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Multilateralism and Regionalism:
the building block or stepping stone debate
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Summary:
The establishment of World Trade Organization (WTO) represented a significant milestone, creating the framework for continuous liberalization of flows of goods, services and capital. In the recent decade we could notice another phenomenon taking place in the world economy, regionalism. It reacts on certain insufficiencies of multilateral trade liberalization. The examination of the mutual relationship between multilateralism and regionalism has been until now mainly focused on resolution of the problem, whether regionalism creates a "stepping stone" or a "building block" of multilateralism. This contribution tries to describe the mutual relationship between multilateralism and regionalism using the tools of statistical approaches.

Keywords: Multilateralism, Regionalism, Trade, Liberalization.

Multilateralismus a regionalismus:
diskuse o „stavebních kamenech" či „kamenech úrazu"
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Abstrakt:
Ustavení Světové obchodní organizace (WTO) představovalo důležitý mezník, vytvářející závazný rámec pro postupnou liberalizaci toků zboží, služeb a kapitálu. V posledním desetiletí můžeme ve světové ekonomice zaznamenat další fenomém, regionalismus. Ten reaguje na některé nedostatky mnohostranné obchodní liberalizace. Sledování vzájemného vztahu mezi multilateralismem a regionalismem se až doposud soustřeďovalo na řešení problému, zda regionalismus představuje "kameny úrazu" nebo naopak je "stavebními bloky" multilateralismu. Tento příspěvek se pokouší popsat vzájemný vztah mezi multilateralismem a regionalismem s využitím statistických nástrojů a metod.

Klíčová slova: multilateralismus, regionalismus, obchod, liberalizace.

JEL: F01, F04, C19, C59

Content

Introduction

Since the establishment of the General Agreements on Tariffs and Trade and its trade regime in 1947, the trade restrictions were dramatically reduced. During the past decades, there could be recognized another trend as well. Due to the slower process of multilateral trade liberalization, several regional integration institutions were created. The Regional Trade Agreements (RTAs) represent a dynamic development in the world economy. It constitutes an alternative approach towards the multilateral governance of the international trade under the World Trade Organization (WTO). However the WTO plays a crucial role in the recent economy, especially due to its dispute settlement mechanism and its ability to verify the violation of any agreement to third parties, the RTAs will certainly act as an important source of potential conflicts or synergies.

This paper tries to outline the issue of the mutual relationship between multilateralism and regionalism, while suitably using the methods of applied statistics. We stem from empirical studies that try to analyze the mutual relationship between multilateralism and regionalism on the basis of applied statistics methods, especially describing statistics and we introduce conclusions, achieved by using the mathematical models and regression analyses, which describe the development of external, non-preferential tariffs in dependence on the change of preferential tariffs. Our paper tries to outline the nature of both alternative trade regimes that are analyzed through the tools offered by the applied statistics. Analyzing the duties and other restrictions to trade, authors use the empirical data methods as well as regression and verbal analyses of data set. The authors do not have the ambitions to offer a complex statistical analysis of regionalism and multilateralism or to use all the available tools that can be found in the field of applied statistics.

1. Mutual Relationship between Multilateralism and Regionalism

In the globalized environment, which is characterized by growing global competition and therefore by the pressure on flexibility of national economies as they want to keep or enhance their position in the world markets, the most efficient tool is *liberalization*. Liberalization of economic relations, i.e. removing of barriers for free movement of goods, services, capital, intellectual property rights and labor forces, is under way at three basic levels: global, regional and national one. At the global level, it takes the form of multilateral liberalization, at regional level – regional integrations and at the national level – transformation and reform measures, enhancing the adaptability of economies and all of their partial segments. In this paper, the third aspect stands without the authors´ attention.

