

Analysis on the Development and Influence of Overlapping Free Trade Agreement¹

ANALYSES SUR LE DÉVELOPPEMENT ET LES INFLUENCES DU CHEVAUCHEMENT DES ACCORDS DE LIBRE ÉCHANGE

CHENG Xinxuan² WANG Ying³ LIU Yongliang⁴

Abstract: Since the 1990s, FTAs (FTA) have developed rapidly, and overlapping free trade agreement comes into being naturally. The overlapping free trade agreement causes multiple duplicate of rules of origin as well as reduces the economic efficiency of the operation of FTAs; industries in the area bring about cohesive effect in hub country, and specialization effect of decentralization in spoke countries; the phenomenon of overlapping free trade agreement complicates the relationship between FTA and multilateral trade system (MTS), making the occurrence of transitional institutional arrangement possible in the process of upgrading from FTA to Customs Union.

Key words: Overlapping; Free Trade Agreement; Rules of Origin; Customs Union
FTA

Résumé: Depuis 1990, FTAs (FTA) s'est développée rapidement et le chevauchement des accords de libre-échange apparaissent. Le chevauchement des accords de libre-échange génère de multiples duplicata de règles d'origine ainsi que l'affaiblissement de l'efficacité économique des opérations de FTAs; les industries dans la région engendrent des effets cohésifs dans les pays-centres et des effets de spécialisation à cause de décentralisation dans les pays-satellite; le phénomène du chevauchement des accords de libre-échange complique les relations entre FTA et le système d'échange multilatéral (MTS) en rendant possible l'occurrence des arrangements institutionnels traditionnels dans le processus d'actualisation de FTA à la union douanière.

Mots-Clés: chevauchement; accord de libre-échange; règles d'origine; union douanière; FTA

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² Professor of Management College of Hebei University, China.

³ Professor of Hebei Beifang university, China.

⁴ Professor of economic college of Hebei University, China.

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Globalization brings both benefits and serious uncertainty risks to every country. In order to obtain trade creation effect brought by regional preferential arrangement and reduce risks brought by the opening up at the same time, regional economic organization becomes important strategic choice for many countries. At present, the form of regional economic organization embodies mainly in Customers Union, FTA, common market and economic & monetary union. Most of the regional organizations are still in the stage of Customs Union or FTA, in which, the FTA becomes the first choice for many countries due to its characteristics such as limitation of sovereignty transfer, directness of benefit attaining, easiness of agreement-reaching, etc. For that reason, at the end of 1990s, many overlapping free trade agreements came into being. The rocketing development of this phenomenon will bring about significant influence upon the operation of regional economic organizations and MTS.

1. DEVELOPMENT OF OVERLAPPING FREE TRADE AGREEMENT

Overlapping free trade agreement is a special phenomenon emerged in the later part of 1990s during the development of FTA. In the last century, there emerged two climaxes for the development of regional trade agreement; the first one emerged in the 1930s while the second one emerged in the 1980s. The international environments, in which the second regional trade agreement boom, have undergone dramatic changes, which mainly embody in: the degree of trade liberalization for finished products of developed countries increase greatly; many developing countries are giving up the strategy of anti-trade and anti-market-system and participating actively in the MTS; direct foreign investment occupies the main position in foreign economy.⁵ On this background, many countries all wish to obtain huge actual economic benefits by establishing FTA. As it is stated in WTO report that by the end of July, 2007, the number of regional trade agreement notified to WTO increased from 50 in the 1990s to 380, increasing almost 8 times. In which, 205 of agreements are under implementation. Before 2010, the number will increase to about 400. By the end of 2007, the trade volume between countries in the area had accounted for about 50% of the global trade volume. Many member countries of WTO participate in more than one free trade agreements, which leads to the emergency of multitude of overlapping free trade agreements. Overlapping free trade agreement is a phenomenon, in which one country (region) concludes free trade agreements with many countries (regions) respectively. This concept means the Star system put forward by Parker at first; however, it is gradually replaced by the statement of Hub-and-Spoke system.⁶ When one country (region) concludes agreements with many countries (regions), the country (region) is like hub and those countries who conclude with it are like spokes, and there is no free trade agreement between these spoke countries. If spoke countries also sign agreements with many countries, multilevel overlapping free trade agreement will be formed. At present, 97% of member countries of WTO have participated in free trade agreements, and most of them participate in more than one agreements.⁷ Therefore, many overlapping free trade agreements emerge, and some countries are both hub country and spoke country. Member countries of European Union and countries of European Free Trade Agreement have signed at least 19 free trade agreements, and Columbia, Venezuela and Chile have signed 8-18 such agreements with some countries of Central America. After signing Bilateral Free Trade Agreement with Canada, the USA has signed North American Free Trade Agreement with Mexico as well; at present, its negotiation with Chile has finished; the FTA of Americas planed to be established by the end of 2005, has not yet reached an agreement due to problems such as agriculture, anti-dumping, etc. Those three countries above mentioned of North American FTA are all member countries of Asia-Pacific

