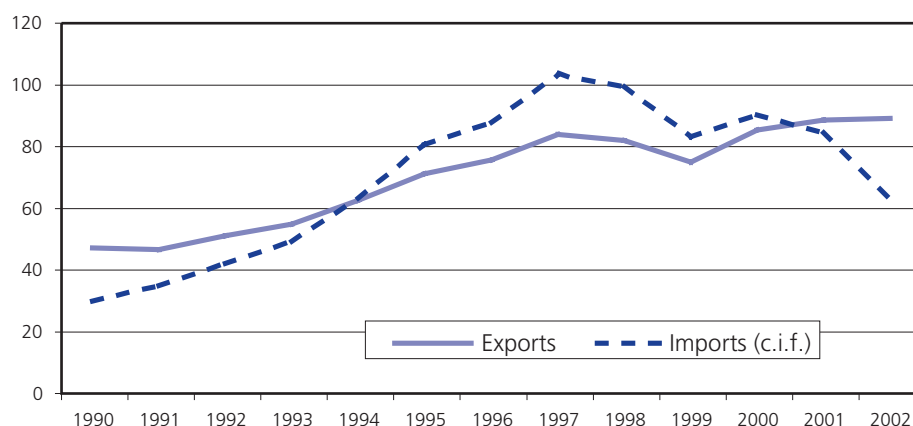
MERCOSUR countries increased their overall exports by 1 per cent, as the dramatic contraction of intra-regional trade by more than one-third was offset by an increase in shipments to all other destinations of 8 per cent. Brazil, the country least dependent on intra-MERCOSUR trade, increased its total merchandise exports by 4 per cent. In 2000, intra-MERCOSUR trade had accounted for about one-fifth of both total exports and imports. But given the economic difficulties experienced by the region in the last few years, these shares have fallen quite precipitously. In the case of exports, the intra-MERCOSUR share has now been cut almost by half (from 20 to 11 per cent). And despite the quite substantial preferential margin (about 13 per cent on average) on imports originating in MERCOSUR countries, the share of intra-MERCOSUR imports has fallen back to levels last seen prior to 1995.

¹² A major exception to this regional development was the increase in FDI flows to Mexico.

Chart IA.4

Diverging developments in MERCOSUR merchandise trade in 2002

(Billion dollars)



Source: WTO

Latin America's merchandise exports increased slightly as the decline in intra-regional trade was balanced by increased shipments to other regions. The recovery of commodity prices in the course of the year and the upturn in the US economy contributed to this rise. While most Latin American countries saw a reduction or stagnation in their imports, those of Costa Rica increased by 9 per cent. Mexico benefited from the recovery of the US market while for Costa Rica, the recovery in semi-conductor shipments boosted both imports and exports. Despite the continuation of low prices for a number of primary commodities, exports of many Central American and Caribbean countries recovered strongly.

Economic activity in Western Europe remained subdued as Germany, the largest economy, experienced declining domestic demand. Domestic demand growth remained positive in the rest of the region, but was sluggish in several other countries. In the euro zone, public consumption was the most dynamic expenditure category while private consumption slowed down and fixed investment in the enterprise sector fell nearly 3 per cent. In the midst of this poor economic situation, further progress was made in the process of European integration.

At the beginning of the year, another major step in monetary integration was taken with the introduction of euro notes replacing ten national currency notes. (Box IA.1).

Box IA.1: Effects of the euro on trade and financial markets

The introduction of the euro in January 1999, followed by the elimination of national currencies in the euro area in 2002, is bound to have powerful effects on trade and financial flows.

The euro is now the second most widely used currency worldwide. Around 1 per cent of the official foreign exchange reserves of IMF member countries were denominated in euro at the end of 2001. About half of the euro area's external trade is denominated in the euro. Some one-fifth of global foreign exchange trade involves the euro. The share of euro-denominated international debt securities issued by non-residents has risen to 29 per cent (compared to 44 per cent for the dollar). Fifty countries include the euro in their exchange rate policies as an anchor or reference currency (although these countries only account for 4 per cent of global GDP).

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In theory, the introduction of the euro should be conducive to trade growth. Floating currencies create uncertainty that discourages international trade and investment. Once currencies are fixed, this uncertainty is eliminated. Moreover, if trading nations adopt a common currency, this will eliminate the transaction costs of currency exchange. One study estimates that belonging to a currency union or currency board can as much as triple trade among currency union members. Finally, trade in a common currency leads to trade creation while there is no evidence of trade diversion.¹

The introduction of the euro can also have indirect effects on trade and financial flows arising from the impact of policies on macroeconomic stability and economic growth. These effects stem from the ability of the monetary authorities to control inflation within a common currency area, and thus the seignorage tax, as well as the level of interest rates.

The euro has facilitated the integration of financial markets in the euro area. Interest rates converged rapidly – typically to the level of German rates – well before the common currency was launched. There has been some consolidation of financial industries with the EU area through mergers and acquisitions as well as growth in the establishment of branches by other EU banks, although the changes have been relatively modest.² The introduction of the euro has also facilitated a switch in investment financing away from bank-intermediated credit to other sources of financing.³

Last year saw a significant weakening of the US dollar against major currencies. The euro moved from substantially below parity to the dollar (86 cents per euro) at the start of the year to \$1.05 to the euro at the end of the year. The euro also strengthened by about 10 per cent against the yen, moving from 114.8 to 125.7 yen to the euro by the end of the year. On a trade-weighted basis, the euro appreciated by about 6.8 per cent during the year.⁴ The reasons for a weaker dollar include a slower than expected economic recovery in the United States, loss of confidence as a result of a spate of corporate scandals, rising geopolitical tensions and a widening current account deficit towards the end of the year. A strengthening euro could reduce competitiveness of euro area exports and increase imports. However, this does not seem to have occurred as during the first 11 months of 2002, euro area exports rose by 2.1 per cent while imports declined by 4.1 per cent. These combined to create a substantial increase in the goods surplus (by 56.7 billion) compared to the level in 2001.⁵ One explanation for this is that there may be lags in the way exchange rate changes affect trade flows.

¹ Frankel and Rose (2001). For further evidence see Kenen (2002); Lopez-Cordova and Meissner (2000); and Micco, Stein and Ordóñez (2002).

² For more discussion see Baldwin and Wyplosz (2003). Downloadable at <http://heiwwww.unige.ch/~baldwin/THX,-R>

³ Galati and Tsatsaronis (2001).

⁴ Based on data from the ECB Monthly Bulletin (February 2003). The 'narrow' nominal and real effective exchange rates of the euro are weighted averages of bilateral exchange rates with the dollar, yen, Swiss franc and the pound. The weights used are average 1995-97 manufactured goods trade weights of those countries with the euro area.

⁵ ECB Monthly Bulletin (February 2003).

Source: European Central Bank (2002).

In December 2002, the heads of 15 EU governments agreed with their counterparts from the 10 EU accession countries on the financial framework for their future membership. Following the signature of the accession treaties in April 2003, and depending on the pace of ratification of the treaties by the respective parliaments, the EU enlargement to 25 countries could be achieved by May 2004 (Box IA.2). Among other trade policy developments in 2002, the conclusion of free trade agreements with Jordan, South Africa and Mexico, and the start of Cotonou Economic Partnership Agreement negotiations should be highlighted.

Box IA.2: The enlargement of the European Union from 15 to 25

The key measures. At its meetings on 12-13 December 2002 in Copenhagen, the European Council formally closed negotiations with ten countries and approved their accession to the European Union. The ten countries are Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovak Republic, Hungary, Slovenia, Cyprus and Malta. The actual accession of the ten countries is scheduled to take place on 1 May 2004 provided that the 2003 schedule of conditions is respected (mainly ratifications).

Likely impact of the enlargement. As shown in the table below, the ten acceding countries will account for 15 per cent of the EU population and 19 per cent of the EU area. While significant, historically this is not the biggest enlargement of the EU. The expansion from six to nine EU members in 1973 was larger in terms of the population criterion. All previous accessions added more in terms of land area than the current accession. But by far the smallest contribution will be in the economic size of the market. The ten countries will only add 5 per cent to the EU's GDP, which reflects both the small size of most of the acceding countries as well as low income per capita.

Shares of the acceding countries in population, surface, GDP and exports of the enlarged EU (1973-2004)
(Percentage)

The Enlargement of the European Union	Date	Population	Surface	GDP	Exports
From Six to Nine	1973	25	22	20	21
From Nine to Twelve	1981-86	18	31	9	3
From Twelve to Fifteen	1995	6	27	7	9
From Fifteen to Twenty Five	2004	15	19	5	6

Sources: Revue Elargissement, Paris, MINEFI – DREE/Tresor, No. 37, p.2, and WTO Secretariat.

The enlargement is not expected to increase sharply the shares of trade between the EU(15) countries and the ten acceding countries. The main reason is that most of the trade re-orientation has already taken place under the umbrella of the Europe Agreements – extended free trade agreements – which preceded the enlargement. Under those agreements, the acceding countries have enjoyed virtually duty free access to the European market for industrial products since 1994 (fully free access since 1998). The share of the EU in total imports of the ten prospective members remained constant at 58 per cent between 1995 and 2001. The share of acceding country exports going to the EU increased from 60 per cent to 68 per cent during the same period. The share of the new entrants in total EU trade remained very small and stable over this period, at between 4 per cent and 5 per cent.

Based on 2001 world trade values, enlargement will increase the share of intra-EU trade in the EU's total trade from nearly 62 per cent to 67 per cent, while the share of the EU in world merchandise exports (including intra-EU flows) will reach 41 per cent. The degree of integration of the acceding countries is also apparent from the sharp increase in FDI flows from the EU. The latter increased from 1.5 per cent of GDP of the acceding countries in 1996 to 3.2 per cent of GDP in 2000. The EU accounted for 80 per cent of acceding countries' FDI inflows in 2000.

Since the acceding countries will be adopting the common external tariff of the EC, other trade partners will be concerned with how their current market access to the ten countries will be affected. In adopting the *acquis communautaire*, Central and Eastern European countries are likely to increase average protection in agriculture and decrease it in industry and services. In contrast, the Balkan countries will decrease their

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average protection in all three sectors.¹ Given that all ten countries are also WTO Members, accession could result in improvements over existing WTO commitments in some areas but a deterioration in others. WTO Members who may be adversely affected will have the right to negotiate for compensation.

¹ Francois and Rombout (2001).

Given the depreciation by about 5 per cent of the US dollar vis-à-vis the euro, the pound and various other European currencies, Western European trade performance measured in dollar terms concealed the stagnation in volume terms. Western Europe's merchandise exports in dollar terms increased by 5.5 per cent, while the expansion of imports was limited to 3.5 per cent. EU imports from third countries languished while intra-regional trade rose by 4.5 per cent. The most dynamic part of EU trade was exports to third countries which expanded by about 6 per cent. Among the other Western European countries, Switzerland's merchandise exports rose by 7 per cent, largely due to the appreciation of the Swiss franc. The stagnation of the Swiss economy left its imports unchanged from the preceding year. Turkey's imports recovered strongly in 2002, from a contraction in the preceding year, while exports continued to expand at double digit rates. Western Europe's commercial services exports, which account for nearly one half of world services trade, increased by nearly 8 per cent, somewhat faster than imports, with exchange rate changes accounting for most of this increase in dollar terms. Exports of transportation services experienced the weakest growth, while exports of other commercial services showed the most dynamic performance in 2002.

More than a decade after the fall of the Berlin Wall and the dissolution of the USSR, many transition economies are still struggling with their transformation from planned to market-oriented economies. The progress made in the transition has been uneven and despite numerous achievements, the reform process is still incomplete in particular in CIS economies. Six out of the 15 successor states of the former USSR have already joined the WTO. Armenia will be the seventh after its parliament signs its protocol of accession, which was agreed upon by WTO Members on 10 December 2002. The Baltic States and five Central East European countries concluded their accession negotiations with the EU in December 2002, thereby anchoring their economies to Western Europe. Over the last decade, trade and investment flows have already linked these economies in a substantial way to Western Europe. One of the outstanding features of the transition process has been the massive re-direction of trade flows from within the region to trade with countries outside the region, and in particular, to Western Europe. This shift in structure can be observed not only in the trade of Central/Eastern Europe or the Baltic States, but also in the CIS countries. Efforts to sustain intra-regional trade through various forms of RTAs have only had limited success so far.¹³ Intra-CIS trade in 2002 was still at about the level reached in 1994, while extra-CIS exports nearly doubled between 1994 and 2002. Despite the relatively strong economic growth in the region, the share of intra-regional trade in CIS merchandise exports and imports declined to one third and one fifth respectively. Part of this further decline can be attributed to restrictive trade measures introduced by Russia on imports from Ukraine in mid-2001.

Merchandise trade of transition economies was sustained by strong domestic demand growth, above all in private consumption, and by rising FDI inflows into Central/Eastern Europe. The region's merchandise and commercial services imports rose at double-digit rates. Export growth was somewhat less dynamic than imports, but was still twice as fast as growth in world merchandise and commercial services trade.

Merchandise exports of the transition economies expanded by 8 per cent, reaching a new record level of \$310 billion in 2002. Russia, the leading trader in the region, recorded merchandise export gains of 3.5 per cent, while 11 other transition economies recorded import growth in excess of 10 per cent. Preliminary data suggest that the transition economies' commercial services exports and imports both rose by about 8 and 12 per cent respectively in 2002.

¹³ For a discussion of the various CIS intra-regional agreements, see UNECE (2003).

The preliminary data available on Africa's output and trade in 2002 do not indicate a reversal of past trends with respect to incomes or participation in world trade. Average per capita income levels changed little and Africa's trade growth lagged behind global trade expansion. Although various debt indicators improved and non-oil commodity prices recovered somewhat from their depressed levels in 2001, a broad-based expansion of output and trade has not yet occurred.

In 2002, Africa's merchandise and commercial services trade lagged behind the global trade expansion.¹⁴ Merchandise exports and imports recorded only marginal gains. The African oil exporters saw a further decline in their exports (-3 per cent) and a fall in their imports in the order of 5 per cent to 10 per cent. South African exports and imports recovered by 2 per cent to 3 per cent from the preceding year's decline. Exports of the other non-oil exporting African countries were much stronger and expanded by about 6 per cent. A strong rebound in exports in 2002 from the preceding years' decline in a number of countries (including Morocco, Egypt, Côte d'Ivoire and Ghana) accounted for most of this strength in the export growth of non-oil exporters in Africa.¹⁵ However, it is estimated that only six out of 53 African countries achieved a sustained expansion of their exports over the 1999-2002 period.¹⁶ Africa's overall merchandise import growth was held back by import contraction in Nigeria and Egypt, the third and second largest merchandise importers in Africa in 2001. In at least 15 other African countries, however, there was double digit import growth.

Various initiatives have been undertaken to strengthen Africa's production and trade capacity. These include such mechanisms as debt cancellation (HIPC), improved regional cooperation (NEPAD, African Union), the Cotonou Agreement and various trade preference schemes. A recent example is the African Growth and Opportunity Act (AGOA) of the United States, which improves the access of African products to US markets. Although the largest part of US imports from Africa is accounted for by fuels, there are some indications that a number of non-oil exporting countries have experienced markedly higher shipments to the United States in 2002. While overall imports of the United States from Africa decreased by 20 per cent, imports from non-oil exporting countries which are full beneficiaries of AGOA preferences rose by 6 per cent. The strongest increases in shipments to the United States were reported by Kenya, Swaziland and Lesotho. Initiatives such as AGOA and the EU's Everything But Arms are new and therefore may need more time to mature. However, the available evidence suggests that they have not yet succeeded in bringing about sustained growth in trade to the beneficiary countries. This reflects in part the reality that various supply-side constraints are also key to Africa's growth and trade performance.

In 2002, the Middle East's trade and output growth was curbed by a fall in the region's oil production and growing political tensions. As fuels account for more than three quarters of the region's merchandise exports, a decline in oil output has immediate repercussions on export revenues. One notable feature of Middle East trade in recent years is the increased orientation of its exports to Asia, where more than one-half of the region's fuel exports are shipped.

Merchandise and commercial services trade of the Middle East lagged behind world trade growth in 2002. The region's merchandise exports are estimated to have decreased only slightly, despite lower exports from various large oil exporters in the region. This is due to a number of smaller traders who reported double-digit export growth. Given the rising tensions in the region, earnings from tourism suffered, leading to an overall decline in commercial exports of about 4 per cent. In Israel, both exports and imports continued to be at depressed levels.

Merchandise imports of the region increased only marginally. Stagnating import levels in two major countries (Saudi Arabia and Israel) contrasted with a double-digit increase in Iran's imports. The region's overall trade surplus was reduced somewhat, but was still large enough to offset the region's commercial services trade deficit, which widened in 2002.

¹⁴ At the time of writing (in early March 2003) only four African countries have reported full-year data on their merchandise trade.

¹⁵ Sharp increases in the prices of cocoa and gold helped export recovery in Côte d'Ivoire and Ghana.

¹⁶ The six countries are Equatorial Guinea, Lesotho, Mozambique, Seychelles, Sierra Leone and Tanzania.

The rather moderate share of intra-regional trade (less than 8 per cent of merchandise exports) can be attributed partly to similarities in the production structures of the countries in the region. In order to strengthen the integration of the gulf economies, a planned customs union among the members of the Gulf Cooperation Council was advanced by two years, to 1 January 2003. Various free trade agreements with major partners outside the region are also being pursued. In the first half of 2002, Jordan concluded free trade agreements with the EU, the United States and EFTA.

In 2002, trade developments in Asia were shaped by the diverging growth paths between Japan, still Asia's largest economy, and China and India, the two most populous nations in the world. While Japanese domestic demand stagnated, China and India continued to grow rapidly. ASEAN countries and other East Asian economies also experienced stronger economic growth in 2002 compared to the preceding year, but for most of them, the expansion was less than the rates of growth achieved in the early nineties. The exchange rates of some major Asian traders strengthened against the dollar. The yen recovered strongly during the year from its low levels at the beginning of the 2002. Both the Korean won and the Singapore dollar also appreciated against the dollar.

A major aspect of trade policy developments in Asia was the continuing spread of bilateral free-trade agreements. Until recently Asia had the largest number of countries which were not members of any bilateral free trade agreement. But some of these countries signed their first free trade agreement in 2002.¹⁷ Japan and Singapore signed an FTA in January 2002. Leaders of ASEAN and China signed a framework free trade agreement which would be realized in ten years time. ASEAN countries continued with the accelerated tariff liberalization among its members. The year 2002 also saw the implementation by China and Chinese Taipei of the liberalization commitments agreed to in their WTO accession protocols.

Asia's merchandise trade recovered vigorously in the course of 2002 but the annual average values of both exports and imports still remained below their respective 2000 levels. Trade in commercial services was less dynamic than merchandise trade in 2002, with exports up by 5 per cent and imports advancing only marginally. While the deflation of the IT boom was the largest single factor leading to the sharp fall of Asia's exports in 2001, the moderate recovery in this sector was a major element in the overall 2002 recovery. The rebound of about 6 per cent in the trade of the six Asian economies with a high share of electronic goods in their exports was not strong enough to offset fully the severe contraction experienced in 2001. Part of the incomplete recovery in IT can be attributed to the relocation of IT plants from Japan and developing East Asian economies to China. Chinese exports of computers, telecom equipment and semiconductors rose by about one third in 2002, much stronger than the growth in exports of the same products of the six major IT exporters in Asia.