Multilateral liberalization, or else multilateralism (at this form being used in the narrower sense) represents the institutional form of reducing barriers of the economic activity at the national borders and consequently leads towards the development of world flows of goods, services and factors of production. It does so within the framework of *World Trade Organization – WTO* and its contractual parts (General Agreement on Tarrifs and Trade, General Agreement on Trade in Services, Trade Related Intellectual Property Rights Agreement). The fundamental institutional coverage of the world trade is secured, along with the principles of liberalization and consolidation[1] by the principle of non-discrimination. It means that all countries should be given the same, i.e. national treatment on the basis of *Most Favored National Treatment – MFN*. Any removal (reduction) of trade barriers between some of the member countries is applicable to all the others, by which mean this treatment becomes automatically multilateral, therefore non-preferential. This is the reason, why multilateralism represents the widest and potentially the most effective mean of reduction of barriers to the international trade. Huge number of negotiation participants (as far as 151 countries of 1st of February 2008) is also a weak point of multilateral trade negotiations, as the big heterogeneity of member states contributes to the slower pace of multilateral liberalization.

The solution that can overcome this contradiction could be represented by *regionalism*[2], which tries to integrate economies at the similar level of economic development or the economies, which have the common interest on mutual economic relations. It is defined as the trade or economic policy of a state that leads towards the liberalization of relations between two or more countries and contributes therefore to their closer linkages and mutual integration. Those forms of cooperation and integration tend to creation of *regional integration groups,* which can have the features of integration without any treaty or can be created, at the majority of cases as the result of so called Preferential Trade Agreement – PTA, PTAs. These agreements are concluded on the basis of exceptions from the rules of multilateral liberalization (Art. XXIV GATT, Art. V GATS, enabling clause). As the general name for PTAs the term – Regional Trade Agreements – RTA, RTAs is being used. Resulting from the names of treaties, regionalism deals generally with the conditions of *preferential* trade liberalization. In respect to the multilateral liberalization, it is the breach of the non-discrimination principle, meaning that as a result of removal of trade and economic barriers, it brings the advantages only to member states and

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[1] According to the principle of *liberalization*, participants of multilateral liberalization should not raise the existing barriers to movement of economic activity cross the national borders or create the new ones, i.e. they ought to contribute to reducing of existing barriers. According to the principle of *consolidation*, the multilateral trade negotiations have to lead to the reduction of the burden to the international trade; agreed obligations are enforceable within the institutions of multilateral liberalization (WTO 2003: 10-13).

[2] *Regionalism* has been used as the term describing regional integration, which had become at a certain moment a phenomenon influencing whole world economy and its development since 1960es.

discriminates the countries that stay outside of the integrating organization. More in (Cihelková a kol. 2007).

Due to the complex changes and processes that started at the end of 1980es, RTAs in the recent years, especially after the establishment of World Trade Organization have undergone a significant growth in the number, scope and deepness (WTO 2006: 7). They markedly shape and even change up to now valid rules of the world trade. Regionalism has become an adequate alternative to the multilateral trade negotiations and a firm part of international trade environment. More, many countries that had preferred the multilateral approaches for a long time have become signatories of several RTAs.[3] Also the United States pay to the regional trade agreements an enhanced attention. Another important fact is that the increased number and geographical range of RTAs often include countries that belong to different continents or cultures.

The investigation of mutual relationship between multilateralism and still growing number of RTAs is presently an important part of research related to the world trade order (Panagaria 2000: 477-512). It is focused on two key issues. First, the effects of non-preferential multilateral treaties on trade liberalization compared to the advantages of RTAs and other preferential treaties. Second, the political consequences of growing number of RTAs and related swing of many crucial countries to regionalism, which can lead on one hand to the weakening of the substance of multilateralism, but on the other hand it can represent certain pre-steps of multilateral trade liberalization. Especially this problem, which is often interpreted as the question *whether regionalism that is strongly incorporated in national state strategies support or curb the process of multilateral integration*, seems to be recently the key issue related to the interaction between multilateralism and regionalism.

Without analyzing in detail the opinions of supporters [i.e. R. E. Baldwin (1995); Cadot (2001)] and opponents [P. Krugman (1993), A. Krueger (2000), Levy (1997), McLaren (2002)] of regionalism that J. Bhagwati called as *Building Blocks versus Stumbling Stones Debate,* we would like to mention that the regional agreements on trade liberalization bear significant implications for further development of multilateralism.