⁵ Schiff, M. 2000. Multilateral Trade Liberalization, Political Disintegration and the Choice of Free Trade Agreements uersus Cusoms Customs Unions, *Word Blank*.

⁶ Park and Yoo. 1989. More free trade areas: A Korean perspective. In Jeffrey J. S. (Ed.), *Free Trade Areas and US Trade Policy* (pp, 141-158), Washington DC: Institute for International Economics.

⁷ WTO Report, 2007, www.wto.cn

Economic Cooperation (APEC); as it is arranged in the agreement that FTA for developed countries in APEC will be established in 2010 while FTA for developing countries will be established in 2020. In this structure of overlapping free trade agreement, some countries have become hub countries, such as the USA, Mexico, Chile, Singapore, etc. Take Mexico for example, it has concluded 10 free trade agreements, including the USA---Canada, Chile---Bolivia, Columbia---Venezuela, Nicaragua, Costa Rica, European Union, European FTA, Israel, Guatemala---Salvador and Honduras. Countries and regions concluded free trade agreements with Chile include: Ecuador, Venezuela, Bolivia, Peru, Southern Common Market, European Union, Canada, Mexico, and the USA. Singapore of the Asia has also signed agreements with Japan, New Zealand---Australia, and the USA. EU has signed free trade agreements with 10 countries of ASEAN, Mediterranean Countries, South Africa and Mexico; it is negotiating with Southern Common Market and Chile at present, which will make EU a very big hub area while other countries spoke ones of the system.

The emergence of the phenomenon of overlapping free trade agreement has inevitable connection with the development of economic regionalization and globalization. At first, FTA becomes important choice for one country because of the difficulties faced by MTS.

After the Uruguay Round in 1994, WTO was established formally; comparing with GATT, the operational mechanism of WTO is more institutionalized and the binding force for member countries is intensified. However, there still exist insuperable problems, such as being lack of democracy and transparency on decision-making mechanism, invalidity of trade-dispute settling mechanism and serious phenomenon of trade protection etc. These problems cause the MTS to present unreasonableness and unfairness, and it is hard for developing countries to obtain deserved benefits. Especially in trade areas of agricultural products and textiles, the tariff of products exported from developing countries to developed countries runs up to as much as 300%, and the trade quota of textiles has not reduced as expected. The unbalanced degree of world economic development has aggravated. It is hoped at first that Doha Round can solve problems in the MTS, however, when it is announced in July, 2008 that a new round has failed, making the development of MTS fall into difficulties. Under such international economic environment, FTA has become an important strategic choice when a country is attempting to obtain stable and relatively large economic benefits.

Next, it is the result of pursuing many market effects for one country to participate in more than one FTAs. Participating in a FTA is as same as entering a "single market" for one country, namely, all producers and consumers will face the mutual rule. Single market not only brings static effects of trade creation, but also produces dynamic effects, such as competition effect, investment effect and scale effect etc. which will be a great impetus to the economic development of member countries. For a country, by participating in many FTAs, it can enjoy both preferential arrangements of many free trade agreements and effects brought by many markets, and then it will become a hub country, developing sufficiently those industries with relative advantages, realizing economy of scale and promoting the development of the entire industry.

