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## **THE ESSENCE AND TYPES OF FREE TRADE AREAS IN THE SYSTEM OF MODERN INTERNATIONAL RELATIONS**

The study investigates the formation of free trade areas in the international economic relations. Traditional free trade areas focus on foreign trade aspects of commodity movements and are guided by fundamental WTO rules, such as rules of origin and most favored nation treatment. While the new generation of trade agreements from leading countries expands the scope of the WTO regulatory aspects, they include investment protection, competition policy, labor standards, and environmental protection. Accordingly, such agreements are divided into two categories: "WTO plus" (WTO +) and "WTO extra" (WTO-X), that is, those falling within the current mandate of the WTO, and which include provisions on issues outside the WTO. In addition, responding to the demands of the modern business environment, the agreements not only extend the scope of regulation, but also increase the degree of detail of scenarios for the development of trade relations. Accordingly, the researchers developed the indexes of flexibility and depth of transactions coverage.

**Keywords:** Free Trade Area, Integration, International Agreement, Most Favored Nation, World Trade Organization.

**Problem statement.** Modern trade is developing in the conditions of globalization and regionalization of world economic relations. A characteristic feature of trade relations development in the 21st century is the growing role and importance of international trade agreements.

States consider trade agreements as an integral part of the overall strategy for the development of regions and individual countries on the basis of liberalization and deepening of interconnections. But in modern conditions countries face the challenge not only to create effective trade agreements, but also to find new in-depth forms, taking into account the requirements of the modern business environment both on the international and national levels.

**Analysis of recent research and publications.** The theoretical basis for the study of the essence of free trade areas is found in the writings of foreign authors such as S.Baier and J.Bergstrand in the paper «Economic determinants of free trade areas», G.Grossman and E.Helpman in the publication «Free Trade Agreement Policy», as well as R.E. Baldwin with J.Ravenhill. Among the Ukrainian authors who devoted scientific works on the subjects of free trade areas, their essence, effects and economic content, the following are: O.I. Shnirkov (scientific articles and a section in the monograph «Economic Association of Ukraine with the European Union»), V.I. Muraviev (Articles and monographs on the legal aspects of the functioning of free trade zones, in particular in the EU), A.S. Filippenko in the articles «The theory of international economic integration» and «Preconditions and factors for the formation of a free trade zone between Ukraine and the EU».

**The aim of the article** is to identify current forms of free trade areas, regulatory aspects of their functioning, formulated in the GATT / WTO, finding out world trends in the formation of free trade areas.

**Key study findings.** After notifying the agreement between Mongolia and Japan in June 2016, there is currently no WTO member country that would not participate in international trade agreements. Their number increases annually, and in 2017 there are 440 valid trade agreements notified in the WTO, 52% of which are free trade zones<sup>1</sup>.

In the 21st century, the goal of establishing free trade areas (FTA) is to provide trade incentives by reducing customs tariffs, increasing stable trade flows and thereby achieving a higher level of economic interconnection.

<sup>1</sup> Figures on Regional Trade Agreements notified to the GATT/WTO and in force. *World Trade Organization*. <<http://rtais.wto.org/UI/publicsummarytable.aspx>> (2017, July, 20).

In modern world economy there were two key changes in international trade processes. WTO plays a central role in the liberalization of border trade barriers. In the postwar years, the central factor in trade liberalization was the mutual reduction of tariffs between industrialized countries under the GATT on the basis of the principle of the most favored nation. At the beginning of the 21st century, trade liberalization was largely unilateral (for developing countries), while developed countries focus on regulating domestic laws that impede the integration of markets for goods, services and investments. In this way, the role of multilateral negotiations in reducing trade barriers diminishes and the role of bilateral intergovernmental economic relations, new multilateral free trade agreements (FTAs) is increasing. For example, in the Asian region in 2000 and 2015, the number of bilateral free trade agreements notified by the WTO was 9 and 96 respectively, while multilateral agreements, including interregional, were 5 and 38 respectively<sup>1</sup>. In addition, the world economy is no longer bipolar with the US and EU leaders, and China, Brazil, India and other countries are equally important. And since globalization does not lose its pace, the WTO retains its value, but more as a multilateral institution to monitor compliance with the norms, principles and rules of trade.

All free trade agreements in the WTO are united by the fact that they are reciprocal trade agreements between two or more partners. These include free trade agreements and customs unions, notified in accordance with Article XXIV: 7 of GATT 1994 and paragraph 2 (c) of the Enabling Clause (Enabling Clause, which is formally referred to as the «Decision on Differential and More Favorable Treatment, Reciprocity, and Fuller Participation of developing countries» adopted under the GATT 1979), and agreements on economic integration in accordance with Article V: 7 of the GATS.

In the system of modern foreign trade relations, there are several differences between free trade agreements and other regional agreements, and the first is the degree of economic integration. Traditional free trade areas focus on regulating of such aspects of international cooperation as: abolition of tariffs in mutual trade, elimination of quantitative restrictions in mutual trade; developing rules for determining the country of origin. They eliminate cross-border barriers to the international movement of goods. Such simple free trade area is limited to the foreign trade aspects of goods' movement. Regional agreements, established before 1995, concerned only trade in goods and mostly took the form of free trade areas and, less commonly, customs unions, and were associated with the liberalization of trade<sup>2</sup>.