On one hand, regionalism can support multilateral trade negotiations. Establishment of strongly integrated regions with an advanced degree of mutual liberalization of relations can make the negotiations simpler in the sense that it would reduce the number of competing subjects and therefore ease the agreement on the further liberalization procedure. The experience with up to now development of regionalism show that within many RTAs among certain

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[3]   It is important to mention Japan, Singapore, Australia or New Zealand.

groups of countries there were negotiated rules and obligations that could not be possible to achieve at the recent state of multilateral negotiations. Regional agreements allow for faster and also easier movement of relevant countries toward free trade that includes wider range of goods and services than could be achieved at the multilateral level. Individual RTAs can serve as certain "testing mechanism" for potential world-wide liberalization in the new areas as services, intellectual property rights, environment, investments and competition. The concrete cases of rules that were originally negotiated at regional level and later became a part of multilateral system of liberalization already exist.

However it is important to admit that due to the strengthening of regionalism, the common rules of world trade are loosened and sometimes unclear regional blocks with different rules and obligations are created. With growing involvement of many countries at RTAs, their motivation and willingness to the promotion of liberalization within World Trade Organization decrease. So regional agreements substitute, in a way, WTO as a forum for negotiations about further world-wide trade liberalization and therefore they can threaten further development of multilateral trading system. Besides the danger of discrimination (and even protectionism), regionalism bears also the systematic risk, which in embodied in a danger of fragmentation of world economy into competing trade blocks, which could be involved in the mutual trade wars and could destroy the process of multilateral liberalization. A part of this problem is represented by a complicated situation of developing countries within the framework of their integration with developed economies. For small countries this development brings enhanced requirements on their negotiating and administrative resources. Discriminating character of international integration organizations, which lead to the diversion of trade, results in a decrease in the total wealth in the global economy[4].

2. Attempts to quantification of Dependencies between Multilateralism and Regionalism

Mutual relations between multilateralism and regionalism were analyzed at a number of publications. Only few of them get over the framework of regular verbal analysis that would confirm the arguments pro or contra the "building blocks" or "stepping stones" theories. So in spite of the significant importance of these contributions analyzing the relations between two major tendencies of world economy *only couple of them uses empirical analyses* that would confirm their statements.

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[4]   It is so in despite of the fact that application of the progressive elements of current regionalism decreases relatively the discriminating nature of regional integrations, which is caused by the parallel development with multilateral liberalization that leads to the global removal of trade barriers and to the smaller diversion of trade.

One of the few exceptions in this sense is the statistical analysis of *incidence of regionalism on the approach of countries towards multilateralism at the certain concrete moment*. It is focused on inquires, how the liberalization in the framework of preferential treaties motivates some countries to changes in their tariffs within the MFN clause. This analysis of data sets is quite complicated due to the lack of available and accurate data.

A significant contribution in this field is represented by the work of *Nuna Limaa* (2005), which confirmed that the preferential tariffs within United States PTAs have created obstacles on the track to deeper liberalization within the Uruguay Round of GATT. Limao found out that liberalization of originally preferential tariffs was during multilateral liberalization that followed relatively small. He uses the arguments that the United States concluded preferential agreements expecting that the partner country would grant them with preferences in other areas than just trade. More specifically, it can be represented by cooperation in the attempt to fight drug trafficking or by any political support. The United States did not use the preferential tariffs with similar motives as other countries and their determination to multilateral liberalization stems from different impulses than in the case of developing countries.

Among contributions about approaches of developing countries to multilateralism, paper by *Faezeh Foroutan* (1998) shines. It focuses on the formation of regional trade blocks among almost fifty developing countries and its consequences for their external tariffs. The author came to the conclusion that countries actively included into regional treaties decreased their external tariffs faster than countries without any engagement in RTAs. On the other hand, Foroutan in her empirical study did not separate the effects of regionalism from other trends within world economy, by which she devaluated her results a little bit.

The most sophisticated analysis of implications of regionalism on further multilateral trade liberalization could be probably found in the work of *Antonio Estevadeordala, Caroline Freund a Emanuela Ornelasa* (2005: 10-33). Their paper tries to describe, using regression and empirical analyses, how tariffs of ten Latin American countries within the Most Favored Nations clause are influenced by the development of their preferential tariffs within the RTAs. Authors first formulate the regression model as the methodological base for further analyses and which they consider to be a suitable description of the development of tariffs depending on certain variables. Afterwards, the model is used for empirical analyses of acquired data, which tries to take portrait of dependency between non-preferential and preferential tariffs. The analyses uses data between 1989 and 2001 stemming from indications about each sector of economies, which are later aggregated.