In addition, the development of overlapping free trade agreement also meets the political requirement of influencing international rules by virtue of the power of regional organization for one country. Those countries who participate in more than free trade agreements are mainly small countries. With small economic scales and relatively weak economic strength, influence of one of these counties upon international rules is limited. However, participating in FTA offers the chance for these countries to bargain with other countries and organizations in the form of regional organization as a whole through the collective path, so as to strengthen the ability of competition and formulate economic rules suitable to themselves. However, as the widespread emergency of the phenomenon of overlapping free trade agreement, problems brought about it progressively appear.

2. ECONOMIC EFFECT OF OVERLAPPING FREE TRADE AGREEMENT

For the research on the effect of regional economic organization, the theory of Trade Creation and Trade Diversion of Viner is still the classical model in analyzing Customs Union. However, for the effect of FTA, no clear analytic framework and answer have been achieved as yet; a consensus is reached by scholars only on the point that "FTA is a suboptimal choice".⁸ The emergence of overlapping free trade agreement complicates the analysis of FTA. The paper tries to analyze the influence of overlapping free trade agreement upon regional economy in the angle of general law.

In the first place, the overlapping free trade agreement leads to the decline of efficiency in regional economic operation. The fundamental difference between FTA and Customs Union lies in that: there is no tariff barrier between member countries of FTA, while external tariff level is decided by every respective country; however, there is not only no tariff barrier between member countries of Customs Union, the external tariff level is also consistent. This special arrangement of the FTA leads easily to "trade deflection".⁹ For that reason, there exist regulations related to rules of origin in all FTA agreements, and commodities without tariff in the area must conform to that rules, namely, product added value created by member countries must account for certain proportion of the total value (such as the proportion specified by NAFTA is 62.5%); or products imported from outside the area must undergo transformation to become another type of product. The rules of origin limit the choice of producers in member countries; in order to meet the rules of origin, producers have to purchase intermediate inputs with high cost from other member countries with the region, and then export the finished products after processing and producing to other member countries. Take Mexico as example, who, in order to export automobile to the USA with tax exemption, has to purchase parts of high price from the USA instead of purchasing those parts of low price from Japan as before. Certainly, if country outside the area think that it can make profits by investing in the region, it can enter the internal region by direct investment; however, at the time of obtaining market in the area, it has to pay relatively high investment cost. From that it can be seen that, the rules of origin protect producers in the area (mainly producers of intermediate producers) and enhance the effect of trade diversion; however, from the world point of view, they reduce the efficiency in resource allocation.

Every free trade agreement has its own rules of origin, and every one is different from others in certain way. As described by Bhagwati, overlapping free trade agreement is just like pot and bowl, bringing about multiple duplicate to the rules of origin, and it is applied to almost any place and any product as a large number of non-tariff barriers. If a country concludes different free trade agreements with a number of countries, commodities between the hub country and other spoke countries could flow freely, while trade between the spoke countries must face tariff barriers. Products of spoke countries must enter the hub country first, and then enter other spoke countries. In order to comply with the rules of origin, spoke countries will purchase more intermediate input goods from the hub country to make them into final products, and then export to other spoke countries through the hub country; or invest to set up factories in the hub country. It is obvious that producers in the hub country obtain special returns in the overlapping free trade agreement, while these in spoke countries are in the face of discriminatory treatment. Furthermore, the rules of origin will lead to the export of protection from one country to its partner countries, which will force member countries to purchase inputs with high cost from partner countries, and then export with tax exemption to partner countries to make profits. And overlapping FTA will cause rules of origin to transfer protection of one region to another; trade diversion effect has caused expansive transfer between many spoke countries and the hub country, thus the overall benefit level of

⁸ Krishna, P., Panagariya, A.(2000). A Unification of the Theory of Second Best. *Journal of International Economics*, 52(2), 235-257.