Two main factors left their mark on Japan's trade in 2002. Weak domestic demand and the depreciation of the yen vis-à-vis the US dollar on an annual average basis favoured export growth over import growth and led to a decline of both dollar export and import prices. Consequently, the recovery in the dollar value of Japan's merchandise exports was limited to 3 per cent and imports contracted further by nearly 4 per cent. The second outstanding feature in Japan's trade in 2002 was the sharp increase in bilateral flows with China. Japan's exports to China rose by 20 per cent while its imports increased by 7 per cent. Last year China replaced the United States as Japan's largest supplier of goods.

China's export and import growth accelerated sharply during the year. For 2002 as a whole, merchandise exports and imports increased by more than 20 per cent, while in the fourth quarter of 2002, trade value exceeded the 2001 figure by one third. The boom in China's trade can be attributed largely to record investment inflows in 2002, which were largely directed to the export sector. Caution should be exercised in linking trade liberalization measures introduced in the context of China's WTO accession directly to the country's trade performance last year. However, trade liberalization in the automobile sector, for example, caused a fall in domestic prices which

¹⁷ For a discussion on trends in regional free trade agreements see Section IB.3.

contributed to a large increase in demand for passenger cars, a surge in imports of automotive products (an increase of 40 per cent in value terms), and a large increase in domestic production. China's trade in agricultural products remained also in 2002 far less dynamic than trade in manufactured goods. China's exports of agricultural products increased (in value terms) by 13 per cent and exceeded thereby the expansion of imports, which grew by 8.5 per cent. In short, the momentum of China's ascendancy in Asia continued last year as a result of continuing high GDP growth, increasing FDI inflows and strong trade expansion.

Another interesting feature of Asia's trade is the relatively less dynamic performance of Singapore and Hong Kong, China in recent years. This can be attributed to at least two factors. First, both Singapore and Hong Kong, China have become high income economies which have lost their competitive edge in many of their traditional exports of manufactured goods and have therefore shifted their economic development strategies to the services sector. Following a double-digit decrease in 2001, exports of domestically produced goods of Hong Kong, China contracted by 18 per cent, while those of Singapore recovered by only 1.5 per cent. Second, within the services sector, the position of these economies as regional distribution/transit centres is being challenged by their neighbours. One indication of this development can be seen in the growth of ports in neighbouring countries. The expansion of container traffic in ports in Malaysia and China outpaced those in Singapore and Hong Kong, China.¹⁸ Singapore's exports of commercial services are estimated to have decreased again slightly in 2002, while those of Hong Kong, China increased by 6 per cent.

Merchandise and commercial services trade data of the world's largest traders are reported below (see Appendix Tables IA.1, IA.2 and IA.3 at the end of this Chapter). Among the main features of the 2002 merchandise services trade developments one can highlight the following developments: among the 30 leading merchandise traders five reported a double-digit increase in their exports while those of the US and Canada decreased. Merchandise imports declined for Japan, Switzerland and Brazil as did the retained imports of Hong Kong, China and Singapore. The strongest merchandise import increases (in excess of 10 per cent) are reported by China, the Russian Federation and India (see Appendix Table IA.1).

Commercial services trade by principal trader showed also a large variation in their performance in 2002. While eight services exporters reported an expansion between 10 and 30 per cent, six other exporters recorded a stagnation or a decrease in their exports in 2002. The results on the import side are also mixed as seven traders reported an increase in excess of 10 per cent while six other major importers recorded a decrease or stagnation (see Appendix Table IA.3).

¹⁸ The container traffic volume rose in Shenzhen, Shanghai and Tanjung Pelepas (Malaysia) by 50, 35 and 30 per cent respectively. The corresponding rates for Hong Kong, China and Singapore are 4.5 and 8 per cent. (Neue Zürcher Zeitung, 15 January 2003)

B SELECTED ISSUES IN TRADE AND TRADE POLICY

1. SELECTED FEATURES OF SOUTH-SOUTH¹⁹ TRADE DEVELOPMENTS IN THE 1990-2001 PERIOD

(a) Introduction

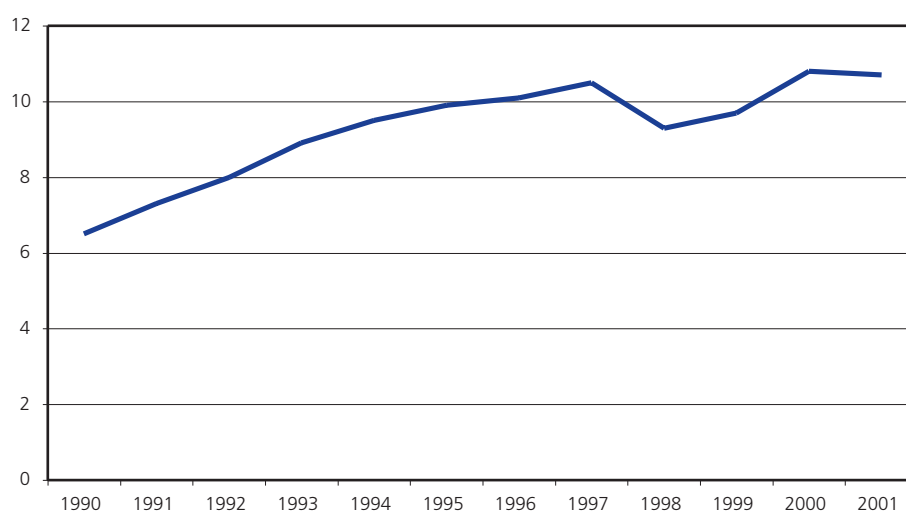
South-South trade has long been promoted as a means to reduce the dependence of developing countries on markets of developed countries and to enhance diversification of Southern exports beyond primary commodities. Most of the mechanisms that were created to foster co-operation among developing countries were largely subregional and regional arrangements, many of them preferential in nature. During the 1950s and 1960s, the promotion of South-South trade was in many instances part of a set of policy measures anchored in a strategy of import substitution behind high trade barriers. South-South trade grew in spurts as developing country economies went through stop and go cycles. Despite efforts to promote and diversify South-South trade, primary products continued to dominate these flows in most regions, and by 1990 South-South trade accounted for only 6.5 per cent of world trade.

Over the last decade, however, developing country economies have grown much faster than those of the developed and transition countries and are expected to continue to do so in the first decade of the 21st century.²⁰ Positive growth performance in the 1990s was a principal factor leading to the share of South-South trade in world trade almost to double, reaching 10.7 per cent in 2001 (see Chart IB.1). Since 1985, the trade and investment regimes of a large number of developing countries have been liberalized and access to their markets has improved significantly. Foreign direct investment inflows into developing countries increased fourfold between the beginning and the end of the 1990s. Investment flows among developing countries rose sharply and are tentatively estimated to be in the order of \$50 billion in 2000²¹.

Chart IB.1

Share of South-South trade in world merchandise trade, 1990-2001

(Percentage)



Source: WTO, International Trade Statistics.

¹⁹ Developing countries, or the South, comprise the following regions: Latin America, Africa, the Middle East and Asia excluding developed Asia (Japan, Australia and New Zealand). Hong Kong, China's re-exports are not included in the trade flows.

²⁰ The World Bank report *Global Economic Prospects 2003* forecasts that real GDP growth in developing countries will expand by 4.7 per cent annually while that of the industrial countries will grow by 2.5 per cent annually between 2003-2015. Similarly, the IMF's medium-term baseline scenario (2003-2007) projects an annual GDP growth rate of 5.7 per cent for the developing countries and 3.1 per cent for the advanced economies. IMF, *World Economic Outlook*, September 2002, Table 45, p.233.

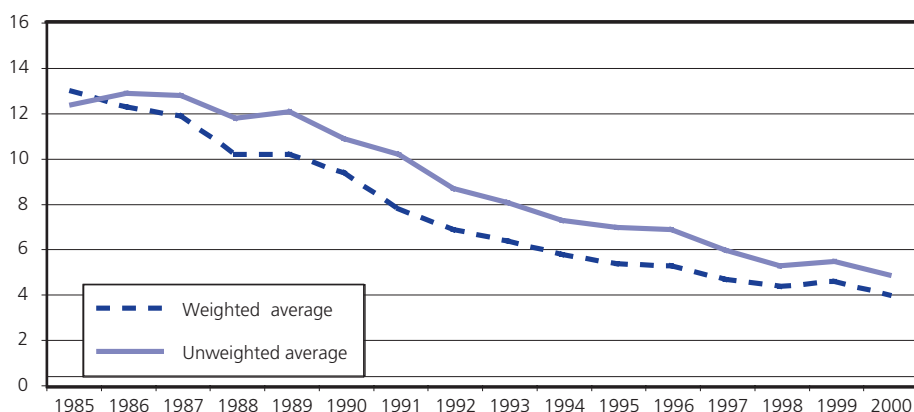
²¹ Aykut and Ratha (2002).

The combination of above-average economic growth and substantial trade and investment liberalization led to dynamic growth in developing country trade flows. For the 1990-2001 period, merchandise export and import growth exceeded world merchandise trade growth in both value and volume terms. Intra-developing country trade was the main beneficiary of the higher economic growth and more liberal trade regimes in the developing countries. Despite these significant reductions in the obstacles to trade, the developing countries still maintain higher tariff and non-tariff barriers on average than the developed countries. The persistence of these barriers suggests the potential for further trade liberalization and consequent expansion of South-South trade.²²

Chart IB.2 (and Appendix Table IB.4) report on the reduced tariff protection – measured by the ratio of duties collected to imports – for a selection of major developing country importers. The chart shows that for the average of the sample countries, the ratio of duties collected to imports decreased from more than 12 per cent in 1985 to less than 5 per cent in 2000.²³ The chart also shows that average applied tariffs have fallen in developing countries from a level above 25 per cent in 1985 to less than 15 per cent in 2000. Nevertheless, wide differences remain in levels of protection, both among developing countries and product categories. The dollar value of customs duties collected by developing countries on their total merchandise imports in 2000 was about \$83 billion. This is equivalent to more than 60 per cent of import duties collected globally. Further liberalization could boost developing countries' imports and exports in the years ahead and could sustain the expansion of their output, contribute to rising overall income levels and reduce poverty. Developing countries in Asia and Latin America provide several important examples of how trade and investment liberalization have stimulated trade (for example, several countries in South-East Asia, China, recently India, Mexico and Chile).

Chart IB.2
Developing countries^a have substantially lowered import duties
between 1985 and 2000

(Ratio of duties collected to imports)



^a Data refer to 10 selected developing countries accounting for 60% of developing countries' merchandise imports.

Source: IMF Government Finance Statistics Yearbook and national statistics.

²² The potential for trade liberalization in general to contribute to development is taken up in more detail in Chapter II of this Report.

²³ One has to take into account that a decline in the ratio of import duties to imports might be partly due to a change in the product structure of imports (i.e. a shift to less taxed products). Very high tariffs leading to negligible import values have also only a minimal weight in the calculation of this ratio.

Despite their increased popularity, regional and bilateral preferential trade arrangements have not contributed in a significant way to the rapid expansion of intra-developing country trade during the 1990-2001 period. It is estimated that the share of intra-regional trade in those RTAs formed among developing countries remained unchanged at 20 per cent of South-South trade between 1990 and 2001.²⁴ This conclusion regarding the lack of a significant contribution by RTAs in South-South trade is very similar to other findings with respect to South-South trade in the 1970s and 1980s.²⁵

The expansion of intra-developing country trade is not only held back by trade barriers but numerous other non-trade barriers as well.²⁶ Among the major obstacles faced by many developing countries are relatively high transport, insurance and communication costs, difficulties in trade financing and insufficient marketing and distribution skills. The lack of product diversification can also be an obstacle as dependence on a few (non-fuel) primary products facing sluggish long-term demand growth constitutes a structural handicap for the expansion of trade. This is true for trade in general, as well as trade with other developing countries having similar resource endowments. This means that trade liberalization needs to be complemented by measures that address these infrastructure and supply-side bottlenecks, and for which resources need to be mobilized.

(b) General trends

(i) *Intra-developing country trade expands faster than world trade*

What have been the main features of merchandise trade flows among the developing countries over the 1990-2001 period? Over this eleven-year period South-South trade expanded twice as fast as world trade (10 per cent versus 5 per cent). The value of South-South trade rose from \$219 billion in 1990 to \$640 billion in 2001. The share of intra-developing country trade in world merchandise exports rose from 6.5 per cent to 10.7 per cent in 2001, representing a historic peak in terms of the last 50 years.²⁷ Another way to gauge the increased importance of South-South trade is to compare it with South-North trade. In 1990, the dollar value of intra-developing country exports was equivalent to 41 per cent of South-North exports. Eleven years later, the ratio had risen to 60 per cent.

The share of developing country exports to other developing countries rose from 28 per cent in 1990 to 37 per cent of their total exports in 2001. The share of imports from the South in developing countries' imports exceeded 41 per cent of total imports by 2001, an increase of 10 percentage points from the 1990 level. In recent years the share of South-South trade in total developing country trade has been larger for imports than for exports as the developing countries recorded a substantial overall merchandise surplus at the end of the 1990s, a marked reversal from the situation at the beginning of the decade (see Chart IB.3).

²⁴ The calculations cover all intra-RTA trade irrespective of the fact that not all products benefit from RTA preferences and, even for those that do, not all preferences are used due to additional transaction costs such as increased documentation requirements linked to rules of origin. One should also be cautious about how some intra-regional trade flows are reported because they may inflate regional totals. In the case of ASEAN, for example, there is a large discrepancy between intra-regional exports and imports (In 2001, intra-regional exports were \$90.4 billion while intra-regional imports were \$76.5 billion). The discrepancy in this case can be largely explained by Singapore's re-exports being counted as intra-ASEAN exports despite the fact that some originate from non-ASEAN countries.

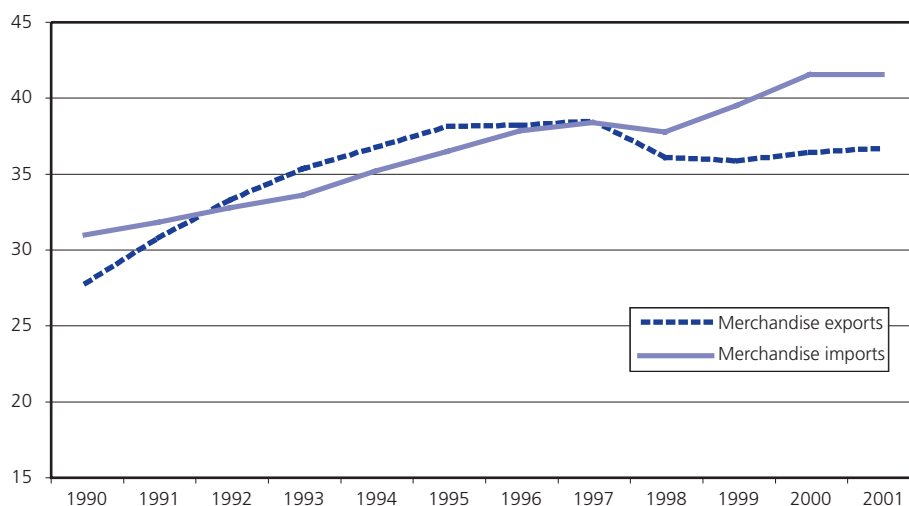
²⁵ Greenaway and Miller (1990) observe that "South-South arrangements have generally failed to encourage South-South trade".

²⁶ Langhammer and Hiemenz (1990) make the distinction between material barriers, political barriers, economic barriers and political-economic barriers, while UNCTAD (1994) differentiates between structural and policy-induced obstacles to South-South trade.

²⁷ Excluding intra-EU trade from the world total, the corresponding share increased from 9 to 14 per cent in the 1990-2001 period.

Chart IB.3

Share of the South is rising in developing countries trade, 1990-2001
(Percentage)



Source: WTO, International Trade Statistics.

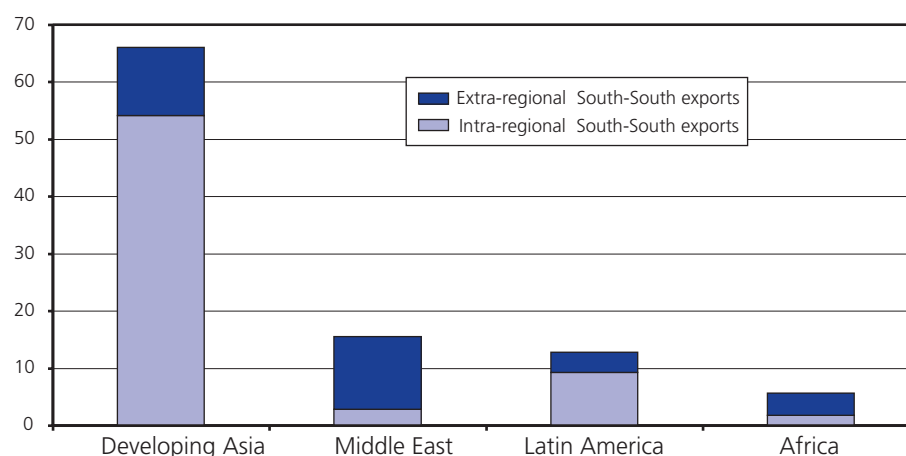
The overall increase in the share of South-South trade between 1990 and 2001 was strong and rather steady on the import side. However, for exports a strong increase in the first half of the 1990s was followed by an erosion of the share in the second half. The steeper rise of the export share than that of imports up to 1996, and its stagnation thereafter while the import share continued to grow, has much to do with the relative strength of demand growth in the developing countries. Up to 1996, demand growth in developing countries exceeded that of the developed and transition countries by a very wide margin, turning the former into a prominent export destination for all regions. Partly due to the Asian financial crisis and the reduction of net capital inflows into the developing countries since 1996, domestic and import demand became much weaker than in the first half of the 1990s in both absolute and relative terms. Since developed country demand did not suffer a similar weakness in the second half of the 1990s, Southern exports to the North continued to expand at the same rate while exports to other Southern countries became less dynamic (falling from a 17.2 per cent growth rate in the first half of the 1990s to 6.8 per cent in the second half) (see Table IB.1).

Developing countries are very heterogeneous with respect to economic size, income levels, the degree of industrialization, outward orientation and trade structure. This makes it necessary to examine more disaggregated data in order to understand the driving forces behind South-South trade expansion. An analysis of South-South trade by product group and by region/country is presented below.

(ii) Intra-developing country trade is highly concentrated on Asia

More than two-thirds of intra-developing country trade originates from and is destined to developing Asia (see Chart IB.4). This high share primarily reflects the relatively large size of the developing markets in Asia. The developing Asian economies accounted for nearly one-half of the GDP of developing countries and more than two-thirds of its population in 2001. The weight of developing Asia in the total GDP of developing countries increased over the 1990-2001 period as the rate of economic expansion in Asian developing economies (6.5 per cent) exceeded that of the other developing regions (about 3.1 per cent). As with income growth, developing Asia's intra-regional trade and trade with other developing regions has been dynamic, exceeding the growth of South-South trade in general. This strong trade performance can be attributed in part to open trade and investment policies in the major developing economies of Asia.

Chart IB.4

Developing Asia is the predominant region in South-South trade, 2001
(Percentage)

Source: WTO and UNSD, Comtrade database.

The share of developing Asia in intra-developing country exports rose from 60 per cent in 1990 to 66 per cent in 2001, while the share of the other developing regions – Latin America, Africa and the Middle East – suffered a decline. On the import side, the share of developing Asia accounted for more than two-thirds of total intra-developing country imports (see Table IB.1).