After the creation of the WTO and the expansion of multilateral trade agreements in the area of services and trade aspects of intellectual property rights, the new FTAs also seek to cover these provisions from a regulatory perspective. In addition, new EU-US trade agreements are expanding the scope of the WTO's regulatory aspects, including investment protection, competition policy, labor standards, and environmental protection. H. Horne and P. Mavroidis [<sup>2</sup>] distribute such agreements into two categories: «WTO plus» (WTO+) and «WTO extra» (WTO-X). The first category corresponds to the provisions of the FTAs that fall within the current mandate of the WTO, in which the parties have bilateral commitments that go beyond what they have taken on a multilateral basis. On the other hand, the WTO – X category includes those provisions that relate to issues outside the current mandate of the WTO, such as commitments to labor standards (Table 1).

Thus, another feature of the FTA is the deepening and complication of transactions. L. Baccini and A. Dur arranged data on integration treaties and proposed a system of indexes of depth and flexibility of transactions<sup>3</sup>. The depth of the agreements coverage demonstrates their complexity and expansion through seven components of the agreement, such as tariff reductions, government procurement, competition and intellectual property rights, trade in services, investments, and standards. Until the 1970s, free trade agreements covered only tariff reduction and trade in goods and services. Since the 1980s, treaties have been significantly deepened and include common standards, procurement and competition conditions. Such trade blocs as the largest countries in Europe, the USA and Japan launched the integration processes in manufacturing, trade, services, cross-border direct investment, and finance. One of the deepest FTAs is NAFTA (1992), EFTA-Ukraine (2010), bilateral agreements between the USA and Australia with other developed countries (Table 2)<sup>4</sup>.

<sup>1</sup> Free trade agreements. *Asia regional integration center*. <<https://aric.adb.org/fta-trends-by-geographic-area-wto-plurilateral>> (2017, July, 25).

<sup>2</sup> Horn, H., Mavroidis, P.C., Sapir, A. (2009). Beyond the WTO? An anatomy of AU and US preferential trade agreements. <[http://bruegel.org/wp-content/uploads/imported/publications/bp\\_trade\\_jan09.pdf](http://bruegel.org/wp-content/uploads/imported/publications/bp_trade_jan09.pdf)> (2017, July, 25).

<sup>3</sup> Dur, A., Baccini, L., Elsig, M. (2014). The Design of International Trade Agreements: Introducing a New Database. *Review of International Organizations*, vol.9(3), 353-375.

<sup>4</sup> Regional trade agreements and the WTO. *World Trade Organization* <[https://www.wto.org/english/tratop\\_e/region\\_e/scope\\_rta\\_e.htm](https://www.wto.org/english/tratop_e/region_e/scope_rta_e.htm)> (2017, July, 25).

Table 1

**Areas of regulation of deep free trade areas**

WTO +	WTO extra		
Free trade area for industrial goods	Anticorruption regulation	Civil defense	Illegal Immigration
Free Trade Area of Agricultural Goods	Competition policy	Innovation policy	Prohibited drugs
Export duties	Protection of consumer rights	Cultural cooperation	Industrial cooperation
Sanitary and phytosanitary measures	Data protection	Dialogue on economic policy	Information society
Technical barriers to trade	Laws on the protection of the environment	Education and training	Money laundering
State trading enterprises	Investments	Power engineering	Nuclear safety
Antidumping and compensatory measures	Capital movement	Financial Aid	Political dialogue
State aid	Regulation of the labor market	Health protection	Governance
Government Procurement	Intellectual Property Rights	Social issues	Regional cooperation
Trade-related Investment Measures (TRIMS)	Human Rights	Statistics	Research and technology
Trade Aspects of Intellectual Property Rights (TRIPS)	Approximation of legislation	Taxation	Small and medium enterprises
Trade in Services (GATS)	Audio and video products	Terrorism	Granting visas and asylum

Table 2

**Examples of free trade areas with their depth and flexibility**

Title	Year	Model agreement according to the development of countries	Depth of Coverage Index of Flexibility	Depth of Coverage Index of Flexibility
El Salvador-Nicaragua	1951	South-South	1	0
Central American Free Trade Area (CAFTA)	1958	South-South	1	1
Caribbean Free Trade Association (CARIFTA)	1965	South-South	1	2
Economic Community of West African States (ECOWAS)	1975	South-South	1	0
USA-Canada	1988	North-North	3	5
North American Free Trade Area (NAFTA)	1992	North South	7	6
Southern Africa Development Community (SADC)	1996	South-South	2	4
Australia-Singapore	2003	North South	7	3
Korea-Turkey	2012	South-South	4	6

In the 2000s, most of the concluded agreements were free trade agreements between developed and developing countries. At the same time, they cover the widest range of issues of international relations between countries – from tariff regulation to the protection of intellectual property rights. Besides, the average index of flexibility exceeds 5, which indicates a high level of readiness for various ways of developing national markets and international trade.