In a certain sense Estevadeordela, Freund and Ornelasa develop a standard approach of theoretical models to regional economic integration, which is based on the assumption that member states within their preferential trade treaties immediately and completely eliminate their trade barriers. This is absolutely in accordance with article XXIV GATT[5], but it does not reflect the real situation. In the case of developing countries we face the fact that many PTAs were created on the basis of enabling clause, which does not include any requirement on immediate removal of tariffs and which makes our analysis even more complicated. The models deal with another problem related to the fact that liberalization within preferential agreements varies a lot at different sectors and in different countries. Another trouble that complicates the result of any study is caused by the membership of many countries in various PTAs, with different pace of liberalization. The adequate approach requires the aggregation of preferences for each single country.

Let us illustrate in following two parts of our paper the procedure that was used by the authors mentioned above, including the results they came to.

3. Linear Regression Model

Regression analyses of a dependency of development of non-preferential tariffs within the MFNs clause on a development of preferential tariffs within preferential trade agreements is based on the formula

$$\textbf{PREF}_{ijt} = \sum_{k} [\textbf{MFN}_{ijt} - \textbf{r}^{k}_{ijt}] * [\textbf{M}^{k}_{ijt} / \textbf{M}_{ijt}] \qquad (1)$$

where

    $PREF_{ijt}$ is aggregated margin of preferences of country j in industry i in the year t towards k partners

    MFN_{ijt} - external tariff (within the MFNs clause) of country j, in industry i, in the year t

    r^{k}_{ijt} - preferential tariff of country j, towards country k, in industry i, in the year t

    M^{k}_{ijt} / M_{ijt} - proportion of country k on total import of country j in industry i, in the year t

Formula (1) defines a variable $PREF_{ijt}$, i.e. margin of preferences. It is defined as the product of the difference between the external MFN tariff and preferential tariff of country j, for a specific industry, concrete year and towards concrete country, and a share that this concrete country has on the total import of given

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[5]   Article XXIV GATT requires that member states of PTAs remove tariffs and other barriers to trade on basically every item of their mutual trade. However, the complete removal of mutual tariffs within any PTAs is generally very unusual.

country during certain year. If we aggregate the margins of preferences for every investigated country, we obtain weighted arithmetical average of the difference between non-preferential and preferential tariffs, where as the weight the share of a concrete partner on the total import is used.

Tariffs within the Most Favored Nations clause are modeled as

$$\mathbf{MFN_{ijt} = a_{ij} + a_{jt} + a_{it} + b * (PREF_{ijt\text{-}1})} \tag{2}$$

where

MFN_{ijt}	is external tariff (within the MFNs clause) of country j, in industry i, in the year t
a_{ij}	- constant expressing an effect of industry i and country j
a_{jt}	- constant expressing effect of country j in the year t, it reflects the countries approach to the liberalization
a_{it}	- constant expressing effect of industry i, in the year t
b	- a factor that express the influence of preferential tariffs on external tariffs
$PREF_{ijt\text{-}1}$	- aggregated margin of preferences of country j, in industry i, in the previous year

Formula (2) describes the dependency of external tariffs on five variables. Three of them, $a..$, are given. It is not clearly said, how – their concrete values can be instituted to the formula according to a personal discretion. It is only stated that they are constants reflecting certain effects. $PREF_{ijt-1}$ is the margin of preferences from equation (1) belated of one year, so it is therefore the difference between non-preferential and preferential tariffs in the last year. It is multiplied by factor b, which describes, whether external tariffs develop directly or inversely as the margin of preferences in the last year. We do not know anything about its value yet, but on its value the results of the model depends.

