The cornerstone of the post-World War II world trading system is the most favoured nation (MFN) clause that underlies all GATT-negotiated reductions in tariffs. Through the MFN clause, non-discrimination creates global order out of an essentially mercantilist system. Most importantly perhaps from the standpoint of lesser nations with little bargaining power, through the application of the MFN clause, purely bilateral bargains negotiated under the auspices of the GATT become available to all. Enormous progress towards global free trade has been made under this non-discriminatory approach to tariff reductions. For example, between the opening of the first round of multilateral talks in Geneva in 1947 and the close of the Tokyo round in 1979, the average US tariff had declined by nearly 92 percent. On the eve of the Uruguay round in 1987, the average tariff for the United States was 4.9 percent, for the European Community it was 6.0 percent, and for Japan it was 5.4 percent.

This long period of progressive trade liberalisation also witnessed two waves—waves because they came suddenly, and the first one at least, foreshadowed—of regional trading arrangements. The first came during the early 1960s. Under the impetus of the European Common Market, regionalism spread throughout Africa, Latin America and other parts of the developing world. The United States was then a hegemon and a staunch supporter of multilateralism. Regionalism then came to a halt during much of the 1970s.

The second wave started in the middle 1980s. This time around, the United States was a major player. Following the negotiation of bilateral free-trade areas (FTAs) with Israel and Canada, the United States launched a proposal for a hemispheric FTA with the Enterprise for the Americas Initiative (EAI). And, most recently, the United States initiated the agreement for the North American Free-Trade Area (NAFTA) with Canada and Mexico. At the same time, European integration spread with the Southern (Greece, Portugal and Spain) and the Northern enlargements
second waves of regionalism. Instead, we prefer to discuss first the second wave of regionalism and the concomitant rise of trading blocs. This choice reflects the strong feeling shared by many that trading blocs are in the making and that this new wave of regionalism is here to stay.

In section 1, we review the causes behind the rise of trading blocs, why they are here to stay, and then turn to a brief discussion of the economics of trading blocs. We close with a summary of the lessons of history offered by the trading blocs in the 1860s and the 1930s. In section 2, we ask whether the first wave of regionalism achieved its goals, the discussion centering around the propositions derived from the theory of FTAs and CUs. The 'new' regionalism - a term we use to distinguish it from the first wave of regionalism - occupies section 3. Central to this discussion is that the new initiatives go beyond the extension of trade preferences to institutional aspects, and that the second wave of regionalism is occurring in a very different world-trading environment than the first. Finally, section 4 returns to a discussion of the implications of the 'new' regionalism for countries with limited bargaining power. At issue is how best these less powerful countries can protect their interests, and the role of multilateralism in promoting them.

1 Regionalism and (versus?) multilateralism

1.1 Revival of regionalism: why?

How do we explain the current revival of regionalism around the world? In Chapter 2, Jagdish Bhagwati argues that the single most important reason why regionalism is making a comeback and is likely to be more durable than the first round is the conversion of the United States. The first round failed principally because the United States was firmly committed to the multilateral approach and did not endorse the regional approach except in the case of the European Community. Even there, it saw and subsequently used regionalism as an instrument to promote multilateralism. An organised Western Europe under the leadership of the European Community facilitated the GATT-led multilateral negotiations.

Unfortunately, this has changed in recent years. Disappointed by a lack of progress at the GATT negotiations, the United States has decided to switch course and gone on to conclude first the Canada-US Free-Trade Agreement (CUSTA) and is now going ahead with the North American Free-Trade Agreement (NAFTA). The United States has also announced its intention to negotiate free-trade agreements with groups of other Latin American countries under the EAI. Alongside this, the European Community has continued to widen and deepen its integration. These develop-
ments have, in turn, led other countries to reconsider the regional option. East Asia, in particular, is beginning to fear that a regional bloc there may be the only way to meet the challenge posed by developments in the Americas and Europe. Even developing countries are beginning to fear that their access to world markets may be curtailed considerably if trading blocs become reality and they are left out.