Middle East exports to the South rank second in size among the four developing regions, accounting for almost \$100 billion or about 15 per cent of intra-developing country trade. The Middle East has the smallest share of intra-regional trade of all developing regions, a feature which can be attributed to the pre-eminence of fuels in the exports of many countries in the region. The lack of product diversification, combined with similarity in resource endowments, constrained the expansion of trade within the Middle East.

Latin American exports to all developing countries amounted to \$82 billion or 13 per cent of South-South trade. Intra-MERCOSUR trade alone reached \$15 billion in 2001, representing 2.4 per cent of intra-developing country trade. The region's expansion rate for both exports and imports was very close to the overall growth rate of intra-developing country trade.

Africa has the smallest share of intra-developing country trade. In 2001, the value of African exports to developing countries was estimated to be in the order of \$36 billion, which accounts for slightly less than 6 per cent of intra-developing country trade. This represents a moderate decrease from 1990, as export growth to all developing countries was held back by the poor performance of Africa's trade.

Table IB.1

South-South merchandise exports expanded strongly in all developing regions, 1990-2001

(Billion dollars and percentage)

	Value	Share	Annual percentage change		
	2001	2001	1990-1995	1995-2000	1990-2001
Developing Asia	422	66.0	21	6	11
intra-developing Asia	345		21	6	11
Middle East	99	15.5	7	13	8
intra-Middle East	18		6	8	7
Latin America	82	12.8	16	4	9
intra-Latin America	59		18	5	10
Africa	36	5.6	12	9	9
intra-Africa	11		12	-6	6
South-South	639	100.0	17	7	10

Source: WTO and UNSD, Comtrade database.

The importance of Southern markets in the total exports of developing regions differs widely. For developing Asia and the Middle East, 4 out of every 10 dollars are earned from shipments to other developing countries. The corresponding number for Latin America and Africa is 2.50 dollars out of 10. In Latin America, the ratio is increased to 4 dollars out of 10 when Mexico, a member of NAFTA, is excluded from the regional total. This leaves Africa with the lowest share of trade with other developing countries. The level of intra-African trade is low in all major product categories. Even for agricultural and manufactured goods, intra-African trade accounts for less than 15 per cent of the region's total exports. Fuels account for a significant share of African exports, but for geographical and historical reasons, Western Europe and the United States, rather than developing countries, account for most of the trade in this product category.

What can be said about the contribution of RTAs among Southern countries to the expansion of South-South trade in the 1990s? First, as can be seen from Chart IB.4, the share of intra-regional trade in Asia accounts for four-fifths of developing Asia's South-South trade, the highest share among the four developing regions. More than half of Latin America's exports to developing countries are shipped within the region, while for both Africa and the Middle East, developing markets outside those regions are far more significant. What is notable about this chart is the inverse correlation between intra-regional trade shares and the number of RTAs. Developing Asia, with only one major RTA, has the largest share of intra-regional trade, whereas Africa, with the largest number of RTAs, has the smallest share of intra-regional trade. Second, over the entire 1990-2001 period, the growth of intra-RTA trade among developing countries was 10 per cent, identical to the growth of trade among developing countries (see Table IB.2)

The breakdown of intra-developing country trade by region reveals also the origins of the sharp deceleration in the expansion of South-South trade between the first and second half of the 1990s which was more pronounced than for world trade. The geographic breakdown (see Table IB.1) shows that the regions with the most dynamic export growth in the 1990-95 period, developing Asia and Latin America, are also those which recorded the steepest deceleration in their merchandise export (and import) growth in the 1995-2000 period (see Appendix Table IB.1). The principal RTAs in these two regions, ASEAN and MERCOSUR, recorded even steeper deceleration of their export expansion than their respective home regions.

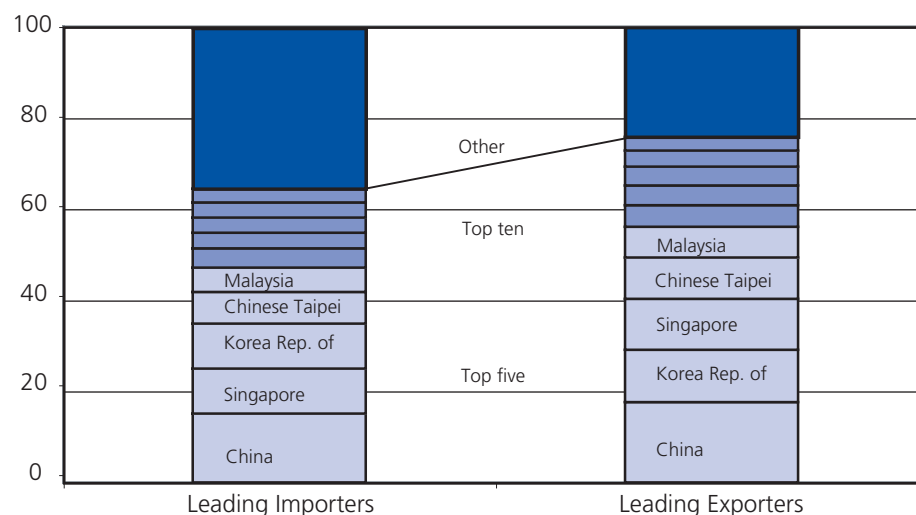
Table IB.2
Contribution of RTAs to South-South trade, 1990-2001
 (Billion dollars and percentage)

	Value		Share		Average annual change		
	1990	2001	1990	2001	1990-1995	1995-2000	1990-2001
South-South exports	219	639	100.0	100.0	17	7	10
Intra-South RTA	44	129	20.3	20.1	21	4	10
MERCOSUR	4	15	1.9	2.4	28	4	13
ASEAN	29	90	13.2	14.2	23	5	11
Other RTAs	11	23	5.1	3.6	11	3	7

Source: WTO and UNSD, Comtrade database.

Besides being focused on Asia, South-South trade expansion was concentrated among a small number of traders exporting primarily manufactured goods. For 2001, the five (ten) leading exporters in intra-developing country trade accounted for 50 per cent (70 per cent) of South-South trade. On the import side, the concentration is less pronounced as the top five (ten) traders accounted for 41 per cent (60 per cent) of South-South trade (see Chart IB.5). The five leading exporters are also the five leading importers, with four of them being developing economies in Asia. The countries that have experienced the most rapid expansion in their trade with developing countries are Mexico (18 per cent), India (14 per cent), China (14 per cent) and the Republic of Korea (14 per cent)²⁸. All these countries have greatly reduced their trade barriers (see Appendix Table IB.4) and recorded above average trade growth over that period.

Chart IB.5
South-South trade is concentrated on a few leading traders in 2001
 (Percentage shares: cumulative)



Source: WTO, International Trade Statistics.

While there are marked differences in the regional pattern of South-South trade, the variation is even greater at the country level. The degree of reliance on developing country markets differs sharply among individual exporting countries, ranging from more than 90 per cent in the case of Bhutan and Somalia, to less than 10 per cent for Mexico and Libya. A small number of countries have a share similar to the average rate of 37 per cent, as can be seen in Appendix Chart IB.1. Out of a sample of 121 developing countries, 32 countries reported a very high share

²⁸ The figures in parentheses are the average growth rates of exports and imports to developing countries over the 1990-2001 period.

of exports to developing countries i.e. a share in excess of 50 per cent and rising up to 99 per cent (Group A). At the other extreme of the ranking were about 32 countries for which shipments to other developing countries accounted for less than 20 per cent of their total exports (Group C). Between these two extremes, there is a third group for which intra-developing country exports represented between 21 and 49 per cent of total exports. No single factor could be found to explain the degree to which a developing country depended on other developing markets. Product diversification of exports, product structure, income levels, location in a particular geographic region, and membership in an RTA do not stand out individually as dominant determinants of these trade flows. Among the developing countries which exported more than one half of their merchandise exports to other developing countries, one can find several LDCs and high income developing countries. Developing countries which had limited product diversification could be found in both groups A and B. Only small, landlocked countries who had a large developing country as a neighbour tended to be more prominent in group A (e.g. Bhutan, Mongolia) than in other groups (see Appendix Chart IB.1). For these countries, geography seems to play a predominant role.

(iii) *Manufactured goods play a leading role in intra-developing country trade*

Trade in manufactured goods has been the most dynamic component of intra-developing country merchandise exports, expanding by 12 per cent annually in the 1990s and accounting for nearly two-thirds of intra-developing country trade in 2001. Agricultural trade expanded at only half that rate, while the growth in mining products (mainly fuels) averaged nearly 9 per cent. The shares of agriculture and mining products are somewhat larger in intra-developing country trade than in developing country exports to developed countries. For all major product categories, intra-developing country trade grew faster during the 1990-2001 period than developing countries' trade with developed or transition economies. Consequently, for all three product categories, the weight of developing markets in developing country exports increased over the last decade, ranging from about 40 per cent for agricultural products and mining products to 35 per cent for manufactured goods (see Appendix Table IB.3).

At a more detailed level, office and telecom equipment and automotive products experienced the highest annual average export growth during the period 1990-2001, at 18 per cent and 17 per cent respectively. Above average growth in intra-developing country trade also occurred in chemicals and clothing. South-South trade in chemicals amounted to \$59 billion (or 9.2 per cent) in 2001, exceeding food exports and the combined value of intra-developing country trade in textiles and clothing. Developing countries depended on other developing markets for more than one-half of their chemicals and textiles (slightly more than 60 per cent) exports, but only 11 per cent and 22 per cent respectively of exports of clothing and other consumer goods involved intra-developing country trade. Exports of agricultural products to other developing countries was the least dynamic element in intra-developing country trade.

Fuels continued to play a major role in intra-developing country trade. Although the share of fuels in trade among developing countries decreased slightly between 1990 and 2001 to 22 per cent, fuels remain the largest single traded product. Indeed, the share of fuels in intra-developing country trade was larger than its share in developing country exports to developed countries in 2001.

(c) *Factors contributing to the dynamics of intra-developing country trade: 1990-2001*

As noted above, rapid growth in intra-developing country trade from 1990-2001 is largely the consequence of strong export and import performance of developing Asian countries. This is linked to above average GDP growth in the region, fuelled in part by open trade and investment regimes. Trade liberalization in Asia took various forms in the 1990s, but much of it occurred on an autonomous MFN basis. China's reduction of tariff and non-tariff barriers since the mid-1980s fits into this context, reflecting a fundamental re-orientation towards a market economy and preparations for WTO accession. The Uruguay Round and the Information Technology Agreement made significant contributions to further liberalization of Asia's trade in the second half of the 1990s. The contribution made by developing Asia to the expansion of intra-developing country trade differs markedly by period and sector. It was particularly strong in the first half of the 1990s and in trade of office and telecom equipment.

The most dynamic component (and the second largest product category after fuels) in intra-developing country trade – office and telecom equipment – benefited from tariffs that were already low in Asian developing countries in the early 1990s. The tariffs on information technology (IT) products were fully eliminated through the WTO Information Technology Agreement. This open regime for IT products favoured the inflow of foreign direct investment and the establishment of production networks across Asia. Consequently, developing Asia has become a major player in global trade in office and telecom equipment and accounts for 90 per cent of intra-developing country trade in this product category. The combination of trade liberalization, large inflows of foreign investment directed at the establishment of production networks (especially in electronics), and the surge in global demand for information and technology products were major elements in the rapid growth of developing Asia's trade. The development of export processing zones has also played an important role in the overall trade performance of developing countries in Asia and in this sector.

Automotive products account for only 2.5 per cent of intra-developing country trade. In addition, the share of developing markets as a destination for developing countries' exports of automotive products (23.5 per cent) was one of the lowest of all product categories reported in Appendix Table IB.2. But between 1990 and 2001, imports from all developing countries recorded an eightfold increase.

Despite automotive products being a dynamic category in intra-developing country trade, the contribution made by developing Asia to the expansion of South-South trade in this sector was quite different. Developing Asia's imports of automotive products from developing regions expanded less than those of any other developing region between 1990 and 2001 and accounted for just one quarter of intra-developing country trade in automotive products. For automotive products, the developing Asian economies accounted for a much smaller weight in South-South trade and contributed far less to its expansion than in the electronic goods sector. High trade barriers – both tariff and non-tariff – on automotive products in developing Asia have contributed to this outcome.

Much of the expansion in South-South trade in automotive products has taken place in Latin America, although its exports of automotive products to developing countries are largely confined to other Latin American countries (more than 90 per cent of exports are intra-regional). MERCOSUR countries and more recently Mexico have become significant market outlets for developing countries exporting automotive products. MERCOSUR's share in Latin America's imports of automotive products from developing countries increased markedly between 1990 and 1995, but fell sharply thereafter. This development can be attributed to a rapid increase of Mexico's imports from Brazil in recent years while intra-MERCOSUR trade shrank. Mexico's imports of automotive products from developing countries have increased strongly, as Mexico liberalized its trade regime and has succeeded in establishing itself in the global automobile production network.

Trade in chemicals accounts for 9.2 per cent of South-South trade and expanded very dynamically over the 1990-2001 period (see Appendix Table IB.2). About two-thirds of intra-developing country trade in chemicals consists of organic chemicals and plastics, two categories comprising mainly petrochemicals. Medicinal and pharmaceutical products are estimated to account for less than 5 per cent of intra-developing trade of chemicals. Exports and imports of Asian developing countries account for two thirds in intra-developing country trade in chemicals. The strength of the position of Asian developing countries coincides with tariff rates which are – on average – much lower than in other developing regions (see Appendix Table IIB.7).

In the second half of the 1990s, India and Mexico reported the highest growth of imports from developing countries (see Table IB.3). Oil imports accounted for nearly one-half of India's imports from developing countries in 1995 and the rise in oil prices played a major role in that regard. However, India's imports from developing Asia and in particular from China; Hong Kong, China; Singapore; Indonesia and Thailand more than tripled between 1995 and 2001 and expanded much faster than those from the oil exporting countries

of the Middle East. In the case of Mexico, the high growth of imports from developing countries can be largely attributed to a quadrupling of imports from developing Asia. Most of this increase was in office and telecom equipment and to a lesser extent also in consumer goods, with the main beneficiaries in developing Asia being China, the Republic of Korea and Malaysia. Finally, it should be noted that those developing countries which experienced strong overall trade growth were also those which saw a large expansion of their trade with the South.

Table IB.3

Trade expansion varies among the leading South-South traders in 1990-2001

(Billion dollars and percentage)

	Exports				Imports			
	Value	Annual percentage change			Value	Annual percentage change		
	2001	1990-95	1995-00	1990-01	2001	1990-95	1995-00	1990-01
China	72	19.7	9.1	13.8	71	23.5	10.9	14.4
Korea, Rep. of	74	28.5	6.4	14.4	65	20.4	11.9	13.6
Singapore ^a	72	20.7	3.7	9.7	61	15.9	3.7	7.5
Chinese Taipei	61	20.0	5.2	10.1	42	16.4	12.0	10.9
Malaysia	42	20.7	5.6	10.5	33	20.5	6.8	11.1
Thailand	28	27.6	3.6	13.1	28	15.0	3.8	8.2
India	19	24.7	8.3	15.2	27	12.4	19.7	13.3
Brazil	22	16.5	1.7	9.0	22	14.8	3.5	7.7
Saudi Arabia	33	6.3	11.1	7.1	9	5.7	4.9	4.9
Indonesia	25	19.3	9.0	11.5	16	14.1	3.8	7.2
United Arab Emirates	18	5.8	13.5	8.6	21	25.0	10.6	16.2
Mexico	8	19.0	4.7	10.9	26	19.2	29.9	24.7

^a Includes significant re-exports or imports for re-export.

Source: WTO and UNSD, Comtrade database.

One cautionary note to all of this is that there was a marked deceleration in the nominal trade expansion among the developing countries between the first half of the 1990s and the 1995-2001 period. This reflected the deceleration of GDP growth in developing Asia and Latin America in the second half of the 1990s because of the Asian financial crisis, various crises in Latin America but also different global price trends in the first and second half of the nineties. In the 1990-95 period, world trade prices increased by 10 per cent, but decreased by 12 per cent between 1995 and 2000. What may have balanced that trend were oil price developments. Falling oil prices between 1990 and 1995 depressed the exports of the major oil suppliers (i.e. Saudi Arabia and the United Arab Emirates) to the developing countries, but rising prices between 1995 and 2001 strengthened the relative performance of oil exporting developing countries, also in South-South trade.

(d) Conclusions

South-South trade has been a dynamic component of the global trade expansion over the last decade. A key contributor to this outcome was the strong trade performance of a number of middle income developing countries that trade with other developing countries, particularly in Asia. The combination of high growth in the global IT industry and production sharing arrangements in this industry across much of Asia also played a significant part in the growth of South-South trade.

This increase in trade among developing countries, particularly in manufactured goods, may validate the view that South-South trade is important to allow developing countries to escape from excessive reliance on primary commodity production and exports. It is important to bear in mind, however, that in the case of numerous poorer developing countries, much is required on other fronts in order for them to benefit fully from open markets, not least in the sphere of infrastructure development and in terms of a broad range of measures required to facilitate trade.

Where growth in South-South trade has contributed to diversification and development, this has not come about, to any major degree, through preferential arrangements among developing countries, but rather through creating the underlying conditions to exploit comparative advantage. Trade liberalization has played a part in stimulating trade, including with other developing countries. In recent years, some of the larger developing countries have become major markets for other developing countries. Despite the successes of a number of developing countries over the last decade, tariff protection often continues to be high, in particular on products such as automotive products and clothing, and in agriculture, where other developing countries are likely to have a comparative advantage. In addition, a significant part of the liberalization undertaken by developing countries in the last decade has not been bound in the WTO, which increases the risk of future trade policy reversals and the economic costs associated with uncertainty.

The Doha Agenda provides a valuable opportunity for the momentum of the last decade to be maintained. In the midst of one of the most difficult periods for the global economy, a number of middle-income developing countries have shown surprising economic strength and have been an important source of demand growth for other developing countries, and also the rest of the world. The work programme on agriculture and non-agricultural tariffs can be an important source of efficiency gains for developing countries, an impetus for growth, and a means for increased trade with both developed and developing countries. Finally, much has been said here about the scope for fostering growth and development through action aimed at freeing up South-South trade. But this in no way diminishes the considerable contribution that could be made from further trade liberalization in developed countries. These issues are considered further in Chapter II of this Report.

2. NON-FUEL COMMODITY PRICES

(a) Introduction

The impact of low and volatile commodity prices on the development prospects of poor countries is a recurring issue in international trade. The dependence of a large number of poor countries on commodity exports and the volatility of commodity prices combine to present a formidable development challenge. The problem has assumed renewed prominence because of the pronounced declines in many commodity prices in the course of the last decade.

The issue of commodity prices has not escaped the attention of the GATT. As early as 1957, the GATT had noted the "excessive short-term fluctuations in prices of commodity products". They commissioned a report by a group of experts, the Haberler report (1958), which in turn identified developed country trade policies as contributing factors to the problem. In response to the conclusions of the report, the GATT adopted an action programme, which included as one of its objectives the expansion of the export earnings of developing countries.²⁹ Part IV of GATT 1994 (Trade and Development), which was introduced in 1965, makes explicit reference to the need to provide more favourable and acceptable conditions of access as well as to devise measures to attain stable, equitable and remunerative prices for primary products.³⁰

Issues arising in the field of commodities are numerous and complex. It is not intended here to cover all of these issues. In what follows, some basic information on the magnitude and extent of the decline in prices will be provided. The section will also examine the possible causes of price declines and the degree to which the Doha work programme, particularly on domestic support, export subsidies and tariff escalation, might ameliorate the problem. Since the behaviour of oil prices has diverged from that of non-oil commodity prices and oil producers face a different set of development challenges, the analysis will focus more narrowly on non-oil commodity prices.