⁹ Trade deflection refers to the process, in which, countries outside the area export products to countries of low tariff in the border of this area, and then transfer them to the countries of high tariff, enjoying tax avoidance on the condition that tax rate in the area is zero.

the region will be lowered.¹⁰

Trade dispute also reduce the efficiency of regional economic operation. Every regional agreement has its own rules, covering different products; however, due to special relationship between hub and spokes, inextricable relationship is produced between regions in aspects such as product flow, choice of production place for enterprises and tendency of investment etc., as a result, trade disputes between hub and different spoke countries will emerge in abundance. Such as in the case of the USA, regulations in the free trade agreement signed by it with Canada vary from regulations of NAFTA; if disputes emerge, they will need to be solved jointly by committees of these two FTAs. In overlapping free trade agreements, it is very common for disputes to emerge on whether one product conforms to rules of origin. For that reason, frequent emergence of trade dispute has also led to the decline in the efficiency of regional economic operation.

In the second place, the overlapping free trade agreement brings about a re-allocation effect on industries inside the area. In the FTA, there is no tariff barrier among member countries, and commodities in the area could flow freely; a country's trade structure will change along with it and has re-allocation effect on its industries eventually. Effects of FTA on industrial re-allocation are embodied in two aspects: one is the structural readjustment of industries outside the area and inside the area; the other is the structural readjustment of industries between the member countries in the area. For structural readjustment of industries between countries outside the area and inside the area, as countries outside the area face a variety of tariff barriers, they will enter the FTA by means of direct investment, which, obviously will lead to the cohesive effect of industry in the area. For industry allocation among member countries in the area, simple FTA will result in the flow of resources to the area of high returns, getting industrial structure in the area optimized. However, as for the overlapping free trade agreement, industries in the area will show an obvious specialization effect of cohesion and decentralization due to the emergence of Hub-and-Spoke. A simple model is adopted to explain as follows.

Assuming there are 3 countries, namely, 1, 2 and 3. 1 and 2 constitute a FTA while 1 and 3 constitute a FTA; however, there is no agreement reached between 2 and 3. This is a typical structure for overlapping free trade agreement: 1 becomes the hub while 2 and 3 become spokes. Every country has two departments, one is commodity department, which produces under the condition of unchanging returns to scale; the other is industry department, which is an imperfect competitive company and possesses the characteristics of increasing returns to scale.

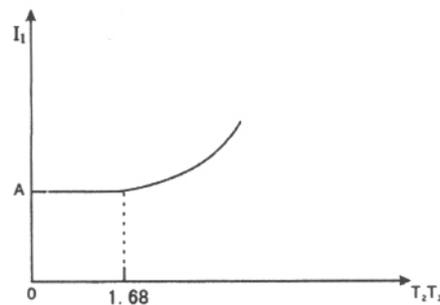
Assuming there is no chain relation of input and output between companies in the area and every country is able to produce products of relatively high elasticity of substitution; because products produced in 1 can enter 2 and 3 freely, then products of 1 will face big market demand while similar products produced in 2 or 3 can only enter 1, facing relatively small market demand. For products produced in 1 with the effect of increasing returns to scale, as demand increases, its production scale will expand and cost will lower; comparing with those similar products produced in 2 and 3, it has stronger competitiveness, and more and more production of such products will be centered on 1, on the contrary, production in 2 and 3 will shrink gradually, as a result the cohesive effect of industry emerges. That is what put forward by Krugman as "Hub Effect".¹¹

Assuming that there is no chain relationship of input and output between companies in the area, and each country could produce products of relatively great elasticity of substitution, in respect that products manufactured in country 1 could have access to the 2 and 3. Therefore, products of country 1 will face a market of great demand, while the similar products manufactured by 2 or 3 could only enter country 1 to be in the face of a relatively small market demand. Products manufactured by country 1 have the effect of increasing returns to scale; along with the increase in demand, its production scale will expand and the costs of products will be reduced, becoming more competitive than similar products manufactured by 2 and 3; more and more production of such products will be carried out in country 1, and that in 2 and 3

¹⁰ Krueger. (1995). Free Trade Agreements versus Customs Unions, *NBER Working Paper*, No.5084. Cambridge, Massachusetts.