Taking first differences, we get

$$\mathbf{\Delta MFN_{ijt} = (a_{jt} - a_{jt\text{-}1}) + (a_{it} - a_{it\text{-}1}) + b * (\Delta PREF_{ijt-1}) + u_{ijt}} \tag{3}$$

In formula (3) we expressed the first differences as the augmentation of external tariff depending on the augmentation of other variables. Since at a_{ij}, there is no index t, it is clear that the difference between years must be zero and therefore the variable dropped out of the formula. Magnitude u_{ijt} is a random error with zero medium value that is used just because of mathematical accuracy; it does not influence the result of the model.

We assume that the approach of a given country towards the trade liberalization (a_{jt}) does not change with time. We assume as well that liberalization within each

industry (a_{it}) proceeds at constant pace, but with certain shocks that reflect sudden conclusions of multilateral trade agreements, which liberalize the trade within this industry.

We can therefore write

$$(a_{jt} - a_{jt-1}) = y_j$$
$$(a_{it} - a_{it-1}) = y_i + y_t$$

It simplifies the equation (3) to the form of

$$\Delta \mathbf{MFN_{ijt}} = \mathbf{y_i} + \mathbf{y_j} + \mathbf{y_t} + \mathbf{b} * (\Delta \mathbf{PREF_{ijt-1}}) + \mathbf{u_{ijt}} \qquad (4)$$

where

y_i	is constant effect of each industry
y_j	- constant effect of each country
y_t	- constant effect of each year
b	- factor expressing the influence of margin of preferences on external tariff

If the factor b is positive, then we can assume that preferential tariffs lead countries towards further increase in external tariffs and therefore that PTAs and more generally regional economic integration creates a stepping stone for multilateral trade system. If factor b is negative, the theory of RTAs as the building blocks of multilateral liberalization is strengthened. It would mean that countries lower their external tariffs according to their engagement into preferential treaties. In regard to a complete understanding of following empirical analyses, it is important to mention that sectors and industries with high original tariffs usually report the most significant decrease of tariffs in absolute terms. Due to this reason the initial level of tariffs is also controlled (MFNinit).

4. Empirical Analyses by means of Multiple Regression

In empirical study, the data about external tariffs according to the Most Favored Nations clause and mutual preferential tariffs of *ten countries in Latin America*. Countries Argentina, Brazil, Ecuador, Chile, Colombia, Mexico, Peru, Paraguay, Uruguay and Venezuela were analyzed. Data about external and preferential tariffs were acquired during 1989 and 2001 from *national statistical resources of analyzed countries* and then supplemented with data related to the MFNs tariffs within each sector of ten economies from *World Integrated Trade System*. In the studied sample, there are positive as well as negative changes of MFNs tariffs present, roughly at the same frequency, which would indicate relatively common

increase of external tariffs. To be more concrete, one third of external tariffs decreased, one third increased and one third remained at the same level. In regard to this, we abstract from the binding rules of World Trade Organization as they are stated for instance in Article XXIV GATT and we assume that the increase in tariffs towards third countries is possible. On the other hand, their decrease is at average higher than their increase, so by the end it generally comes to the liberalization of trade.

The conclusions of the study, using average annual data are presented in Table 1, which secures the data stationarity.

Table 1: Changes in tariffs (MFN and preferential) on annual basis

Variable	Mean	SD	Median	Min	Max	NOB
MFN	15.02	8.47	14.02	0	117.33	11 345
MFNinit	25.61	14.14	22.78	0	85	11 722
dMFN	-1.22	4.53	0	-63.00	39.44	10 147
dlnMFN	-5.93	26.05	0	-296.62	353.29	9 975
Pref	2.36	3.66	0.66	0	54.52	9 358
Dpref	0.34	1.49	0.026	-11.969	18.49	6 980
dlnpref	0.84	3.58	0.086	-18.55	18.97	6 980

Source: Estevadeordala, A., Freund, C., Ornelasa, E. (2005: 22)

Single variables in Table 1 represent:

Mean	is an average value of controlled variable
SD	- standard deviation
Min	- smallest value in observed sample
Max	- highest value in observed sample
NOB	- number of observation in the sample
MFN	- tariff value according to the Most Favored Nation clause
MFNinit	- initial level of tariff value according to the Most Favored Nation clause
dMFN	- change in tariff according to MFNs clause in percent points
dlnMFN	- change in tariff according to MFNs clause in v percentages
pref	- value of margin of preferences within MFNs clause
dpref	- change in margin of preferences in percent points (first differences)
dlnpref	- change in margin of pref. in percentages (first differences of logarithms)