(b) Movement of non-oil commodity prices

Last year saw a recovery in non-oil commodity prices, with some prices moving up from historic lows reached in late 2001. The unit export value indices for food, beverages and agricultural raw materials rose by about 9 per cent, 12 per cent and 2 per cent respectively. However, there continued to be some weakness in metal prices, with the index falling by 4 per cent during the year. The immediate prospects for commodity prices hinge on the strength and speed of the global economic recovery, the resolution of geo-political risks, as well as weather-related trends (e.g. *El Niño*). Some recent forecasts suggest that non-oil commodity prices will increase by 5.8 per cent in nominal terms this year and by about 8 per cent in real terms by 2005.³¹ Given that the prices of non-oil commodities have been falling for quite some time now, the recovery, while welcome, still means that prices will be below their average in the 1990s. In the medium term, changes in trade policies, through reductions in domestic support, export subsidies and tariff escalation, may bring about some improvements. The long-term prospects for commodity prices will depend on the pace of technological progress in agriculture, which augments supply, and the success of diversification in the economies of commodity producers.

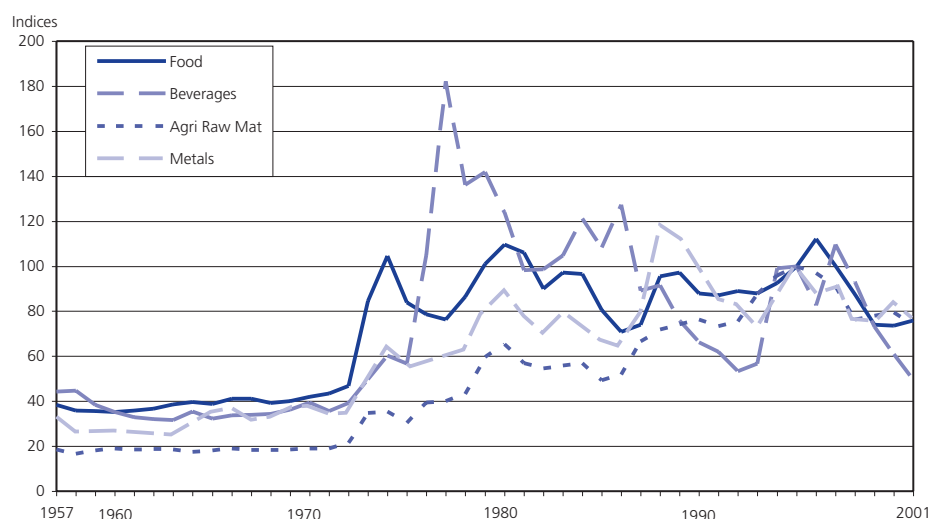
²⁹ Hudec (1987).

³⁰ Article XXXVI of GATT 1994 states that: "Given the continued dependence of many less-developed contracting countries on the exportation of a limited range of primary products, there is need to provide in the largest possible measure more favourable and acceptable conditions of access to world markets for these products, and wherever appropriate, to devise measures designed to stabilize and improve conditions of world markets in these products, including in particular measures designed to attain stable, equitable and remunerative prices, thus permitting an expansion of world trade and demand and a dynamic and steady growth of the real export earnings of these countries so as to provide them with expanding resources for their economic development".

³¹ See for example the World Bank (2003).

Over the long term, real commodity prices have suffered a decline marked by significant volatility. The original finding about the terms of trade decline of commodity prices was based on data which covered the period from 1876 to 1947 (Prebisch, 1950). Contemporary research has continued to confirm this secular decline with price data up to the end of the 20th century (Ray, 1977; Grilli and Yang, 1988; Diakosavvas and Scandizzo, 1991; Bloch and Sapsford, 2000; Cashin and McDermott, 2002). The conclusion is robust regardless of the commodity price data used or the deflators chosen.³²

Chart IB.6
Commodity prices, 1957-2001
(Indices, 1995=100)



Source: Commodity price indices of food, beverages, agricultural raw materials and metals are taken from the IMF's International Financial Statistics series.

The history of commodity prices since the mid-1950s is shown in Chart IB.6. After the commodity boom associated with the Korean War, nominal commodity prices entered a relatively stable phase before shooting up again during the commodity price boom of the 1970s. By the mid-1990s, nominal prices began a pronounced downturn so that by the end of the decade they were about 15 per cent lower than at the beginning. Chart IB.7 plots the relative prices of commodities during the same period. The relative commodity prices are derived by deflating the prices of commodities with the manufacturing unit values (MUV) of industrial countries.³³ The indices derived in this way can be interpreted as the relative price between a basket of primary commodities and a basket of manufactured exports of the industrial countries. With the exception of agricultural raw material prices, all the other relative price series exhibit a clear downward trend. From 1957 to 2001, the estimated annual reductions in food, beverage and metal prices are 1.9 per cent, 2.4 per cent and 1.3 per cent respectively (see Table IB.4). However, the time trend on agricultural raw material prices was not significant. Volatility, as measured by the coefficient of variation, was most severe for beverages while the price of agricultural raw materials exhibited the least turbulence.³⁴

³² For example, Grilli and Yang (1988) constructed a US dollar index series (1900-86) based on international prices of 14 major non-fuel commodities and used the UN's manufacturing unit values as their deflator. Cashin and McDermott (2002) used *The Economist's* industrial commodity price index (1862-1999) for their price series and the US GDP deflator.

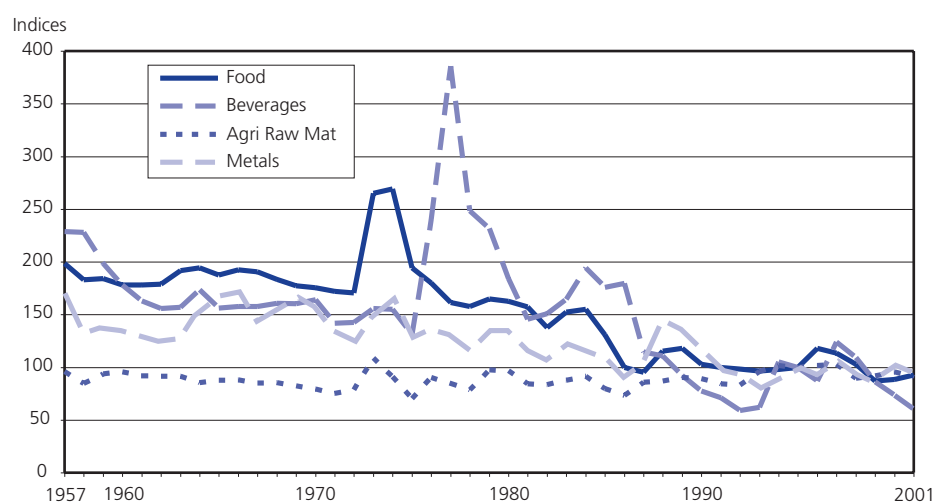
³³ Unit value index in dollar terms of manufactures exported from the US, UK, Germany, France and Japan weighted proportionally to the countries' exports to developing countries. The index, most recently used in *Global Economic Prospects: 2003*, was made available by the World Bank.

³⁴ It should be noted that a measure of volatility like the coefficient of variation will tend to overestimate the difficulties posed by price changes on farmers. This is because if the change in price was anticipated, farmers (as well as consumers) could make the necessary adjustments beforehand no matter how large the change in price. The real concern is with unanticipated changes in prices for which adequate preparations cannot be made.

Chart IB.7

Relative commodity price developments, 1957-2001

(Indices, 1995=100)



Source: IMF (2003). International Financial Statistics. Manufacturing unit values from the World Bank.

Table IB.4

Measures of trend and volatility in selected commodity prices, 1957-2001

Commodity	Trend coefficient	Coefficient of variation
Food	-1.92 ^a	0.30
Sugar	-2.30 ^b	0.46
Beverage	-2.42 ^a	0.41
Coffee	-1.91 ^c	0.54
Ag. raw materials	-0.11	0.09
Cotton	-2.04 ^a	0.39
Metals	-1.26 ^a	0.20
Aluminium	-1.21 ^a	0.21
Copper	-2.13 ^b	0.50

^a Significant at the 1% level

^b Significant at the 5% level

^c Significant at the 10% level

Notes:

1. Since the logarithm of the relative price indices are regressed on time, the trend coefficients are average annual percentage changes in relative prices.
2. The coefficient of variation is the ratio of the standard deviation to the mean. Normalizing the standard deviation by the mean allows us to better compare the variability of different statistical series.

(c) Impact on developing countries

While the share of non-fuel commodities in the exports of all developing countries was only 12.3 per cent in 2001, they are still important for a large number of developing and least-developed countries. About 25 least-developed countries, many of them in Africa, depend on non-fuel primary products for more than half of their exports (see Table IB.5 for the list).

Table IB.5

Least-developed countries dependent on non-fuel commodity exports

(Average: 1998-2000)

Country	Share of non-fuel commodities in total exports	Major commodity exports
1 Zambia	99.8	Copper
2 Liberia	99.8	Rubber, timber
3 Mauritania	99.5	Iron ore
4 Guinea Bissau	97.7	Cashew nuts
5 Samoa	96.8	Coconut oil
6 Chad	95.0	Cotton
7 Mali	94.5	Cotton
8 Benin	93.7	Cotton
9 Uganda	90.5	Coffee
10 Vanuatu	88.4	Copra
11 Central African Rep.	88.2	Diamonds, timber, cotton, coffee
12 Malawi	87.0	Tobacco, tea, sugar, cotton, coffee
13 Comoros	82.9	Vanilla, cloves
14 Burundi	82.8	Coffee, tea, precious metals
15 Dem. Rep. of Congo	82.1	Diamonds, copper, timber
16 Gambia	80.8	Seeds for soft fixed oils, cotton
17 Burkina Faso	79.0	Cotton
18 Tanzania	78.2	Coffee
19 Niger	73.3	Uranium
20 Mozambique	64.6	Cashews, cotton, sugar
21 Rwanda	58.7	Coffee, tea
22 Maldives	57.4	Fish
23 Guinea	56.7	Bauxite, alumina, gold, diamonds
24 Myanmar	54.0	Foodstuffs, precious stones
25 Lao PDR	51.0	Wood products, coffee, tin

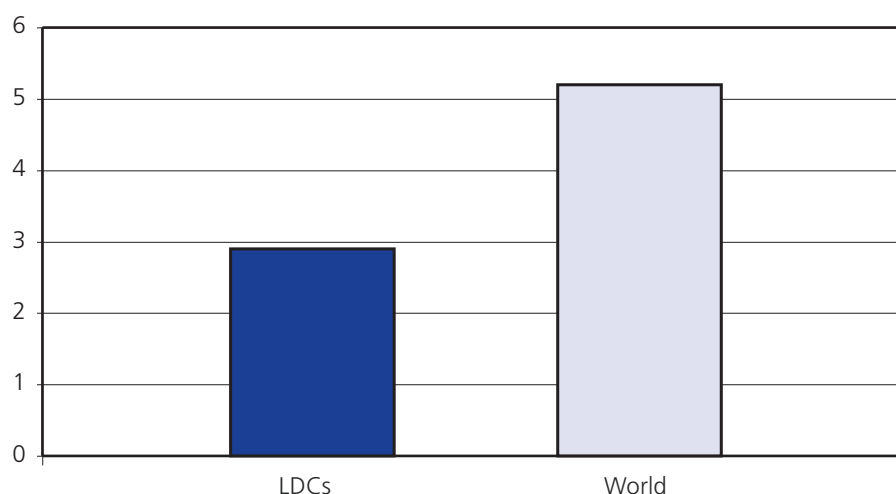
Source: WTO and UNCTAD (2002).

Some idea of the impact of price behaviour on the exports of these commodity-dependent exporters over the past decade is seen in Chart IB.8. While the value of world merchandise exports grew by an annual average of 5.8 per cent over the 1990-2002 period, the corresponding rate was about 2.9 per cent for the commodity-dependent LDCs. For the specific example of coffee, the International Coffee Organization (ICO) estimated the export earnings of coffee-producing countries for 2002 at \$5.5 billion, which is less than half of the annual average of \$10-12 billion they received in the early 1990s.

Chart IB.8

Exports of LDCs dependent on non-fuel primary commodities, 1990-2002

(Annual average percentage change)



Source: WTO.

But reduced export revenues do not tell the whole story as commodity price shocks can retard GDP growth rates. Negative price shocks have had a statistically significant (adverse) impact on the economic performance of Africa (Deaton, 1999). The terms of trade reduction of 36 per cent in the 1980s cost Africa 0.7 percentage points in its growth rate (Hadaas and Williamson, 2001).³⁵ This suggests that the consequences of commodity price shocks can persist, and with growth stalled, threaten rising poverty in the affected countries.

(d) Underlying causes

It might be useful to separate the discussion on underlying causes into those that explain the long-run behaviour of prices and those that explain the short to medium-run movements. The framework of analysis for the behaviour of long-term commodity prices has been largely shaped by the Prebisch-Singer thesis, which focuses on differences in demand elasticities for manufactures and commodities, as well as market power enjoyed by developed countries in manufactured goods. However, an explanation that is based on technical progress and secular improvements in agricultural productivity, is also a plausible alternative.

In the short to medium term, some of the underlying causes of price declines include trade policies in developed countries, the structure of the international market for commodities, and global macroeconomic conditions. Large agricultural subsidies in a number of important commodities have the effect of depressing their world prices. Tariff escalation in developed markets increases developing countries' reliance on primary commodities as it discourages the further processing of commodities in the home country. In some commodities, e.g. coffee, there has been rapid expansion of production as new suppliers (e.g. Viet Nam) have entered the market. One important feature of some commodity markets is that price changes in world markets are not reflected in retail prices of finished products. This suggests the possibility that firms involved in the commodity value chain possess market power that reduces prices received by producers. Current global macroeconomic weakness has also been a factor in depressing some commodity prices. The year 2001 saw the first downturn in the global economy since 1990, with world trade falling by about 1 per cent in volume terms.

³⁵ The terms of trade are measured as the relative price of imports and exports. When the terms of trade deteriorate, as they have for many developing countries, this means that these countries have to export more to pay for the same level of imports or import less for a given level of exports. Either way, falling terms of trade reduce national income.

(i) *Long-term causes*

In looking at the issues that bear on the long-term relative decline of commodity prices, it is important to recall that the classical economists had predicted exactly the opposite result.³⁶ For them, the major constraint on the economy was the fixed supply of land. The principle of diminishing returns would ultimately put pressure on agricultural yields and lead to a long-term increase in the relative price of food or agricultural products. Capital accumulation and population growth could not be sustained, as rising food prices kept population in check and stalled human progress.

The favoured explanation of many contemporary economists as to why these dismal predictions did not materialize over the following centuries is based on technological progress and improvements in agricultural productivity.³⁷ Among these favourable influences were the introduction of new crops (e.g. potatoes, maize), changes in farming practices (enclosure movement, the elimination of fallow), the mechanical revolution (the introduction of the reaper in the 19th century and of the tractor in the 20th century) and the application of science to agriculture (the “green revolution” marked by the development and use of high-yielding varieties of rice and other cereals with fertilizers, pesticides and irrigation). Production has grown to feed a rapidly expanding human population, which increased nearly eightfold from 760 million in the middle of the 18th century. These improvements have continued today, with world food availability for direct human consumption growing by 19 per cent to 2,720 kcal/day in the 35 years to 1994-96 (Alexandratos, 1999). This increase in per capita consumption occurred even as world population increased from 3 billion in 1960 to 5.7 billion in 1995. Agricultural productivity growth was not confined to the developed world. Sender (1999) estimates that agricultural productivity in Africa increased by an annual average of 2.3 per cent during the 1965-95 period, a rate that was as rapid as could be expected given the various infrastructure constraints in the continent.

But why should technological change in agriculture lead to a commodity price decline? One explanation is that developing countries have a large supply of farm labour, which is available at the subsistence wage. This large supply of labour prevents the real wage from rising when productivity increases. Thus, any productivity gain simply increases the supply of commodities, and is captured entirely by consumers in the form of lower relative prices.³⁸ This alternative explanation had not drawn as much attention as the Prebisch-Singer hypothesis but has recently garnered some support.³⁹

In the case of metals, the long-term trends in prices are likely to have been shaped by the pace of technological improvements in extraction techniques (e.g. the use of the flotation process in copper) and in the production process (e.g. Bessemer’s invention of the blast furnace and the employment of large reverberatory furnaces for smelting), recycling (e.g. in 1998, about 40 per cent of global demand for aluminium came from recycled aluminium scrap) and substitution by other materials (e.g. replacement of copper wires by fiber-optics).

Either the Prebisch-Singer or Lewis explanation still implies that if a country specializes in commodity production, it will face the long-term challenge of managing adverse terms of trade movements. In the face of continued growth in agricultural productivity, greater diversification in the economic structure of commodity-dependent countries will be the only effective way to manage the problem.

³⁶ Ricardo (1817) and Malthus (1798; 1815).

³⁷ Galor and Weil (2000), Johnson (2000) and Hansen and Prescott (2002). However, see O’Rourke and Williamson (2002), who have argued for an equally important role for international trade in the transition from a Malthusian world to the modern one.

³⁸ This explanation was first articulated in Arthur Lewis’ 1954 paper on unlimited supplies of labour. The inquiry was provoked by the question why the well-documented productivity growth in sugar in the West Indies was not accompanied by an increase in the real wage.

³⁹ Deaton (1999).

(ii) Short and medium-term causes

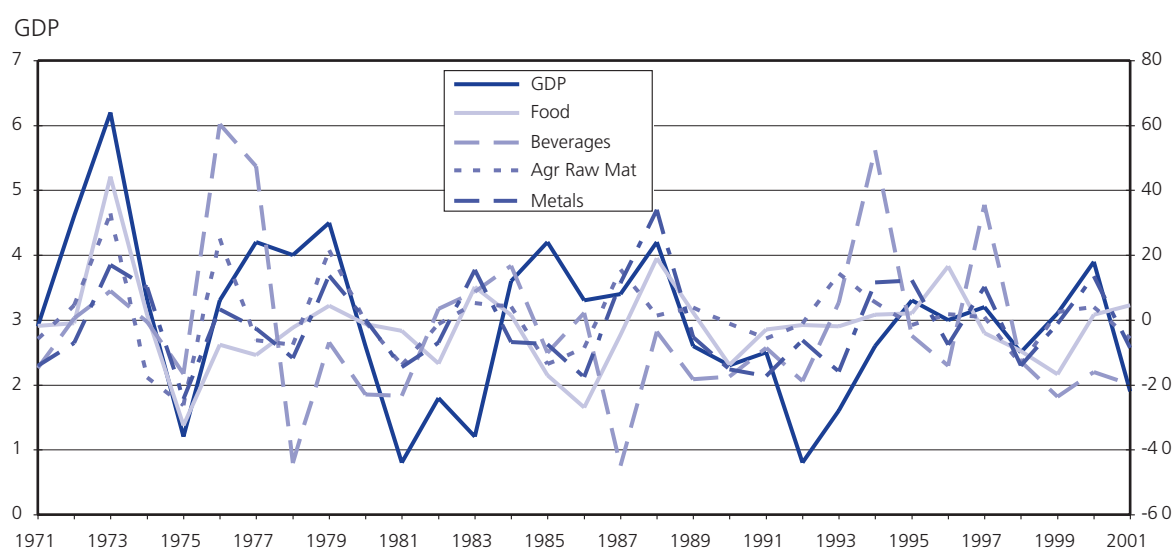
Global macroeconomic slowdown

The strength of the global economy has an important bearing on prices (see Chart IB.9). Periods of rapid global expansion have usually been accompanied by rising relative commodity prices while periods of global weakness put downward pressure on prices. To examine the strength of the relationship, the change in relative commodity prices is compared to the change in real GDP.⁴⁰ The estimated coefficients are all positive and large in magnitude, suggesting a strong relationship. The relationship is much stronger and significant for metals, agricultural raw materials and food (see Table IB.6). However, it is not significant for beverages. Since metals and agricultural raw materials are important inputs in industrial production, their prices tend to be pro-cyclical. One possible implication of this strong business cycle link is that any sustained strengthening of commodity prices will likely have to await a full economic recovery in the major industrialized countries.