¹¹ Krugman, P. R.. (1993). The Hub Effect: Or, Threeness in International Trade. In W. J. Ethier, E. Helpman and J. P. Neary (ed.), *Theory, Policy and Dynamics in International Trade* (pp. 29-37). Cambridge University Press.

will decline gradually, and there will be cohesive effect of industry. This is the “Hub Effect” brought up by Krugman. Assuming that there is the relationship of input and output between companies, products manufactured by 2 or 3 will be in an unfavorable condition initially due to the decline in market demand, however, in respect that there is link mechanism of input and output between companies, country 1 will mainly engage in the production of final products, while 2 and 3 will process intermediate input goods respectively in accordance with its own resources, so as to enter country 1 with duty-free treatment, which reduces the overall production costs and improves the international competitiveness, and enables such products to be exported to countries outside the area. As a result, in the area, there will appear cohesive effect of industry in the hub country and specialization effect of decentralization in spoke countries. The strength of this effect depends on the degree of trade barriers between spoke countries; the higher the trade barriers, the stronger the sensitivity of industrial allocation to the cost (as shown in the diagram below). Demonstration of some overlapping trade areas was carried out by Baldwin, pointing out that Central and East European countries are transferring industries progressively to EU.¹² Demonstration of Mexico is carried out by Hanson, pointing out that under the condition of increasing returns to scale, cohesive effect will emerge in overlapping FTAs.¹³



Note: T_2T_1 refers to trade barriers between 2 and 3; I_1 represents the degree of industry cohesion in country 1. And A represents industrial equilibrium state in the state of global free trade. When the trade barrier between 2 and 3 is higher than 1.68, cohesive effect of industry will appear suddenly in country 1.¹⁴

3. RELATIONSHIP BETWEEN OVERLAPPING FREE TRADE AGREEMENT AND MTS

On the relationship between FTA and MTS, Ai Ze is of the opinion that the MTS promotes the development of open regional organizations;¹⁵ Kruger points out those regional organizations will arouse the objection of interest group to MTS.¹⁶ With the appearance of a large number of overlapping free trade agreements, we need to reexamine the relationship between free trade agreement and MTS.

Overlapping free trade agreement will promote the free trade area developing to opened regional organization. The category of products covered by present-day free trade agreements¹⁷ is very extensive,

¹² Baldwin, R. E.. (1984). *Towards an integrated Europe*. Centre for Economic Policy Research, London.

¹³ Hanson, G. H.. (1994). Regional adjustment to trade liberalisation, *NBER Working Paper*, No.4713.

¹⁴ Puga, D. and Anthony J.V.. (1997). Preferential trading arrangements and industrial location, *Journal of international Economics*, No.43, 347-368.

¹⁵ Ethier. (1999). Regionalism in a multilateral world. In J. Pigott and A. Woodland. *International Trade Policy and the Pacific*, Rim, Macmilan.

¹⁶ Krueger. (1995). Free Trade Agreements versus Customs Unions, *NBER Working Paper*, No. 5084.

¹⁷ 現代的自由貿易協定指 20 世紀 90 年代以後產生的自由貿易區。

mostly including banks, insurances, transportation, investment, intellectual property, technical barriers, etc. But there are seldom agreements that include 100% of products, especially in the field of agricultural products. In 1998, WTO inspected the free trade agreements established after 1990; as a result, there were 43 agreements included 100% of industrial products, while they had choice in the aspect of agricultural products. In the free trade area in North America and all free trade agreements in European Union, competition policy, investment policy, trade & environment policy and trade & labor policy are comprised. These policies are new subjects which are discussed in Doha Round. Obviously, the rules of free trade agreement and those of IVm are not only of definite order and sequence, but the scope they cover is more and more extensive. The appearance of overlapping free trade agreement enables spoke countries to establish potential economic relations with other spoke countries in a pretty broad field by means of hub countries, and finally, promoting free trade areas to be established among spoke countries and making them becoming more opened systems.