As we can see, Table 1 shows that the average annual liberalization within non-preferential relations decreased about more than one percentage point, so

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almost up to 6%. From the average value of almost 26%, the tariffs decreased at the average level of 15%. We can therefore come to a conclusion that *preferential trade agreements stand as building blocks for further multilateral liberalization in the region of Latin America.*

Whether we can this conclusion completely accept will be decided according to the results in Table 2, where the results of the estimated changes in external tariffs as the function of changes in preferential tariffs are presented. The dependent variable is the annual change in tariffs according to the MFNs clause. The independent variable is the change in percentage points in preferential tariffs.[6]

Table 2: Annual Changes in External Tariffs depending on changes in preferential tariffs

Variable	dMFN	dlnMFN
dPREF_1	-0.184	-0.864
NOB	7 097	6 998

Source: Estevadeordala, A., Freund, C., Ornelasa, E. (2005: 23)

Where single variable in Table 2 represent:

dPREF_1   is an independent variable, change in the margin of preferences compared to the previous year

dMFN   - coefficient of change in external tariffs in percentage points depending on dPREF_1

dlnMFN   - coefficient of changes in external tariffs in percentages depending on dPREF_1

NOB   - number of observation in the sample

Table 2 shows the results of statistically estimated formula

$$\Delta MFN_{ijt} = y_i + y_j + y_t + b * (\Delta PREF_{ijt-1}) + u_{ijt},$$

as it was described above. The effects of each country, industry and year are fixed. The values are obtained through the regression analyses, significant at the 5 percent level. In both cases the value of coefficient b is negative, so with the increase of margin of preferences, meaning faster reduction of preferential tariffs in a given year, the external tariffs decrease as well. It *confirms the relevance of the building blocks theory, which means that the regional trade agreements serve as building blocks for multilateral liberalization in the region of Latin America.* The growth of

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[6]   This approach quite weakens the impact of tariff changes, if the initial duty was too law. There would be more suitable if the changes in percentage were used, therefore dlnMFN. Also the cases, where the tariff is at zero level could influence the result of the analyses. If there is a zero tariff, its potentional change could be increase as well. The zero values are left out from the study, which does not influence the conclusions anyway.

preferences leads to the decrease in tariffs according to the Most Favored Nation clause in the following year.

Conclusion

Submitted paper is an outline of verbal, regression and empirical analyses of the development of regionalism in recent years.

One of the main reasons for any creation of RTAs is the attempt to enlarge the access to the new markets, which can be achieved more easily within the preferential agreements than in the framework of multilateral negotiations. With regard to the weaker willingness of many member states of WTO step further in the trade liberalization at multilateral level, the process of establishing regional trade agreement accelerates. Though verbal analyses of reasons as well as impacts of regional integration on multilateral system is still useful, in the current development stage of so called new regionalism seems to be inadequate. Empirical examination of relationship between multilateralism and regionalism is still rare. The exceptions are focused on the investigation of the issue, whether liberalization within PTAs motivates countries to changes of their external tariffs within the Most Favored Nation clause. Our investigation of that relationship with the use of statistical methods is in the very beginning, but we are already certain of its significant importance.

As a basis for our continuous work on empirical analysis of two major trends in the development of word economy we choose and described regression model by A. Estevadeordala, C. Freund and E. Ornelasa. According to the model, the fears that dynamic growth of regionalism in Latin America has negative impact on multilateral system **were not confirmed** and it showed that regionalism contributed to the multilateral reduction of tariffs. We can state that regionalism in Latin America creates building blocks of multilateralism.

On the other hand, it is not clear if it was just a specific case of developing countries or a general rule. We can assume that the analyses of developed regions of world economy would show that regionalism could be a limiting factor of further multilateral trade liberalization. This contribution could be understood as the first step to our own research of this topic. The ideal candidate for further empirical studies of regionalism and multilateralism seems to be Asia as the region with dynamic development and engagement into world economy.

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