Chart IB.9

World GDP and non-fuel commodity prices, 1970-2001

(Annual percentage change)



Sources: World Bank (2002), World Development Indicators IMF (2003), International Financial Statistics.

Table IB.6

Relative commodity prices and global output, 1971-2001

Commodity	Output coefficient
Food	4.73 ^b
Beverages	3.58
Agricultural raw materials	4.56 ^b
Metals	5.43 ^a

^a Significant at the 1% level

^b Significant at the 5% level

⁴⁰ In technical terms, the change in the natural logarithm of relative commodity prices is regressed on the change in the natural logarithm of real GDP. The change in the natural logarithm approximates the annual percentage change of prices and real GDP.

Trade policies in developed country markets

Apart from the global business cycle, the trade policies adopted in the major markets of primary goods exporters will have a bearing on prices. Many developed countries provide substantial domestic support or subsidies to their agricultural sector. The OECD estimated the value of producer support to the farm sector in its members in 2000 to be about \$241 billion, 63 per cent of which was market price support.⁴¹ Table IB.7 shows the current total Aggregate Measure of Support (AMS) for the period 1995-99. Under the Agreement on Agriculture, WTO Members are considered to be in compliance with their domestic support commitments if the current total AMS does not exceed the annual or final bound AMS commitment specified in their schedules. Although the current total AMS has fallen from about \$120 billion in 1995 to around \$75 billion in 1999, the amount still represents a sizeable level of trade-distorting support.

Table IB.7
Current total aggregate measurement of support, 1995-99
(\$ billions)

	YEAR				
	1995	1996	1997	1998	1999
AMS	120	108	99	77	75

Notes:

1. Because of delays in notifications, 1999 was the last year in which there were relatively complete submissions on current total AMS.
2. Notifications from WTO Members were in national currencies. These have been converted into US dollars at exchange rates specified in the source document TN/AG/S/4.

Source: WTO document TN/AG/S/4 and notifications from WTO Members.

By providing incentives for farmers to either maintain or increase agricultural production, the support can put downward pressure on world prices of commodities. Hence, reduction of domestic support, particularly in developed countries, is likely to result in increases in world prices of previously subsidised commodities. A number of recent simulations suggest that developing countries who are net commodity exporters are likely to benefit from this, both in terms of increased exports and also in welfare.⁴² However, an important drawback is that developing countries who are net agricultural importers may face reductions in welfare.

Another trade policy issue that has received significant attention is tariff escalation (see Section IIB.2 as well). While the level of tariff protection on many primary commodities may be low in developed markets, the protection tends to increase with the degree of processing of the commodity. If significant, tariff escalation has the effect of discouraging the further processing of commodities in the home country, thus increasing the exporter's reliance on primary commodities. Table IB.8 gives some indication of the degree of tariff escalation for selected primary products of export interest to developing countries. As a general observation, we find that tariff protection tends to rise with the degree of processing. The degree of tariff escalation differs, sometimes markedly, across countries. For the United States, the biggest differential in applied rates is 7 per cent (coffee) and it is 8 per cent in the case of the EU (cocoa). The differential is larger in the case of Japan at about 22 per cent (cocoa). Much more severe cases of tariff escalation can be found in Mexico for coffee and in Turkey for sugar.

⁴¹ OECD (2002a).

⁴² See Hertel, Anderson, Francois and Martin (2000) and Hoekman, Ng and Olarreaga (2002a, b) who simulate, among others, the impact of a reduction in agricultural support on trade and welfare. For developing countries, the impact of a reduction in domestic support works primarily through changes in the world price benefiting net commodity exporters while lowering welfare of net importers.

Table IB.8

Average applied rates on some commodities in selected OECD countries, 2001
(Percentage)

OECD Member	Commodity				
	Cocoa	Coffee	Jute	Non-ferrous metals	Sugar
Australia					
Unprocessed	0.0	0.0	0.0	0.0	...
Semi-processed	0.0	0.0	3.3	3.4	1.5
Prepared or preserved	5.0	0.0	0.0	4.4	5.0
Canada					
Unprocessed	0.0	0.0	0.0	0.0	...
Semi-processed	1.2	0.0	3.6	1.2	3.8
Prepared or preserved	5.2	0.0	5.5	2.9	7.8
Czech Republic					
Unprocessed	0.0	1.0	0.0	0.0	...
Semi-processed	4.0	1.8	5.1	3.4	41.7
Prepared or preserved	12.7	2.0	5.5	4.2	12.7
European Union					
Unprocessed	0.0	4.2	0.0	0.0	...
Semi-processed	7.0	7.0	1.6	4.3	10.4
Prepared or preserved	8.0	9.8	3.0	4.0	13.4
Japan					
Unprocessed	0.0	0.0	0.0	0.0	...
Semi-processed	5.6	9.0	6.4	2.4	9.2
Prepared or preserved	21.7	19.8	0.0	2.1	19.8
Korea, Rep. of					
Unprocessed	5.0	2.0	2.0	1.5	...
Semi-processed	6.0	6.8	8.0	6.6	23.7
Prepared or preserved	12.3	8.0	8.0	7.2	8.0
Mexico					
Unprocessed	18.0	23.0	13.0	11.3	...
Semi-processed	19.0	72.0	13.0	14.1	17.1
Prepared or preserved	n.a.v.	141.0	23.0	18.6	n.a.v.
Turkey					
Unprocessed	0.0	13.0	0.0	0.0	...
Semi-processed	11.0	13.0	2.0	5.5	50.2
Prepared or preserved	8.0	9.5	3.4	3.9	13.4
United States					
Unprocessed	0.0	0.0	0.0	0.0	...
Semi-processed	0.0	0.0	0.5	2.3	5.8
Prepared or preserved	6.3	6.9	0.0	2.8	8.1

n.a.v. = Non-ad-valorem rates

Source: WTO.

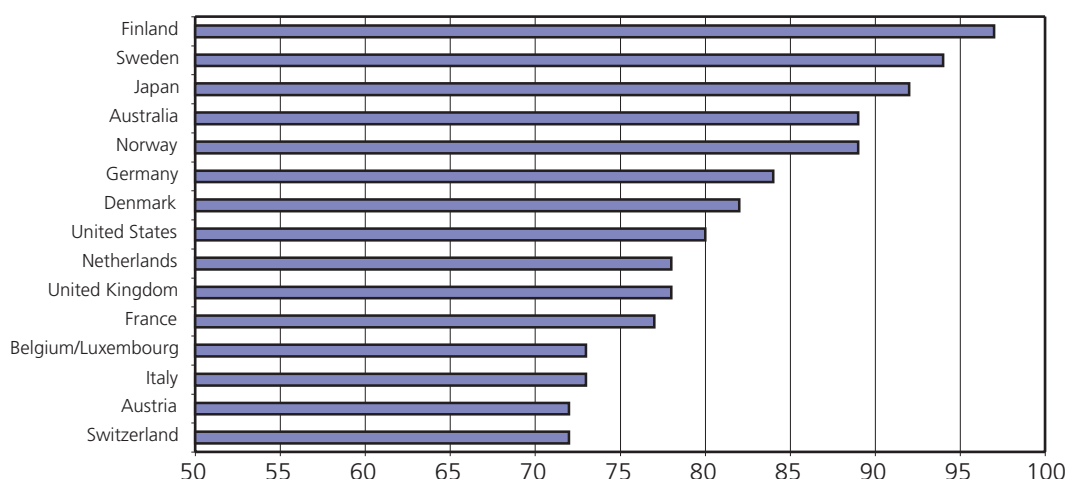
Oligopoly in product markets

One important feature of some commodities is that movements in world commodity prices do not seem to be fully reflected in the retail prices of the finished products.⁴³ There is also a fair degree of concentration in the various stages of the marketing chain. In the case of coffee, for example, the top ten roasters in the world account for an estimated 63 per cent of all processed coffee sales (roasted and soluble).⁴⁴ Chart IB.10 further documents the degree of concentration in 15 developed country markets including the US, Italy, Germany, France and the UK. The behaviour of retail prices, coupled with the large degree of concentration, raises the question of market power by the firms involved in the commodity supply chain. Lack of competition in these markets may allow firms to extract rents from the value chain and lead to lower prices being received by the primary producers.

Nevertheless, recent studies on this question have been unable to find significant monopoly power by market players. A study of the Dutch coffee market (Bettendorf and Verboven, 2000) concluded that while it was oligopolistic, the market was relatively competitive and the weak relationship between world prices and consumer prices was because of the relatively large share of costs other than coffee beans. In the case of the German coffee market, which is the second largest in the world after the US, while there is a long lag (almost two years) before changes in green coffee prices are transmitted to retail prices it is not clear to what extent this slow adjustment reflects market power by firms (Feuerstein, 2002).

This is an area that seems to warrant further research, particularly since most studies have looked at market power in the consumer or retail segment rather than the effect of market power on the producer or farm segment. To the extent that market power is present, and is used to extract economic rents from further down the production chain, the question would be whether action to stem anti-competitive behaviour might be warranted, including through international co-operation.

Chart IB.10
Share of top 5 coffee roasters in selected markets in 2000
(Percentage)



Sources: ITC (2002), International Coffee Guide.

⁴³ Morisset (1998) has found, for example, that the spread between world and domestic prices of a number of commodities (beef, coffee, oil, rice, sugar and wheat) has increased and there is asymmetry in adjustments with upward movements in world prices being passed on to consumer prices while downward movements are transmitted only imperfectly.

⁴⁴ ITC (2002).

(e) Possible responses

In the long term, commodity-dependent countries should work to diversify the export structures of their economies.⁴⁵ Experience from the 1950s and 1960s, however, has shown the limitations of excessive reliance on import substitution or industrial policy to achieve these ends. This is particularly true where these policies have taken the form of high protection from imports, simply creating space for replacing imports with domestic substitutes. Rather, the emphasis should be on investing in human capital, knowledge, better institutions and public infrastructure thereby hoping to build new endowments.⁴⁶ This more nuanced approach to intervention, aimed at increasing technology absorption and diffusion, finding ways of increasing productivity and building the appropriate institutions, may yield better results. These issues are discussed further in Section IIA of the study.

Even with the best pro-diversification policies that a country could pursue, a shift in the structure of production and exports is unlikely to occur immediately or easily. For the short and medium term, a range of responses to the problem of declining prices have been considered. In the past, many governments opted for control of the marketing or supply of primary commodities. Domestically, this control was exerted through marketing boards; internationally, a number of commodity agreements (tin, coffee, cocoa, rubber, etc.) were established.

Concerns about commodity price fluctuations have led to various forms of interventions by governments including marketing boards. However, attempts to insulate domestic producers from gyrations in world prices have often proved financially unsustainable since severe fluctuations in world prices can quickly drain the resources available for commodity price stabilization. Equally important perhaps, involvement by governments in marketing often has squeezed out private traders and by reducing competition in marketing also has a detrimental impact on the farmers. In a study of 18 LDCs, it was estimated that procurement measures (through government marketing boards, which are often the only legal buyers of agricultural outputs), quotas on exports of food crops and other agricultural commodities, and direct taxation of such exports have resulted in an effective tax on agriculture of 8 per cent on average (Schiff and Valdes, 1992). Marketing boards have generally failed to pass on export price increases to producers, and have themselves often been part of the system of *de facto* agricultural taxation.

The past decades have not been kind to international commodity agreements either. Some have collapsed, others faced adverse market conditions which made attempts at stabilization impractical. Others were not able to raise the funds to intervene effectively, while still others have suffered from disagreement over the division of the benefits among countries.⁴⁷ Difficulties have also arisen in circumstances where the implicit objective of price stabilization schemes has been to change secular trends in prices rather than smooth out fluctuations in prices.

Futures markets offer a way to hedge commodity price risk and have been used for a long time in developed countries by trading companies and financial institutions, although these financial instruments are not typically purchased by farmers. Nevertheless, the benefits of such markets can filter down to farmers through intermediaries who package these instruments into simpler forms of price insurance. But financial institutions in developing countries may have little access to hedging instruments in international markets. This is because of the high costs and inherently more risky nature of such transactions. Poor countries may lack the physical facilities (for storage, transportation, processing), legal and institutional infrastructure which are necessary preconditions for the efficient functioning of such markets. The important challenge is to create the necessary conditions for these markets to function successfully in poor countries given the benefits from market-based hedging of commodity price risk.

⁴⁵ See Ng and Yeats (2002).

⁴⁶ See De Ferranti et al. (2002).

⁴⁷ Gilbert (1995).

The long-term reform process of agricultural trade envisioned by the Agreement on Agriculture calls for a “fair and market-oriented agricultural trading system” and a system that results “in correcting and preventing restrictions and distortions in world agricultural markets”. As the Agreement currently stands, it allows some leeway for market instruments, such as export taxes, as a means of managing exports. Some commodity exporters also view export taxes as a measure to counteract tariff escalation.

By dealing with some of the underlying trade policy-related causes of low commodity prices, the Doha work programme offers an opportunity to make a positive impact on the problem. It has assigned importance to the issues of trade-distorting subsidies and tariff escalation. It calls for “comprehensive negotiations aimed at...reductions of, with a view to phasing out, all forms of export subsidies and substantial reductions in trade-distorting domestic support”. The “negotiations ... shall aim ... to reduce or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products of export interest to developing countries”. A successful outcome to the negotiations in agriculture and in market access for non-agricultural products, particularly in areas of interest to commodity exporters, would represent a valuable move forward on a long and difficult path.

3. REGIONAL TRADE AGREEMENTS

(a) Regional trade agreements have multiplied in recent years

The global trading system has seen a sharp increase in regional trade agreements (RTAs) over the past decade or so (Chart IB.11).⁴⁸ A total of 259 RTAs had been notified to the GATT/WTO by the end of December 2002, although only 176 RTAs are currently in force.⁴⁹ An additional 70 RTAs are estimated to be operational although not yet notified and about 70 are under negotiation (Appendix Table IB.5 contains a list of the main RTAs under negotiation at present and their stage of advancement). As of March 2003, only four WTO Members – Hong Kong, China; Macao, China; Mongolia and Chinese Taipei – were not party to a regional trade agreement. With the sole exception of Mongolia, these WTO Members are all engaged in negotiations on preferential agreements.

While the recent rapid growth of RTAs began in the 1990s, the seeds of this development were arguably sown in the 1980s. Part of the impulse towards regionalism was driven then by the seemingly bleak prospects for progress on the multilateral agenda in the wake of the inconclusive 1982 GATT Ministerial Meeting. Moreover, Western Europe was continuing its moves towards deeper and broader regional integration. Highly significant also was the decision of the United States to explore the preferential approach to trade. Prior to this, the United States had relied almost entirely on the GATT and the most-favoured-nation (MFN) principle to define its trade relations with other nations.⁵⁰ The United States signed its first free trade agreement (FTA) with Israel in the mid-1980s, followed by a FTA with Canada in 1988 and the North American Free Trade Agreement (NAFTA) in 1994. The current negotiations on free trade for the Americas (FTAA) span two continents and involve over 30 countries. More recently Asian countries, including Japan, have also departed from exclusive reliance on MFN-based trade.

A major explanation for the expansion in the number of RTAs in the 1990s was the collapse of the COMECON (the preferential arrangement involving the old Soviet Union and Eastern European countries) and the alignment of the Central and Eastern European countries to the European Union. Of the 123 new RTAs in force since 1990, covering trade in goods, about a third were signed among transition economies (Table IB.9). These new agreements were a response to the splintering of COMECON and represented efforts to make up for the forgone preferences. Hence, some of these new RTAs do not necessarily represent increased regionalization of the international trade regime. Another third were agreements concluded as part of the effort of the transition economies to integrate with the European Union.

Regional agreements among developing countries account for about 30-40 per cent of all RTAs currently in force, including those not notified to the WTO. In Africa alone, there are about eighteen trading agreements. Typically, they seek to reach beyond FTAs and establish customs unions or common markets. They tend to encompass a large number of countries and may have extended transition periods, often 20 or 30 years. These long transition periods suggest that some recent RTAs are more a declaration of intent than agreements promising a significant impact on trade flows.

The number of RTAs signed between developed and developing countries has increased over the years. The European Union has played a major role in this respect through a series of agreements with a number of countries including Turkey, Mexico, South Africa and Chile. Euro-Mediterranean Association Agreements have also been concluded or are being negotiated between the EU and the countries of North Africa and the Middle East. These replace the earlier non-reciprocal RTAs signed in the 1970s. Moreover, the post-Lomé Cotonou agreements will be negotiated between the EU and the ACP countries on the basis of reciprocal preferential trade.

⁴⁸ RTAs in the WTO context constitute a permitted departure from the most-favoured-nation principle.

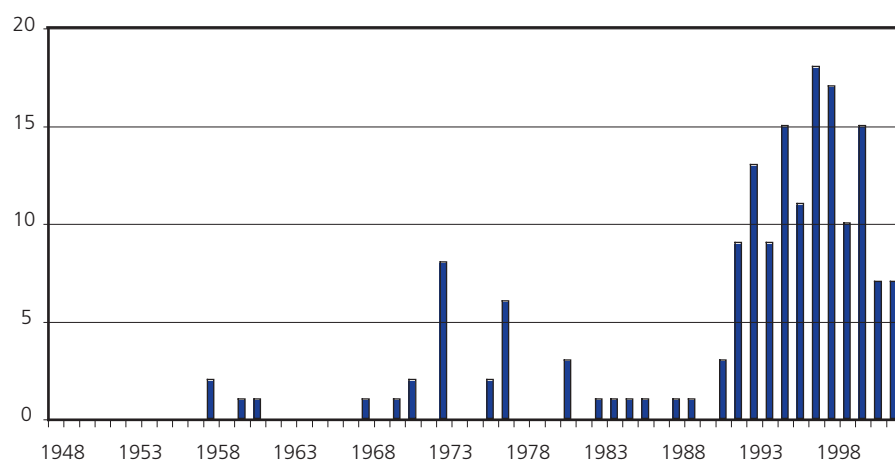
⁴⁹ Some of the notified agreements may have lapsed or may have been superseded. Included in the 259 total are notifications made under GATT Article XXIV, GATS Article V, and the Enabling Clause, including accessions to existing RTAs.

⁵⁰ Exceptions to this included trade preferences for developing countries and the US-Canada Auto Pact.

Chart IB.11

RTAs by date of notification

(Number of RTAs notified to the WTO and in force as of December 2002)



Source: WTO.