The increasing of trading tools involved in free trade agreements deepens the communications among overlapping free trade areas, which facilitates the development from regional economic organization to MTS. Modern free trade agreements comprise more tools, such as the tool that limits member countries to use quantitative restriction, subsidies, etc. Moreover, there is a great development: competition policy has replaced anti-dumping clauses among partners in many regional agreements, such as European

Union, Europe Free Trade Agreement (EFTA), Australia-New Zealand Free Trade Agreement as well as Canada-Chile Free Trade Agreement, etc. This fully illustrates that economic efficiency has been paid more attention to in free trade areas rather than the trade barriers at boundaries have only been eliminated. Higher-level opening up and freedom in the areas make overlapping free trade areas deepen economic communication more easily, make the degree of economic dependence among hubs—spokes—other spokes improved and make the level of merge deepened, which promotes the upgrade of regional economic organizations and facilitates the development to MTS.

From the analysis abovementioned, we could see that, with respect to the scope covered by free trade agreements and the tools applied in them, overlapping free trade agreements are propitious to the development of multilateral trade free system. However, whether the reality is like this, the issues on the consistence between the rules of free trade agreements and those of multilateral trade shall be investigated. In order to guarantee that there is no conflict between regional free trade agreements and the rules of multilateral trade, a certain requirement for regional free trade agreements has been put forward in Article 24 of GATT, that is, “each contracting country thinks that, the purpose of setting up Customers Union and free trade areas shall be for the convenience of trades within each territory of unions and free trade areas; while for the trades between other contracting countries and those within these territories, the barriers shall not be increased.” With respect to each member country newly joining into WTO, in addition to reducing protection and carrying out rules, they must inform WTO of the regional organizations they participate in, and then the workgroup of WTO will inspect the regional agreement regularly. The purpose of these measures is to efficiently avoid that regional organizations hinder the development of MTS. As a matter of fact, WTO hasn’t inspected regional organizations strictly. In Nov., 2000, there were 220 free trade agreements being informed to WTO, among which 62 agreements were inspected and the reports on them were given, while 17 agreements were being inspected, and the inspection of others has not been started. For the rules of origin, the controversy has been set forth by the workgroup of WTO. They think that the rules of origin is related to the test and determine of “other business rules”, and prevent the benefits brought by trade creation in the process of liberalizing the economy of a country, but WTO hasn’t fixed or limited the application of origin principle. WTO’s tolerant attitude towards regional free trade agreements is bound to increase the level of protection to the producers in the areas, which is due to the rules of origin in overlapping free trade agreements; interest groups will make all efforts to take advantage of regional agreements to obtain huge benefits, adopt more time and energy for the coordination in the areas, and then take negative attitude to MTS.

Besides, the operating features of overlapping free trade agreements make the member countries desire to become hub countries, which leads to “domino effect” and the appearance of more overlapping

free trade agreements; meanwhile, it has promoted the setting up of relatively large free trade areas (Meta—bloc), such as Europe Agreement 2004; in 2010, developed countries will set up free trade areas in APEC, and in 2020, the developing countries in APEC will establish free trade areas, etc. These large free trade areas comprise a lot of overlapping free trade agreements. The big powers in the areas have represented the benefits and wills of numerous spoke countries during multilateral trade negotiation; the number of participators of the negotiation is relatively reduced; while the phenomenon on conspiracy is severe, and it will become more difficult to make the negotiation come to an agreement.¹⁸