The Flexibility Index shows how the deal enables participants to overcome unpredictable events in the future, without violating its current conditions<sup>1</sup>. The index varies within 0-8, subject to the following provisions:

1) Agreement between the parties regarding the interpretation of the provisions of the GATT / WTO on guarantees.

2) Conditions for extending security duties different from those specified in the provisions of the GATT / WTO.

3) Terms of use of protective measures during the transition period.

4) Provisions permitting the introduction of safeguard measures for products outside the principle of most favored nation.

5) Permission to temporarily suspend the reduction of customs duties.

6) Provisions on the authorization of minor dumping measures: a) in accordance with the GATT / WTO, b) outside the requirements of the GATT / WTO.

7) Develop a common subsidy policy.

The other difference between FTAs and other regional agreements is the existence of rules of origin only in free trade agreements. These rules are necessary to ensure that trade preferences are granted to the country in which the goods are made. Therefore, FTA agreements include commodity regimes that provide for a system of regulations and procedures for determining the country of origin of goods.

Commercial exchange of goods takes place with products that are wholly obtained or produced in the exporting country, or components from third countries were used in their production. For export products with imported components, it is necessary to determine the conditions, type and quantity of imported components that may be contained in these products, so that the goods may be considered to be made within the country or region in respect of which preferences have been granted. The general approach adopted in most countries is that the origin of the goods is determined by the place where its most recent significant transformation was made. «Significant» transformation is defined as such a transformation, which gives the product its essential, most significant features.

Also, rules of origin are necessary to prevent third parties from enjoying the benefits of the free trade area. This can happen when imports pass through the country with the lowest tariff and are transhipped to other member countries. This phenomenon is commonly referred to as trade deflection. With each new entrant, new rules of origin should be the subject of negotiations. This is a consequence of various comparative advantages of the industry and various factors of production. If the free trade agreement involves the transition to a more economically integrated structure, such as a customs union, the first step is to homogenize the external tariff. Such a development of ties entails additional mechanisms of coordination and cooperation between countries<sup>2</sup>.

The characteristic of FTAs is that they are discriminatory agreements because of their preferential tariff regime. Although the most favored nation (MFN) is the cornerstone of the multilateral trading system, partners in bilateral or regional trade agreements are deliberately neglected. A Member violates the principle of the MFN when it provides preferential terms for goods (services) originating from one or more countries, but the WTO allows for some exceptions. The MFN is the basic principle of the WTO and is defined by Article I of the GATT 1994 (for trade in goods), as well as in Article II of the GATS (for trade in services). Under the most-favored nation (non-discrimination) principle, any preferences (benefits, privileges, immunities) for an imported product apply to a product originating from or destined

<sup>1</sup> Flexibility Measure: The Design of Trade Agreements. *DESTA*. <<http://www.designoftradeagreements.org/>> (2017, July, 27).

<sup>2</sup> Baier, S.L., Bergstrand, J.H., Egger, P., McLaughlin, P.A. (2008). Do economic integration agreements actually work? Issues in understanding the causes and consequences of the growth of regionalism. *World Economy*, vol. 31(4), 461-497.

for a participating country. The principle is unconditional<sup>1</sup>. The content of the principle of the most-favored nation in international trade includes the following elements:

- 1) Is intended to provide for the state the same favorable position (in respect of trade) enjoyed by other states in its territory;
- 2) Grants an absolute right to receive all privileges and privileges enjoyed by third states;
- 3) Usually has an unconditional nature.

Article 1 of the General Agreement on Tariffs and Trade 1994 provides that States Parties shall accord to one another the most unconditional, most-favored-nation treatment. This provision applies to export, import and transit trade transactions, to international payments for export and import operations. The most favored nation treatment applies to customs duties and any charges levied in connection with foreign trade operations. On the other hand, the most-favored-nation clause extends (along with the national regime) to internal taxes and fees, internal rules and laws governing the purchase and sale of goods in the internal territories of the participating countries. The most-favored nation rule formulated in Article 1 of the General Agreement on Tariffs and Trade is indisputable, so the countries that joined the World Trade Organization are obliged to apply this rule in full to the entire range of foreign trade operations.

**Conclusions.** Objective reason for the establishment of free trade areas are the processes taking place in the global economy, and are characterized by the internationalization of production and, consequently, accelerate the formation of regional trade and economic entities and groups. Traditional free trade areas focus on foreign trade aspects of commodity movements and are governed by fundamental WTO rules, such as rules of origin and most favored nation treatment. While the new generation of trade agreements leading countries extend the limits of the WTO and regulatory aspects include investment protection, competition policy, labor standards, environmental protection. Accordingly, such transactions are distributed in two categories: «WTO plus» (WTO +) and «extra-WTO» (WTO-X), those that fall under the current mandate of the WTO, and include provisions on the outside WTO rules. In addition, responding to the demands of the modern business environment, agreements not only extend the scope of regulation, but also increase the degree of detail of scenarios for the development of trade relations. Accordingly, the researchers developed the indexes of flexibility and depth of coverage of transactions. In the future it is expedient to study the world experience of functioning and to find out the effectiveness of deepened and expanded free trade area agreements on the example of individual groups of countries.

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