Table IB.9

Notified RTAs in goods by the date of entry into force and type of partners

(as of January 2003)

	Developed-Developed	Developed-Developing	Developed-Transition	Developing-Developing	Developing-Transition	Transition-Transition	Total
1958-1964	2	0	0	1	0	0	3
1965-1969	0	0	0	0	1	0	1
1970-1974	5	3	0	2	0	0	10
1975-1979	0	5	0	1	0	0	6
1980-1984	2	1	0	1	0	0	4
1985-1989	1	1	0	2	0	0	4
1990-1994	3	3	12	5	0	6	29
1995-1999	3	7	10	4	12	28	64
2000-2002	0	11	4	5	4	6	30
Total	16	31	26	21	17	40	151

Note:

In this table, developed countries include Canada, the United States, EU, EFTA, Japan, Australia and New Zealand; transition countries include the former Soviet Union, Eastern and Central Europe, the Baltic States and the Balkans; the remaining countries are classified as developing.

Source: WTO.

Table IB.10 shows that 43 per cent of world merchandise trade now occurs under the umbrella of preferential trade arrangements. This share will increase as more RTAs are negotiated in the future. If all RTAs under negotiation at present are successfully concluded within the next three years, over 50 per cent of world merchandise trade will then occur among countries linked by preferential agreements.

Table IB.10

Preferential trade share of intra RTAs trade in merchandise imports of major regions, 2000 and 2005

(as of January 2003)

	2000	2005
Western Europe	64.7	67.0
Transition economies	61.6	61.6
North America (incl. Mexico)	41.4	51.6
Africa	37.2	43.6
Middle East	19.2	38.1
Latin America (excl. Mexico)	18.3	63.6
Asia	5.6	16.2
World	43.2	51.2

Note:

Estimates are calculated on the basis of the 113 agreements covering trade in goods notified to the WTO and in force as of July 2000, using trade data for 1999.

Source: WTO.

Not all trade among preferential trading partners takes place at preferential rates. Most agreements exclude certain sensitive sectors. Traders may choose to forgo preferential treatment because the costs of satisfying the requisite rules of origin might be higher than the advantage offered by the preferential margin. Such costs can take the form of higher-priced inputs linked to within-region sourcing requirements under the origin rules or may result from burdensome administrative requirements. Moreover, many applied MFN tariffs in developed countries are already zero. For the above reasons, the estimates reported in Table IB.10 will overstate the impact of preferential trading arrangements as far as tariffs are concerned.

The question of how regional trade arrangements affect the multilateral trading system cannot be understood solely through the prism of preferential tariff margins. Many other factors come into play such as the systemic implications of excluding particular sectors from RTAs, whether deeper integration involving regulation and "inside-the-border" areas of policy imparts an additional discriminatory impact on third parties, and whether regional integration efforts influence the pace of progress in multilateral rule-making and liberalization efforts. When these considerations are factored into the analysis, not to mention the political forces at play, the question whether regional arrangements complement or frustrate multilateralism becomes altogether more complex.

In assessing this issue, it is essential to consider a simple counter-factual question – how far does the choice exist for nations to define their desired trading relations through regionalism or multilateralism? If regionalism is second-best to a multilateral approach in defining trade relations, as suggested by many analysts and commentators, then the core question is whether regionalism has become an easy and ultimately unhelpful option, or whether there are circumstances in which it is the only option. If it is the latter, the policy challenge is to preserve as much as possible, a multilateral focus in the face of real world exigencies. If it is the former, then the challenge is to render regionalism a lesser temptation by moving forward more effectively on the multilateral front.

The rest of this section of the World Trade Report further explores these issues. The next sub-section considers some of the reasons why governments may be attracted by regional trade arrangements. This is followed by a discussion of the evolution of regional arrangements, the degree to which they might achieve deeper integration than is practicable under the WTO, and the ways in which regionalism and multilateralism interact with one another.

(b) The formation of RTAs is driven by economic and political considerations

(i) *The economics*

Economic analysis offers at least two reasons why governments might opt for preferential liberalization. The first of these is an application of the theory of the “second-best”. In a world where policy-imposed barriers to trade exist, and it is impossible to remove them across-the-board, it may still make sense in terms of national and global well-being to reduce these barriers on a selective basis. If some countries are unwilling to liberalize while others wish to do so, for example, liberalization via a regional agreement might be more beneficial to the world than the *status quo*. The brief discussion below of trade creation and trade diversion illustrates why discriminatory liberalization could also make the world worse off, even if those undertaking the liberalization are better off. It could be argued that the willingness of a country to liberalize should not depend on whether others will do the same, since the gains from additional trade would accrue to the liberalizing country anyhow. This is an argument for unilateral liberalization on a non-discriminatory basis.

But reciprocal liberalization moves can yield even higher income gains than unilateral liberalization, and these gains can be augmented if unilateral liberalization was complemented with reciprocal liberalization. Furthermore, there are political economy reasons why governments may find it easier to liberalize when other countries are doing the same. So arguments in favour of unilateral liberalization do not necessarily trump the case for discriminatory liberalization on a reciprocal basis in a world of the second-best.

A second reason for governments to seek discriminatory liberalization is that they may be able to reap gains from trade in product areas where they cannot compete internationally. In other words, regional trade agreements could serve the purpose of shutting out third-party competition from more efficient suppliers. This motivation for striking regional agreements has unambiguously negative connotations for the world trading system. In the first case cited above, discriminatory trade liberalization does not necessarily work against subsequent non-discriminatory multilateral liberalization scenarios. But the exclusionary motivation for discrimination in the second case implies that the spread of regionalism will be an obstacle and not a complement to the multilateral agenda.

What are the circumstances in which the multilateral option might be considered more desirable but is more elusive than a regional approach, driving governments to focus on regional agreements? Three distinct dimensions are apparent. One concerns the possibility referred to earlier that for one reason or another, some countries are simply uninterested in pursuing multilateral liberalization.⁵¹ Second, governments may wish to go deeper in integrating their economies than seems possible in a multilateral framework. They may prefer to remove all trade barriers rather than just reducing some. Or they may want to negotiate agreements on a range of other issues not touched upon or fully dealt with in the WTO, such as investment, competition, trade in services, or environment and labour standards. There may be gains from deeper integration unattainable in the WTO, including harmonization of economic policies or regulations, that is feasible among similar or like-minded countries. Third, governments may regard the multilateral option as too time-consuming, with negotiations being more drawn out because a wider range of interests needs to be reconciled. In addition, transaction costs associated with liberalization will be lower with fewer participants in negotiations.

⁵¹ If the reluctant country is large enough on the world stage, its reticence to enter into liberalization commitments could push other countries towards regional arrangements. If the reluctant country is small, MFN-based liberalization might still be pursued by other countries. If lots of small countries are reluctant, the MFN approach may be rejected by those pursuing a liberalization agenda and they will turn to regionalism.

Sometimes countries, especially smaller ones, may see participation in regional arrangements as a defensive necessity from an economic perspective. Governments may simply fear exclusion from markets, and regard participation as an insurance policy against being placed at a competitive disadvantage through discriminatory policies. The phrase “domino regionalism” has been coined in the literature to capture this kind of motivation, explaining to a degree the explosion of membership in regional arrangements.⁵² A particular reason why some developing countries may be seeking trade agreements with their larger developed country partners is that they are losing the preferential access to those markets previously enjoyed under developing country preference schemes (e.g. exclusion from GSP) or because the developed country is negotiating preferential agreements with other developing countries. Reciprocal regional trade agreements provide a means of maintaining preferential conditions of access, and this can be particularly important if some of the countries with which they are competing to supply the markets in question have not yet been “graduated” out of non-reciprocal preferential access arrangements or benefit from preferential treatment as a result of a RTA.

Another important economic factor behind the conclusion of RTAs is to attract foreign direct investment which will flow toward those countries which enjoy preferential access to larger markets.

Participation in regional agreements may also be valued for its “signalling” properties. If a country can demonstrate to potential traders and investors that it is committed to opening its markets, and that the commitment will not be easy to reverse, this could also be a reason for engagement. In these instances regionalism may not be particularly favoured over multilateralism, except for necessity or expediency.

(ii) *The politics*

Political considerations will inevitably feature in decisions to establish regional trading arrangements. Governments may seek to consolidate peace and increase regional security. However, the impact of the formation of a RTA on regional security can be twofold. On the one hand, creating linkages between economies can make conflicts more costly and favour cross-border collaboration. On the other hand, RTAs can create internal and external tensions. This is because the design of regional agreements affects the way gains are redistributed across members and may divert trade from non-members, thus reducing the welfare of third countries.

Governments may seek to acquire greater bargaining power in multilateral negotiations by first tying in partner countries through regional commitments. The same might happen at a regional level, where a subset of countries potentially engaged in broader regional negotiations would first strike their own agreement in order to increase bargaining power and press for a better outcome. Such empowerment, however, is conditional on the ability of the parties concerned to define a common position.

Just as the economic motivation of signalling commitment to a certain policy stance may induce participation in a regional agreement, so too might the wish to pursue the more political objectives of good governance and durable democracy. Regional agreements could be used to lock in institutional changes. A regional framework could be preferred to the multilateral context if it promises a deeper level of commitment or was likely to yield dividends in a shorter time-frame.

Vested interests within national bureaucracies could also drive RTA formation. Once the bureaucratic machinery has been set up to negotiate regionally, there is a natural temptation for those involved to seek to perpetuate their functions by creating conditions for the negotiation of successive agreements. There is perhaps also a sense in which governments have come to see the negotiation of trade agreements as a natural accompaniment of economic diplomacy. With regional agreements becoming so ubiquitous, the default question asked seems increasingly to be why a regional agreement does not exist with a trading partner, rather than why such an agreement should exist. To the extent that this tendency informs policy, the proliferation of unhelpful, criss-crossing agreements of questionable economic value is a risk that should not be ignored.

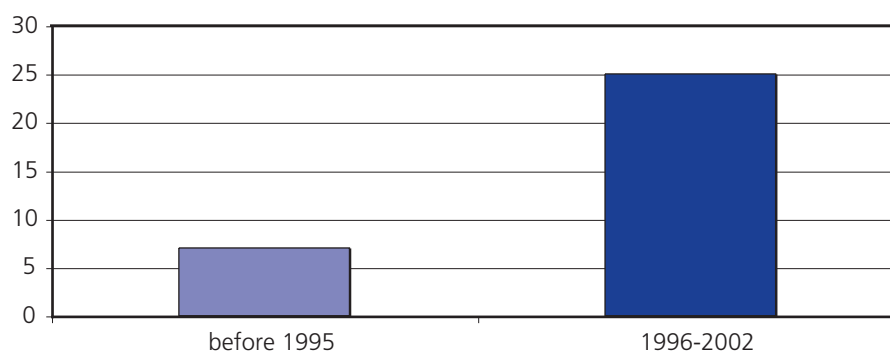
⁵² Baldwin (1995).

(c) Towards a complex network of RTAs

As noted earlier, the international trading system is increasingly characterized by a complex network of preferential trade regimes, sitting side-by-side with the WTO multilateral trading system. We see a rise in cross-regional bilateral agreements, the growing involvement of countries that have traditionally remained outside regional arrangements, the development of inter-linked (overlapping) agreements, and considerable variations in the design and content of RTAs.

One-third of the FTAs currently under negotiation are among countries that belong to different geographical areas. All major countries are involved in cross-regional FTAs. The EU has concluded FTAs with Mexico, Chile, South Africa and numerous other African and Middle Eastern countries and is in the process of negotiating regional agreements with ACP countries under the framework of the Cotonou Agreement. The EU is also negotiating an agreement with MERCOSUR. EFTA has signed a FTA with Mexico and various African countries, and is negotiating FTAs with Canada, Chile and South Africa. The United States signed a FTA with Jordan, and is negotiating with Australia, Chile, Egypt and Singapore. Chart IB.12 illustrates this trend.

Chart IB.12
Rise of cross-regional RTAs: a new phenomenon
(Number of RTAs)



Source: WTO.

Countries that have traditionally remained outside regional agreements are now negotiating and joining RTAs. The last major country to join the trend is Japan, which signed a FTA with Singapore in January 2002. Within the ASEAN region, Singapore has concluded bilateral FTAs with New Zealand (signed in November 2000) and EFTA (signed in June 2002). It has concluded negotiations with Australia and the United States and is negotiating with Canada, Mexico and the Republic of Korea. Japan is considering entering into talks with Canada, Chile, Mexico, and the Philippines. A bilateral FTA between Japan and the Republic of Korea is under negotiation. In November 2002, leaders of China and ASEAN signed a framework agreement commencing negotiations leading to a FTA within 10 years.

The proliferation of RTAs and the increasing number of bilateral free-trade agreements has meant overlapping membership for many countries. A large number of countries are now a party to two or more RTAs. For example, the EU has over 30 preferential trade agreements. Mexico is a member of NAFTA and also has a FTA with the European Union and a number of other countries. Singapore is a member of AFTA and has bilateral FTAs with Australia, EFTA, Japan, New Zealand and the US. All these countries are involved in negotiating future agreements. Chart IB.13 provides a picture of the degree of overlapping in RTAs. The Chart shows recently concluded RTAs and RTAs under negotiation among parties belonging to different regions.

Finally, recent RTAs take many different forms. Many go beyond the simple removal of tariff barriers and quotas. They include the removal or reduction of non-tariff barriers, through harmonization or mutual recognition of product standards and conformity assessment procedures. Increasingly, many RTAs contain provisions on

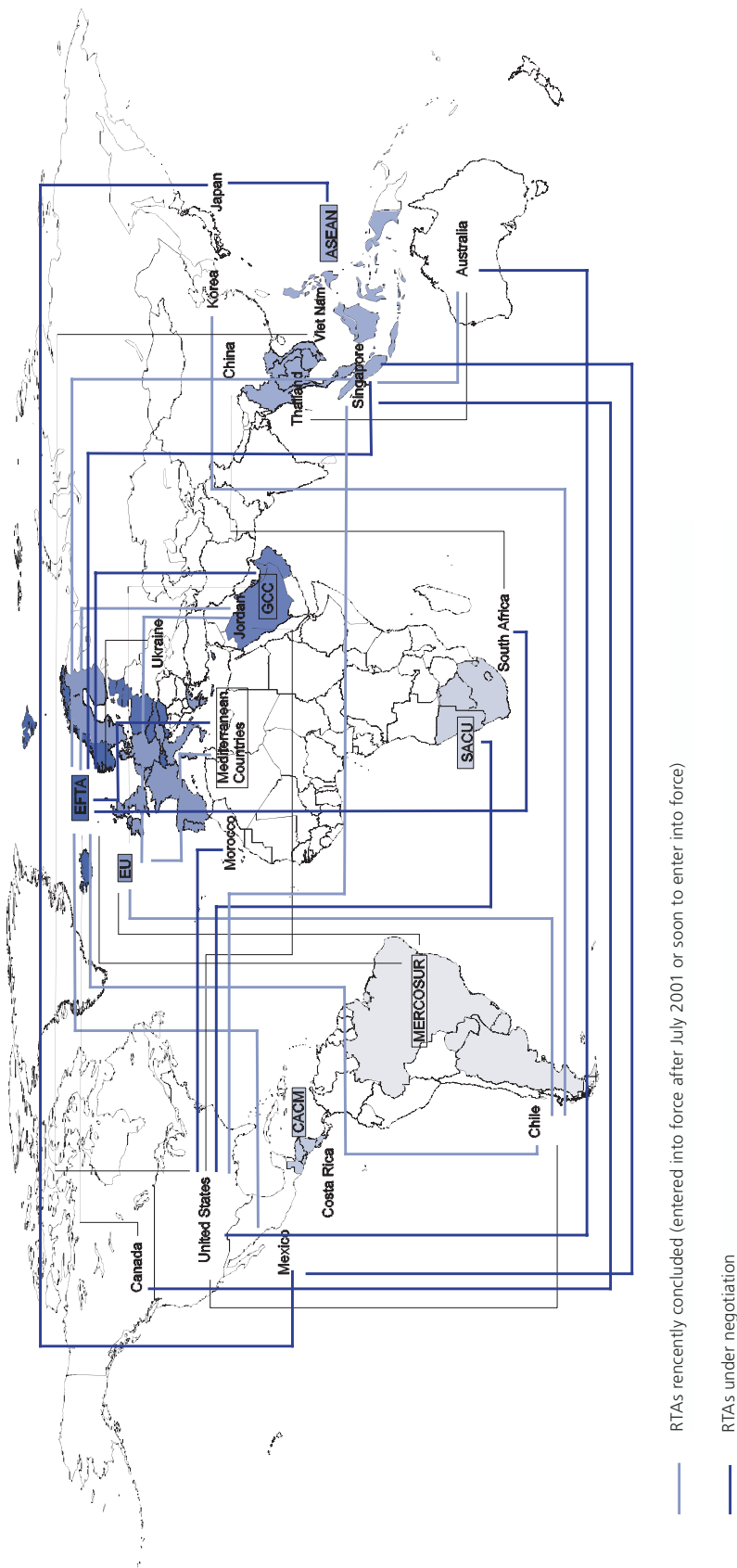
trade in services.⁵³ Some also reach into policy areas that are either not covered or are covered differently by WTO rules, such as capital mobility, competition, environmental standards, investment and labour standards. For example, the agreement between Japan and Singapore covers a broad range of economic aspects such as capital flows, harmonized regulations, co-operation on paperless trade, financial services, media/broadcasting services, movement of professionals and development of human resources. The agreement between the United States and Jordan includes commitments on labour and environmental standards. Both the expected US-Singapore agreement and the agreement being negotiated between the United States and Chile will contain labour and environmental provisions.

With this patchwork of agreements and diverse treatment of issues, governments are increasingly likely to have to manage different provisions within the same policy areas. This carries the risk that some provisions are mutually inconsistent and may hamper trade. Complexity in the trade regime increases the transaction costs of conducting trade and the possibility of mutually inconsistent provisions creates uncertainty as regards the applicable rules.

⁵³ One possible explanation for this is that countries are more likely to gain from preferential liberalization of services trade as barriers in services are often prohibitive (so only domestic suppliers are present) and do not generate tariff revenues so that there are few costs of trade diversion. Furthermore, preferential access (even if it is temporary and followed by multilateral liberalization) may confer long-term advantages in a market given the location-specific sunk costs which apply in some services sectors. Thus, the conclusion of RTAs in services, which are increasingly common, may be used as a means to steal an irreversible march on the competition (Mattoo and Fink, 2002).

Chart IB.13

Cross-regional RTAs recently concluded or under negotiation (2003)



(d) Do regional trade agreements realize deeper integration than the WTO?

In light of the growing predilection among governments to enter into new regional trade agreements, an obvious question to which we alluded earlier is whether RTAs offer deeper integration beyond what can be expected from the WTO in the foreseeable future. A precise answer to this question is not always easy to discern because only partial information exists on many regional agreements. Some commitments are difficult to evaluate with any precision and the picture is further complicated by the plethora of overlapping agreements. However, some analysis can be done on concentration ratios, margins of preferences, tariff peaks and the depth of integration. Such analysis suggests that many RTAs do not offer strong evidence of trade creation, they often do not solve the problem of tariff peaks (high protection in sensitive sectors), and a significant part of trade within RTAs is non-preferential.

As far as liberalization beyond tariffs is concerned, some agreements clearly go in directions precluded by existing multilateral arrangements or go further in the coverage of liberalization. But more generally, it is difficult to establish to what degree a large number of RTAs achieve a deeper level of integration than the WTO. A recent study by the OECD (2002b) assessed to what extent provisions included in RTAs go beyond WTO commitments. The study focused on tariffs (including rules of origin), services, labour mobility, trade facilitation, special and differential treatment and environmental provisions in APEC, NAFTA, EFTA and the EU. The conclusion was that in many respects RTAs have not progressed too much beyond the GATT/WTO agreements, and that it was very difficult to determine whether RTAs represented an improvement in terms of the liberalization of trade. Box IB.1 supports a similar conclusion for the case of ASEAN.