In addition, the political effect of overlapping free trade agreements hinders the development from free trade area to MTS. Overlapping free trade agreements make the rules of origin be of relatively high protecting level, and the producers in the areas are of more opportunities and motivation to persuade the government formulating protective measures. As is known to everyone, in NAFTA agreement, there are 200 pages of provisions related to the rules of origin, among which include automobile, textile, costume, etc., and all of them must be manufactured in the areas for meeting the rules of origin. American producers adopt pretty strict rules of origin persistently to restrict competition, while the producers in Mexico obtain compensation from the high prices what can be accepted in America. Consequently, in overlapping free trade agreements, no matter hub countries or spoke countries, they will carry out rent seeking; the relatively high balance of politics and economy on the level of trade diversion sets back the development of multilateral free trade system. Simultaneously, overlapping free trade agreements also can cause the promotion of hub countries' political status. In accordance with overlapping free trade agreements, the products of hub countries can enter into the markets of spoke countries freely and enjoy the lowest cost. There are economic relations between all spoke countries and hub countries, or they establish relations with other spoke countries through hub countries. Hub countries hold core position and possess relatively powerful economic advantages. They will play a leading role in formulating of rules in multiple areas, thus, their political status has been promoted. However, the spoke countries are marginalized increasingly. Finally, they attempt to establish free trade agreements with other countries and become hub countries. For instance, the countries in Africa are striving for becoming hub countries by carrying out free trade negotiations with Canada and America.¹⁹ This kind of phenomenon will bring about increasingly intense bargaining in multilateral trade negotiation, and the negotiation becomes more and more difficult.

4. DEVELOPMENT DIRECTION OF FREE TRADE AREAS

In line with the law on development of economic integration, free trade areas will be deepened to become Customers Union. Nevertheless, the appearance of overlapping free trade areas, especially as the increasing of free trade agreements, hub and spoke system will become huger and huger, many large hub areas and spoke areas will emerge. For instance, by 2020, when the free trade areas of APEC are set up, among which, the member countries of free trade area in North America will become the hub area which occupies approximately half of global trade; while the countries in Asia and Latin America will become spoke countries and form a large spoke area. The phenomenon will reduce the efficiency of economic operation in free trade areas and make the industries in the area the specialization effect of decentralization and cohesion. Some political and economic interest groups will emerge; the overall welfare level in the areas will be reduced probably. The deepening from FTAs to Customers Union will become more difficult.

At present, the regional organizations in the world exist basically in such two forms as FTAs and Customers Union, and only has European Union realized Economic and Monetary Union. Customers

¹⁸ Winters, L. A.. (1998). Regionalism and the new road. In J. Schott, *Launching New Global Trade Talks- An Action Agenda, Special Report 12*, Washing DC: Institute for International Economics, September.

¹⁹ Schiff, M.. (2002). Regional integration and development in small states, *Policy Research Working Paper*, No. 2797. The World Bank.

Union requires that the member countries shall be of the same external tariff; the level of economic development between the member countries shall be similar, and the political system shall be identical; it is required to transfer the sovereignty. Therefore, it is more difficult to be Customers Union than to enter FTA between countries. The quantity of free trade agreements is larger than that of Customers Unions. With respect to the simple FTA, as the improving of regional economic strength, the extent of mutual dependence between each member country is increased gradually, and the convergence of economic indicator is improved. When a certain extent has been reached, FTAs will transmit to Customers Unions naturally. However, at present, because of the appearance of numerous overlapping free trade agreements, the effect of trade diversion is enhanced, and the level on the protection of producers in the areas is further improved; as a result, in order to maintain the long-run interest structure, the economic and political interest groups will persuade the government and hamper the deepening from FTAs to Customers Union. Under the circumstance, hybrid free trade agreement may be a system arranged for the transition. Hybrid free trade agreement refers to a kind of free trade agreement that combines the advantages of Customers Union with those of FTA.²⁰ In the areas, common external tariff shall be carried out for some products, and some are of their separate external tariff level. Member countries still have the right to formulate external trade policy and adjust the tariff level in accordance with the economic development of the country without permission of other member countries; but the external tariff level of member countries must be relatively low, which shall not produce "trade defection" to make the rules of origin lose effectiveness automatically. Thus, it not only prevents some countries from becoming hub countries but prevents partner countries from becoming spoke countries, which hinders the development of Hub-and-Spoke system. In the overlapping free trade agreements, as the zero-tariff implementation for some products, relatively powerful cohesion will come into being in some fields gradually, especially in the industry field with relatively strong complementary, reasonably

²⁰ Wonnacott, P. and Wonnacott, R. J.. (1995). Liberalization in the western hemisphere: New challenges in the design of a free trade agreement. *North American Journal of Economics & Finance*, 6(2), 107-119.