Box IB.1: The case of ASEAN

The ASEAN Free Trade Area (AFTA) was created in 1992. Originally, it included only six ASEAN countries (Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand). However, as ASEAN expanded its membership to include countries in Indochina, the new countries also joined AFTA. In 1995 Viet Nam acceded to AFTA. Then Lao PDR and Myanmar, and Cambodia followed in 1997 and 1999 respectively.

AFTA was envisioned to reduce intra-regional tariffs or CEPT (Common Effective Preferential Tariffs) rates to a range of 0-5 per cent by 2008. However, the deadline for achieving the latter objective has been continuously brought forward – from 2008, to 2003 and then to 2002. The Agreement now also calls for elimination of all customs duties by 2010. ASEAN's new members have a slightly delayed timetable.

The ASEAN integration process has evolved from “narrow to broad”, from an initial phase where the target was removal of trade barriers on industrial goods to a subsequent phase which saw the inclusion of unprocessed agricultural products. ASEAN integration has also progressed from “shallow to deep” integration. Deeper integration denotes going beyond the simple removal of trade barriers.¹ The AFTA-Plus programme (as this new agenda is sometimes called), includes preferential liberalization of services and investment, harmonization of tariff nomenclature, intellectual property co-operation, the harmonization of product standards and mutual recognition of conformity assessment tests.

Despite the realization of AFTA (at least for its first six members), the share of intra-regional trade has not increased significantly since the 1970s. In fact, the concentration ratio has been decreasing over time. It does not appear that the preferences under AFTA have significantly boosted intra-regional trade. There are a number of reasons for this. First, within ASEAN about 66 per cent of the tariff lines have the same MFN and CEPT rates.² As far as the remaining one third of tariff lines is concerned, since many ASEAN countries have also autonomously reduced their tariffs in the 1990s, the difference between MFN and CEPT rates is small. Given the rule of origin of 40 per cent ASEAN content, traders

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may not have found the difference worth the cost of retooling their production to meet the content requirement. Hence, less than 5 per cent of intra-regional trade is covered by CEPT preferences. Second, many products with strong potential for intra-regional trade (agricultural products such as rice and sugar and industrial products like automobiles) are also politically sensitive and have had their liberalization delayed by a number of members to a later date.

¹ Lawrence (1996) defines the removal of trade barriers as a shallow form of integration.

² As of 1998.

(i) *Many RTAs do not provide strong evidence of trade creation*

The most powerful argument for RTAs is that by providing tariff preferences or duty-free treatment to goods originating from its members, more trade is created. Since it is empirically difficult to isolate the trade creation effects of RTAs, proxies are often used. But even the most widely used proxies, such as intra-regional trade shares or concentration ratios, will tend to give an over-estimate of the trade creation effects, since the increase in trade among partners may just reflect trade diversion (see Box IB.2 on the concepts of trade creation and trade diversion). However, even with the use of these imperfect indicators, the data do not show that trade is increasingly becoming concentrated within RTAs.

Table IB.11 below shows the evolution of intra-regional export shares for the major regional trade agreements. It is true that the share of intra-regional exports as a percentage of regional bloc exports has been increasing since 1970 in most of the major regional trade blocs. Over 60 per cent of EU exports are to other EU partners and over half of NAFTA exports are to other NAFTA partners. However, intra-regional export shares within the EU have remained nearly constant and those for NAFTA have shown an upward trend since 1970, well before NAFTA entered into force in 1994.⁵⁴ Similar patterns can be identified for other major RTAs. MERCOSUR is an exception, where data show a sharp increase in intra-regional export shares after the agreement entered into force.

⁵⁴ Some of the empirical literature finds a significant positive impact of the formation of the EU on intra-regional trade. Results are sharper when estimations are conducted on disaggregated data or focussed on growth in trade flows (Frankel, 1997 and Bayoumi and Eichengreen, 1998).

Table IB.11
Intra-regional export shares, 1970-2001

	1970	1980	1985	1990	1995	2000	2001	year in force
Europe and North America								
CEFTA	...	...	...	...	14.6	11.5	12.4	1993
European Union	59.5	60.8	59.2	65.9	62.4	62.1	61.2	1957
NAFTA	36.0	33.6	43.9	41.4	46.2	55.7	54.8	1994
Latin America and the Caribbean								
CACM	26.0	24.4	14.4	15.4	21.7	13.7	15.0	1961
Andean Group	1.8	3.8	3.2	4.2	12.2	8.8	11.2	1988
CARICOM	4.2	5.3	6.3	8.1	12.1	14.6	13.4	1973
MERCOSUR	9.4	11.6	5.5	8.9	20.3	20.7	20.8	1991
Africa								
CEMAC (UDEAC)	4.8	1.6	1.9	2.3	2.2	1.2	1.3	1999
COMESA ^a	7.4	5.7	4.4	6.3	6.0	4.8	5.2	1994
ECCAS	9.8	1.4	1.7	1.4	1.5	0.9	1.1	1983 ^c
ECOWAS	2.9	9.6	5.1	8.0	9.0	9.6	9.8	1975 ^c
SADC ^b	4.2	0.4	1.4	3.1	10.6	11.9	10.9	1992 ^c
UEMOA	6.2	9.9	8.7	12.1	10.3	13.0	13.5	2000
Middle East and Asia								
ASEAN/AFTA	22.4	17.4	18.6	19.0	24.6	23.0	22.4	1992
GCC	4.6	3.0	4.9	8.0	6.8	5.0	5.1	1981 ^c
SAARC	3.2	4.8	4.5	3.2	4.4	4.3	4.9	1985 ^c

^a Prior to 2000, data unavailable for Namibia and Swaziland.

^b Prior to 2000, data unavailable for Botswana, Lesotho and Swaziland.

^c Year of foundation.

Sources: UNCTAD, Handbook of Statistics 2002; WTO, International Trade Statistics 2002.

The intra-regional trade share is calculated as the ratio of trade among members over total trade (with members and non-members) of the regional grouping. This measure has the unfortunate property that its value will tend to vary with the size of the regional trading arrangement, either in terms of the number of members or the volume of trade among members. Therefore, if new countries enter the RTA or one of the countries experience high rates of GDP growth, the intra-regional trade ratio will increase. At the limit, if all countries in the world became members, the share would equal unity. Because of this, a high intra-regional trade share does not necessarily reflect a greater tendency for RTA members to trade with other partners in the region.

A better measure of intra-regional trade bias is provided by concentration ratios. These are calculated as the ratio of the intra-regional trade share to that region's share of world trade. This measure adjusts for the size of RTAs and their degree of openness to the rest of the world. The idea is to see whether a given country trades more with a fellow bloc member than does any one country in the world. If geographic patterns of bilateral trade are simply proportional to the distribution of total trade, then the concentration ratio should be close to one. But if trade is concentrated within a given regional group, that group should show a concentration ratio in excess of one.⁵⁵ What is particularly important is how these concentration ratios evolve over time, since many factors can explain intra-regional trade bias. If RTAs have a significant trade impact, then the concentration ratio should show a significant increase at about the time when the RTA is implemented.

⁵⁵ An alternative way to correct the bias of intra-regional trade shares is to divide each bilateral trade quantity by both partners' total GDPs. However, adjusting for total trade has the advantage of taking out the unwanted influence of size as well as openness. Other studies measure the trade bias introduced by preferences using intensity coefficients. Intensity coefficients are corrected concentration ratios, where the numerator does not count the first country's trade with itself.

First we note that concentration ratios seem to confirm that there is a bias toward trading with regional partners (see Table IB.12). In all cases concentration ratios are greater than one, meaning that trade is concentrated in the region more than the size and the openness of the trading partners would suggest. On the other hand, this could be the result of factors that have not been taken into account such as geographical proximity. In particular, the very high concentration ratios recorded for most RTAs among developing countries are the consequence of the relatively more important role of transport costs given the undeveloped state of their infrastructure. In other words, high values of concentration ratios may simply reflect the fact that countries trade more with their partners in a RTA because they are also neighbouring countries or they share a common language rather than because of preferences. Geographical contiguity or cultural similarities may reduce the cost of trading with one another. Some countries are “natural” trade partners. This may at least partly explain a coefficient of concentration greater than unity across RTAs, so this kind of analysis is somewhat inconclusive.

Second, the evidence on trade creation, as measured by increased concentration ratios, is not very clear. The concentration ratios for the EU and NAFTA have remained nearly unchanged over time although there is a slightly positive trend for NAFTA since 1990. There is an upward trend in the major Latin American RTAs (Andean Group and MERCOSUR) but a downward trend in ASEAN. As for Africa, the ratios show a great deal of variability, reflecting the unreliability of the trade data. For this reason, the African data are the hardest to interpret.

Table IB.12
Intra-regional export concentration ratios, 1970-2001

	1970	1980	1985	1990	1995	2000	2001	year in force
Europe and North America								
CEFTA	...	...	...	...	9.1	6.2	5.5	1993
European Union	1.5	1.6	1.6	1.5	1.6	1.7	1.6	1957
NAFTA	1.9	2.2	2.7	2.6	2.8	2.9	2.9	1994
Latin America and the Caribbean								
CACM	74.8	103.0	75.4	122.4	151.1	46.9	52.1	1961
Andean Community	1.1	2.5	2.6	4.5	15.4	8.7	9.6	1988
CARICOM	10.7	10.1	19.2	51.4	86.1	128.3	92.6	1973
MERCOSUR	6.2	8.0	3.1	6.6	14.9	15.2	13.6	1991
Africa								
CEMAC (UDEAC)	34.5	7.0	8.4	12.9	19.4	7.0	7.9	1999
COMESA ^a	5.5	12.1	8.9	15.6	17.8	11.6	12.9	1994
ECCAS	18.6	4.5	4.2	4.3	7.2	3.1	3.8	1983 ^c
ECOWAS	3.1	28.5	5.3	14.5	22.0	20.0	20.6	1975 ^c
SADC ^b	2.2	0.2	1.3	3.1	14.0	20.1	16.1	1992 ^c
UEMOA	22	42.0	34.9	80.7	89.3	137.3	140.4	2000
Middle East and Asia								
ASEAN(AFTA)	11.4	4.9	5.1	4.6	3.9	3.4	3.5	1992
GCC	5.7	0.4	1.5	3.2	3.4	1.9	2.0	1981 ^c
SAARC	3.3	7.5	6.6	4.1	4.9	4.2	4.6	1985 ^c

^a Prior to 2000, data unavailable for Namibia and Swaziland.

^b Prior to 2000, data unavailable for Botswana, Lesotho and Swaziland.

^c Year of foundation.

Sources: UNCTAD, Handbook of Statistics 2002; WTO, International Trade Statistics 2002.

Box IB.2: Trade diversion and trade creation: definitions and empirical evidence

Since Jacob Viner's seminal work over fifty years ago, the concepts of trade creation and trade diversion have been used to analyze the economic effects of preferential trading arrangements. Trade creation takes place when, as a result of the preferential rate established by a RTA, domestic production of a product is displaced by imports from a member country, where the good is produced at a lower cost. Trade diversion occurs when as a result of regional preferences, imports from a low cost country outside the regional trade agreement are displaced by imports from a higher cost partner country.

Trade creation and trade diversion have opposite effects on welfare, or income. Trade creation generates welfare gains for member countries without imposing any losses on non-members. Consumers resident in the preferential area will pay less to purchase the same product, so they enjoy a welfare gain. In contrast, trade diversion generates a welfare loss. Trade diversion not only represents a cost for the exporting country outside the regional agreement (that will see its exports reduced), but also a cost for the importing country in the regional trading arrangement. Consumers pay a lower price than before the preference was introduced, but the government loses tariff revenue. In any case, consumers pay a higher price than they could have paid for their imports had liberalization occurred at the multilateral level. Trade diversion occurs when the difference in production costs between the lowest-cost member and the lowest-cost non-member is lower than the tariff rate faced by non-member countries. Therefore, lower external barriers minimize the extent of trade diversion. WTO rules, by requiring that members of a RTA do not raise trade barriers against the rest of the world, seek to minimize trade diversion.

But which is more likely, trade creation or trade diversion? Grossman and Helpman (1995) claim that the formation of trade diverting RTAs is the most likely case. The sectors that are more likely to be excluded from the agreement are those domestic import-competing sectors that face strong competition from abroad. Domestic producers of these sectors will be lobbying to obtain preferential access to the regional market. In contrast, the efficient exporter of the foreign country, that is already competitive in the international markets, will not.

Trade diversion also has negative systemic effects. A RTA that is net trade diverting, not only reduces welfare, but might also have negative effects on further liberalization in the multilateral trading system. How can this happen? Trade diversion favours the inefficient firm located in the preferential area at the expense of the efficient firm located outside that region. A firm located in the region, albeit inefficient, will be able to overcome the competition from a more efficient firm located in a non-member state because it will benefit from preferential rates. Preferential rates act as a form of protection against non-members. Therefore, it is likely that an inefficient firm will lobby against the prospect of future global liberalization, because it will not want to forgo its privileged access to the regional market. Moreover, its lobbying power (as measured by the amount that a firm is willing to pay for lobbying) is likely to be higher after the formation of the RTA than before the regional agreement. This is because the expected loss from international competition is higher. WTO rules reflect the need for RTAs to be compatible with the multilateral trading system by requiring that they eliminate trade barriers on substantially all trade in goods.

To conclude, economic gains depend on the balance between trade creation and trade diversion. In this context, trade diversion can be eliminated by reducing external tariffs so as to keep trade with non-members unchanged (Kemp-Wan Theorem). Other studies show that the balance between trade diversion and trade creation is more likely to favour trade creation, when MFN tariffs before the formation of the RTAs are low (Meade, 1955), member countries of the RTA are already large trading partners (Lipsey, 1957) and transportation costs are low (Summers, 1991).

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Numerous analyses of the economic effects of specific RTAs, undertaken in recent years, show mixed results.¹ The evidence drawn from econometric analysis generally produces different results for different RTAs.² Using aggregate data, many studies find only a slight positive impact on trade creation following the formation of the EU and EFTA and in general no evidence of trade diversion. However, results are in general stronger when the analysis is conducted at the sectoral level. A non-significant effect is in general found for NAFTA, due probably to the insufficient number of observations (NAFTA only has 3 members). There is some evidence of trade diversion for the Andean Group and MERCOSUR. Contrasting results are obtained for ASEAN. Frankel (1997) and Gilbert et al. (2001) observe a positive and significant bloc effect on intra-ASEAN trade, and show that this effect remains significant even when the high level of openness of Singapore is taken into account. In contrast, Winters and Solaoga (1999) find that ASEAN countries trade among themselves less than expected by the gravity model³.

The results derived from simulations of Computable General Equilibrium (CGE) models generally show that RTAs have positive welfare effects. However, the size of the welfare impact depends on whether the model used assumes perfect or imperfect competition.

¹ See OECD (2001a).

² Most empirical models rely on the gravity model. In the basic gravity model, trade between two countries depends on their size and on transaction costs. Typically, size is proxied by their incomes and populations and land areas, while transaction costs are proxied by the distance between the two countries, cultural similarities (such as common language) and geographical contiguity (whether countries share a common border, or if one of the two is an island). In this context, the impact of the formation of an RTA is detected by introducing a regional "dummy" variable.

³ There are only a very few studies on Africa that have been based on the estimation of a gravity model. In many cases, the poor quality of intra-RTA trade data will not allow a test to be conducted on a specific RTA. Therefore, the analysis is often conducted on larger regions, such as Sub-Saharan Africa, or Central-Western Africa and Southern-Eastern Africa.

(ii) *Not all trade occurring within RTAs is preferential*

A portion of the trade flows within RTAs does not take place on a preferential basis because MFN duties on some products are already set at zero. The percentage of MFN duty-free tariff lines is as high as 49 per cent in Canada and 35 per cent in the United States (see column 4 in Table IB.13). Where duties are not zero, they may nevertheless be very low, which also reduces the significance of preference margins arising from preferential trade agreements. Low MFN rates are characteristic of many tariff lines in developed countries. For Canada, the United States and the EU, the simple average bound tariff is below 5 per cent. In addition, cumbersome and costly requirements associated with rules of origin limit the effective use of preferences when preference margins are low. Finally, some sectors do not enjoy any preferences with respect to MFN tariffs, as many RTAs exclude certain sectors or products from coverage.

Table IB.13 also provides an indication of the extent to which partners in some major RTAs enjoy preference margins in relation to MFN trade. The margin of preference depends on the difference between preferential rates and MFN rates and the degree to which preferences have been extended across the spectrum of all products. Table IB.13 shows the differences between average, preferential and MFN rates. For the United States, for example, the average preferential tariff within NAFTA is 0.3 per cent and the comparable MFN rate is 4.6. per cent. As noted above, the table also indicates the percentage of tariff lines which are duty free under the relevant RTA and the MFN regimes (column 4).⁵⁶

⁵⁶ Simple averages of tariff rates across tariff lines can be a misleading measure of the degree of integration. Indeed, since data only refer to tariff lines with *ad valorem* duty rates, those countries with a relatively high number of lines where specific duties apply (that in some cases account for as much as 20 per cent of agriculture) could appear with a lower average tariff rate (the same caveat applies to the percentage of duty free tariff lines).

Because MFN rates are already very low for the industrial countries, the margins of preference reported in column 3 of Table IB.13 are not very big. The margin is less than 5 per cent for the United States and Canada in NAFTA and about the same for the EU in EU-South Africa. However, developing country members of RTAs tend to grant larger margins of preference reflecting the fact that their MFN tariffs tend to be higher and therefore the scope to offer tariff concessions is greater. The margin is more than 10 per cent for Mexico in NAFTA and for Argentina and Uruguay in MERCOSUR. This raises the question of how large the trade creation effects are likely to be in RTAs where both developed countries, who make up the bulk of the trade, and developing countries are members.

Finally, Table IB.13 introduces a ratio called the ratio of margin of preference (RMP). The RMP is the difference between the average applied MFN tariff and the average applied preferential tariff divided by the MFN tariff. This ratio, reported in column 5 of Table IB.13, offers an important insight into the extent to which a RTA has liberalized substantially all trade among its members, a condition required by GATT Article XXIV. The RMP is comparable across RTAs regardless of differences in levels of MFN tariffs. A value of the RMP close to 100 per cent indicates almost complete preferential tariff liberalization. The RMP ratios shown in Table IB.13 indicate sharp differences in the degree to which individual RTA members have liberalized their trade with other partners. In the case of Argentina in MERCOSUR, for example, the RMP of 99 per cent indicates that almost all trade with MERCOSUR partners enjoys preferential rates of zero. In the case of South Africa in EU-South Africa, on the other hand, the RMP of 9 per cent indicates exclusions from preferential coverage.

Table IB.13
Indicators of the preferential tariff treatment within selected RTAs
(Estimates for the end of the implementation period)

(1)	(2)	(3)		(4)		(5)
RTAs	Year	Average applied tariff		Duty free tariff lines (per cent of total)		Marginal preference ratio (per cent)
		Preferential	MFN	Preferential	MFN	
NAFTA						
Canada	2000	0.5	4.4	93	49	90
Mexico	1997	4.0	15.5	49	0	75
US	2000	0.3	4.6	95	35	94
EU-SOUTH AFRICA						
EU	2000	n.a.	5.5	55	19	n.a.
South Africa	2002	9.8	10.7	47	45	9
MERCOSUR						
Argentina	2000	0.1	13.3	100	5	99
Uruguay	2001	0.1	12.3	99	5	99
ASEAN						
Malaysia	2001	3.9	9.2	60	58	57
SADC						
South Africa	2002	5.2	10.7	65	45	52

Note:

For NAFTA, figures reported are simple average applied tariff across products and NAFTA members. Weighted averages across all products are 0.7, 5.8, and 0.5 for Canada, Mexico and the US respectively; where weights are given by the percentages of duty free lines vis-à-vis each of the other NAFTA members. Calculations are based on out-of-quotas tariffs only and include the *ad valorem* component of specific duties.

Source: WTO.

(iii) *Tariff peaks prevail in a number of areas*

A recent study by the WTO Secretariat (2002a) analyzes the extent of tariff liberalization among a selected number of RTAs.⁵⁷ A major result is that “sensitive” sectors in multilateral negotiations are also sensitive sectors in regional agreements, suggesting that the degree of liberalization achieved in RTAs is less than one may be led to believe as far as certain sectors are concerned.

RTAs have frequently not addressed the problem of tariff peaks. In other words, products (or tariff lines) which have high MFN tariffs are also likely to have high (preferential) tariffs in RTAs. For analytical purposes, we shall define a tariff peak as a product (or tariff line) with a tariff of 30 per cent or more. In the case of Malaysia for example, there are a total of 240 tariff lines with MFN rates above 30 per cent. But even in extending concessions under ASEAN, about half (45.8 per cent) of these tariff lines have preferential rates that are above 30 per cent. The percentage of MFN peak tariff lines that remain above 30 per cent under other preferential regimes is equal to 98.2 per cent for South-Africa (EU-South Africa agreement) and 33.3 and 100 per cent for Argentina and Uruguay respectively (MERCOSUR). In the case of NAFTA, only 6.3 per cent (for the United States) and 8.0 per cent (for Canada) of Mexico’s tariff peaks remain above 30 per cent under NAFTA concessions.⁵⁸ However, this does not mean that the problem of tariff peaks has been solved within NAFTA. The percentages of MFN peak tariff lines that remain above 45 per cent for Mexico are 60.3 per cent for duties applying to the United States and 74.1 per cent for those applying to Canada. A similar argument applies for South Africa in SADC.⁵⁹

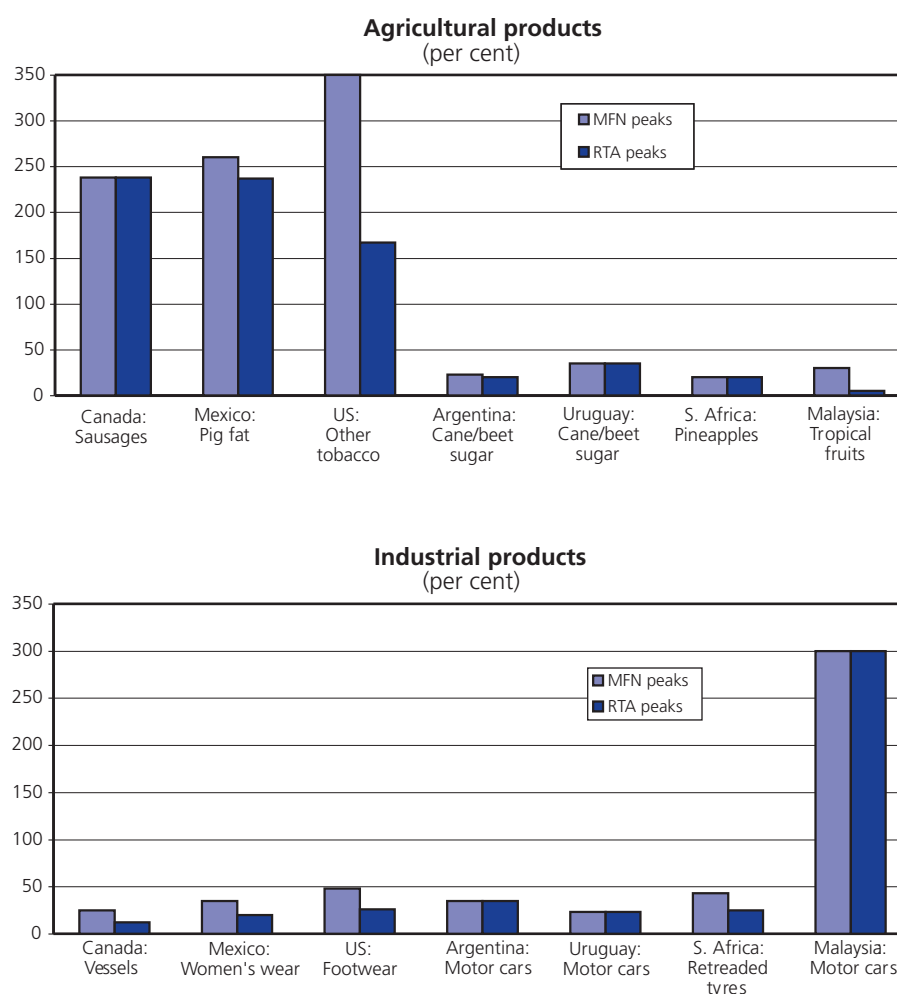
Chart IB.14 reports the highest preferential and MFN tariff peaks for industrial and agricultural products across a selection of countries who are members of regional agreements. The Chart shows that the pattern of protection under preferential regimes tends to be similar to MFN regimes. In short, protection is higher in agriculture than in manufactures in many RTAs, just as it is in the world of MFN trade. The persistence of tariff peaks in RTAs does raise the question of how significant trade creation is in some regional agreements.

⁵⁷ See WTO document WT/REG/W/46.

⁵⁸ In the case of NAFTA, Mexico gives different concessions to Canada and the US.

⁵⁹ Tariff peaks may be a function of transition periods. Many RTAs signed in the last decade contain long transition periods (often 10 years or more) so that tariffs on sensitive sectors do not immediately come down. Hence it is possible that tariff peaks will gradually disappear in some RTAs.

Chart IB.14
Peaks in WTO (MFN) and RTAs tariff schedules
(Selected countries and product groups)



(e) Regional trading arrangements and the multilateral trading system

The economic impact of regional arrangements depends on their particular architecture, including how far they go in reducing trade barriers and how many sectors they cover. It is impossible to draw ex ante conclusions from arguments based on principle. Costs are typically associated with arrangements that penalise third parties and benefits with new trading opportunities created within a regional grouping (see Box IB.2 on trade creation and trade diversion). The risks of distortions associated with RTAs are minimized when these agreements avoid raising barriers to trade with outsiders and when free trade covers all sectors within the preferential area.⁶⁰ An assessment of how regional integration affects countries will inevitably turn up favourable and less favourable elements, and the ultimate verdict will turn on the net balance of costs and benefits for countries both inside and outside preferential trade agreements. The case of Mexico reported in Box IB.3 considers some of the elements that enter into such an assessment for an individual country involved in regional integration arrangements.

⁶⁰ Regional trade agreements would be more strongly positive if they also improved trading conditions for outsiders through multilateral liberalization. In a dynamic sense, they might do that if third parties are able to benefit from heightened economic activity and trade growth resulting from preferential liberalization.

Box IB.3: Involvement in RTAs: the case of Mexico

Mexico is a relatively recent, though increasingly energetic, participant in regional trade agreements. Although long party to a number of preferential partial scope agreements signed under the auspices of the Latin American Integration Association (LAIA), it was the entry into force of the NAFTA in January 1994 which sparked Mexico's involvement in fully-fledged free trade agreements (FTAs). Mexico currently participates in 13 FTAs, ten of which contain provisions on trade in services¹, and is currently engaged in negotiations with Ecuador, Japan, Panama, Peru, Singapore and Trinidad and Tobago, MERCOSUR and the Republic of Korea. Mexico currently derives over 80 per cent of its total imports from preferential partners, giving it one of the world's highest ratios.

Positive effects of RTA involvement

Mexico's involvement in RTAs has enabled it to liberalize its import tariffs through the progressive reduction of duties over a predefined period with a selected number of trading partners. Participation in RTAs, particularly the NAFTA, has exposed Mexican producers to foreign competition and subjected them to strong pressure to increase productivity. Average productivity per worker in the manufacturing sector, which accounted for an average 21 per cent of total GDP during 1996 – 2000, increased at an average rate of 6.8 per cent in the period 1990 – 2001. At the same time, preferential access to the huge North American market has granted certain Mexican producers the demand base, capital, and technology necessary to exploit economies of scale and sustain productivity gains.

Mexico has used its participation in RTAs as a means to introduce complex policy issues of commercial significance into its economic relations (notably services, investment, intellectual property protection, co-operation on competition policy, technical standards and government procurement).

Participation in the NAFTA and other RTAs has helped Mexico attract foreign direct investment (FDI), enabling it to overhaul its manufacturing capacity away from protected, inefficient import substitution towards competitive, export-oriented industries. FDI inflows into Mexico, which averaged \$3.9 billion from 1990 to 1993, trebled in the period 1994 to 1999 and reached \$25 billion in 2001.

A recent OECD study demonstrates that in the period 1970 to 1998², Mexico moved away from specializing in primary goods towards a greater specialization in manufacturing products such as motor vehicles, consumer electronics and computer equipment. This is in marked contrast to Argentina, Brazil and Chile which continue to specialize in primary products. The authors suggest that Mexico's pattern of specialization, which follows a similar path to that of the US and the EU and which is highly dependent on access to FDI or other forms of partnership, may be the result of Mexico's participation in the NAFTA and its increased market integration within North America.

Other considerations

An increase in Mexico's MFN tariff rates in January 1999 (applied MFN rates were raised on some 80 per cent of total tariff lines), coupled with progressive tariff reductions under various preferential agreements, has resulted in a substantial and widening gap between MFN and preferential tariff rates. This has raised some concerns about potential trade diversion. For example, the average MFN tariff on agricultural goods (2001) was 25.6 per cent, while those for preferential partners ranged from 3.2 per cent (Chile) to 23.8 per cent (Israel). For non-agricultural goods (excluding petroleum) the average MFN tariff was 15.6 per cent, while for preferential partners it ranged from zero per cent (Chile) to 5.8 per cent (Israel).

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Mexico has, thus far, failed to take full advantage of liberalization with selected RTA partners as a means of reducing tariff rates on certain highly protected agricultural goods such as poultry, potatoes and pig fat where prevailing rates exceed 200 per cent. Although Mexico has reduced such tariff peaks with certain RTA partners (United States, Chile, Nicaragua and, to a more limited extent, Canada and Bolivia), this is not the case (as of 2001) for its remaining RTA partners.³

Mexico, which already has a \$2 billion trade deficit in agricultural products with the United States, faces increased competition from the more heavily subsidized US agribusiness sector and Mexican farmers face further painful adjustment and restructuring in order to survive increasing floods of imports. Notwithstanding the productivity gains realized in the manufacturing sector, workers have not reaped the benefits, as salaries in 2001 remained lower than the level in 1994 in real terms.

Although Mexico has benefited considerably from its geographic proximity to the huge North American market, it faces increasing competition from lower-cost exporters such as China where wage costs are a third of Mexico's, especially in goods such as apparel, electronics and telecommunications where transport costs are low. Thus, while membership in RTAs, particularly the NAFTA, allowed Mexico a jump start on other suppliers to the US market, it provides no insurance policy against more efficient large-scale producers such as China.

Preferential rules of origin employed by Mexico in its RTAs are diverse and complex, and methods of conferring origin in individual RTAs differ. Some RTA partners (Bolivia, Chile, NAFTA) are entitled to self-certification of proof of origin, while for others (the European Union, Colombia, Uruguay) the proof of origin must be certified by the competent authority in the exporting country. The administrative burden associated with a complex web of differing rules of origin may partly offset trade liberalization goals.

In 1993, Mexico's total exports were \$52 billion, increasing to \$166 billion in 2000. Total imports in 1993 were \$65 billion and increased to \$191 billion in 2000. Mexico's increasingly concentrated economic integration with the United States, which accounted for 73.1 and 88.6 per cent of Mexico's merchandise imports and exports respectively in 2000 (up from corresponding figures of 69.3 and 82.7 per cent in 1993, the year preceding the NAFTA's entry into force), dwarfs all other trading partners and makes the Mexican economy particularly vulnerable to fluctuations in the North American business cycle.⁴ This argues for engagement in concurrent multilateral liberalization in order to dampen the effects of shocks from downturns in preferential markets.

¹ Mexico's RTA partners are Canada and United States (NAFTA), Nicaragua, El Salvador, Honduras, Guatemala, Costa Rica, Columbia, Venezuela, Chile, Bolivia, EU, Israel, and EFTA. With the exception of the RTAs with Costa Rica, Bolivia and Israel, all contain provisions on trade in services.

² Oliveira Martins and Price (2001).

³ It should be noted that the phase-out periods for sensitive products range from six years (in the case of Israel) to 14 years (United States, Bolivia, Costa Rica, Nicaragua).

⁴ For example, merchandise exports to Argentina and Brazil accounted for only 0.6 per cent of total exports in 2001, while other countries in the western hemisphere accounted for less than 5 per cent of the total.

Similarly, the positive and less positive effects of regionalism must be assessed in terms of non-discriminatory alternatives offered by a multilateral approach to trade policy. Given the wide variety of motives that entice governments to pursue RTAs, including non-economic ones, there will always be a drive towards regional arrangements no matter how well the multilateral trading system functions. Regionalism can serve as a catalyst for further liberalization at the multilateral level. A process of "competitive liberalization" could contribute to the removal of trade barriers and to innovative policies in such areas as investment rules and market regulations. Perhaps the most forceful example of this argument is the creation of the European Community, which in turn propelled the United States to initiate successive GATT negotiations under the Dillon, Kennedy and Tokyo Rounds (Whalley, 1998).

The increasing number of regional agreements may also represent a threat to multilateral liberalization. Preferential agreements can distort trade flows and for this reason may be regarded as an inferior option compared to coordinated multilateral liberalization. To sustain that argument it must be assumed that multilateral arrangements are capable of delivering the quality and depth of welfare-enhancing integration sought through regional arrangements. The question, then, is one of balance. Regional arrangements can be destructive of more desirable multilateral outcomes but they can also supplement and build upon multilateralism in positive ways. How can the community of nations reap the benefits of constructive coexistence and avoid the costs of distraction and destructive conflicts of interest?

Four key arguments are put forward as to why regional arrangements might frustrate the attainment of multilateral goals. First, a multiplicity of regional agreements safeguarding varying levels of protection against external third parties will almost certainly engender a degree of trade diversion, and the application of numerous rules of origin and differing standards will make international trade more complex and costly. In contrast, non-preferential trade liberalization will allow the underlying pattern of comparative advantage in the world to emerge, leading eventually to patterns of specialization among countries and regions that make the most efficient use of available resources.

Second, the growing number of overlapping bilateral and plurilateral agreements risks undermining the transparency of trading rules, thus posing a threat to one of the fundamental principles of the WTO. The parallel existence in a single country of differing trade rules applying to different trading partners can represent a barrier to trade not only because of the costs involved in meeting a wide range of conditions of trade rules, but also because it is likely to introduce uncertainty and opacity into the trading system as a whole. In other words, ubiquitous and highly varied regional arrangements may not only reduce profitable trading opportunities, but also undermine the integrity and clarity of the multilateral trading system.

Third, regionalism may adversely affect the internal dynamics of trade liberalization in a political economy sense, especially where RTAs exclude "difficult sectors" from coverage. If groups favouring liberalization can be at least partially satisfied through regional arrangements that exclude more protectionist sectors, then the balance of forces for and against liberalization in a multilateral setting is tilted in favour of those seeking to arrest liberalization. Many, if not most, regional agreements have excluded agriculture. It appears that if agricultural trade liberalization is to be addressed more effectively than it has been so far, this will have to occur in a multilateral setting where the appropriate trade-offs might be found. If this is the case, and manufacturing and service industries with export interests are at least in part satisfied through regional arrangements, who will be left in domestic markets for political influence to advocate on the side of more openness? More generally, regional trading arrangements may create vested interests determined to avoid any dilution of preferential margins implied by multilateral trade liberalization (see discussion of this point in Box IB.2).

Finally, increasing regionalism will tend to distract attention and energy from multilateral negotiations. This is a particular worry at this point in time, given the need to shepherd the current WTO negotiations to a successful outcome.

The two basic WTO rules on regional trade agreements (Article XXIV of GATT and Article V of GATS) recognize that RTAs can make a contribution to the multilateral trading system, even though they entail a departure from the MFN principle. The rules seek to minimize the downside of discrimination by requiring that trade restrictions within the preferential area be removed in substantially all sectors, without barriers being raised on trade with non-members.

The recent proliferation of RTAs, combined with the very limited historical success of Member governments to agree on concrete standards for judging the GATT/WTO conformity of regional arrangements, have resulted in widespread agreement on the need to revisit the rules. Ministers agreed at the Fourth Ministerial Conference in Doha to launch negotiations aimed at clarifying and improving the disciplines and procedures under existing WTO provisions applying to regional trade arrangements. Discussions in the Regional Trade Agreements

Committee so far have focused on transparency issues, such as the definition of rules for notification to the WTO (i.e. when and what needs to be notified). The negotiating group has yet to consider some challenging issues, such as the definition of the requirement that a FTA liberalize “substantially all trade”.⁶¹

(f) Conclusions

Governments opt for regional trade agreements for a variety of reasons. Possibilities for co-operation at the multilateral level may be absent or attenuated. Governments may wish to go further, faster and at lower cost than is feasible in a multilateral setting. Some may see regional agreements as a defensive necessity, to avoid exclusion, or as a means of increasing bargaining power in a broader setting. Politically, preferential trade arrangements can help to consolidate regional security and tie in commitments that are more fragile if they need only be answered to in a national context.

But protectionist motives can also drive pressure for regional arrangements. Where exclusion is the incentive, the results are unlikely to sit well with a multilateral focus, nor promise as much by way of economic gain. Incomplete and distorting arrangements will tend to prevail.

Regardless of whether regional arrangements seek to pursue goals compatible with multilateralism or to short-circuit the discipline of non-discrimination, RTAs can pose threats to a coherent and active multilateral trading system. A proliferation of ill-considered and partial RTAs could turn fears of shortcomings in the multilateral framework into a self-fulfilling reality. The existence of numerous overlapping arrangements can distort trade, raise transactions costs, and undermine the systemic integrity of multilateralism. Regional trading agreements can strengthen vested interests hostile to non-discriminatory outcomes. They can weaken resolve to make multilateralism work by draining away scarce negotiating resources and reducing the effectiveness of pro-liberalization forces in the domestic economy.

The GATT/WTO rules have sought to discourage these features of preferential trading arrangements, but have not achieved what governments would have wished. Clearer rules are important, but insufficient. Political commitment and a clear understanding of the consequences of preferential trading arrangements are vital if the multilateral agenda is to be carried forward.

Two ground rules of policy behaviour could help to consolidate and build upon the benefits of regionalism and promote a more effective multilateral trading system. The first rule would be to refrain from engaging in regional commitments which governments would be unwilling, sooner or later, to extend to a multilateral setting.⁶² The second would be to consolidate the first rule by agreeing to a consultative system that would map and monitor the timing and conditions attached to the non-discriminatory, multilateral application of commitments made in regional arrangements. Such arrangements might provide a more effective link between regionalism and multilateralism than exists today.

⁶¹ Article XXIV paragraph 8.b.

⁶² This assumes that the multilateral framework covers the relevant areas of the rules. Rules on labour rights in a regional agreement, for example, could not be incorporated within the framework of WTO obligations. Regional tariff reductions, on the other hand, could be replicated in the WTO.