A key reason for the United States' conversion to regionalism is the slow progress at the GATT. But why is it that the GATT negotiations are having less success in recent years than in the past? In Chapter 3, Paul Krugman offers four reasons. First, the number of players participating in the process has grown large which makes negotiations difficult and free-rider problem harder to handle. Second, the character of protection has changed. The presence of voluntary export restraints (VERs), anti-dumping (AD) mechanisms, and other forms of administered protection make the negotiating space vastly more complicated than it was in the past. Third, the decline in US dominance has made it more difficult to run the system. Finally, institutional differences among major countries make negotiations more complicated. Pointing to Japan, Krugman argues that with markets in that country 'governed by informal understandings and cartels', offers of tariff concessions by it are not the same as similar offers by the United States 'with its free-wheeling markets'.

1.2 The welfare economics of trading blocs

Given that the current round or regionalism is here to stay and that the possibility of the world dividing into three blocs cannot be ruled out, we must ask how these developments are likely to impact the welfare of the world, and of individual participants. The traditional answer to this question is provided by Viner (1950) who introduced the highly influential concepts of 'trade creation' and 'trade diversion'. To understand this, suppose that starting with a non-discriminatory tariff on all trading partners, the United States forms a FTA with Mexico. Suppose further that shoes are produced under constant costs everywhere and that the FTA results in the United States importing shoes from Mexico. Is this change for the better or worse? The answer, reasoned Viner, depends on who is the pre-FTA supplier of shoes. If the United States produced its own shoes in the initial equilibrium, it must do so at a higher cost than Mexico. In this case, the FTA shifts shoe production from a higher- to a lower-cost source and is trade creating; welfare of the union and of the world rises. If, on the other hand, the United States initially imports shoes from another country, say, the Republic of Korea, that country must be a lower-cost producer of shoes than Mexico. In this case, the FTA causes shoe production to shift from a lower- to a higher-cost source. There is trade diversion and the welfare of the union and the world declines. In this example, trade creation is accompanied by no change in trade with the rest of the world but increased trade between partners; the world as a whole moves closer to free trade. By contrast, trade diversion is accompanied by increased trade within the union at the expense of trade with the rest of the world; national protection is extended to the regional level and the world as a whole moves away from free trade. Traditionally, those who associate regionalism largely with trade creation consider it a positive force and those who think the reverse fear that it will be detrimental to the world trading system.

Today, the issue of regionalism has become more complex. For one thing, regional schemes cannot be considered in isolation as Viner assumed. With blocs forming almost simultaneously around the world, we must take into account the interaction effects as well as possible strategic behaviour among nations. More importantly, as Bhagwati emphasises, the static impact effect is only part of the story. We must also pay attention to the dynamic time-path question: even if a particular regional scheme moves the world towards freer trade, over time it may result in a more protectionist world, and vice versa.

Turning first to the impact effect, we have Krugman's now familiar model of trading blocs. He considers a symmetric world in which there is a large number of identical countries. Individuals consume a differentiated good with many potential varieties. Each nation specialises completely in one variety and imports all the other varieties. At one extreme, with as many blocs as there are countries, each bloc is too small to have any market power. Therefore, Nash tariffs are zero and competitive behaviour maximises world welfare. At the other extreme, with one trading bloc, there are once again no trade restrictions and welfare is maximised. In between, welfare is lower. Starting with one bloc, if we divide the world into two blocs of equal size, each bloc exercises monopoly power over its products and imposes a Nash tariff on imports from its rival. There is trade diversion and each bloc suffers a loss of welfare. Next, suppose we divide the world into three equal blocs. This leads to only one-third rather than half of the goods being subject to free trade and there is further trade diversion. But the reduced size of each bloc also reduces its market power and the Nash tariff declines. This generates a trade-creation effect. With both trade diversion and trade creation taking place simultaneously, welfare may now rise or fall. As the number of blocs rises, the Nash tariff continues to decline and at some point must become sufficiently small to yield a larger trade-creation than trade-diversion effect. The critical question is the number of blocs at which this turning point obtains.
Surprisingly, Krugman finds that for a variety of parameters, the number of blocs for which a declining welfare begins to rise again is three. Taken seriously, this implies that the number of blocs into which the world is most likely to divide—three—minimizes welfare. This finding remains robust to alternative tariff-formation processes. In his Discussion, T.N. Srinivasan contends that Krugman's model 'comes uncomfortably close to being 'theory without relevance'.' Among other things, Srinivasan suggests that the strong symmetry assumed by Krugman is devoid of reality. He then provides an alternative model which allows for both symmetric and asymmetric blocs and shows that in general there is no necessary relationship between the number of blocs and welfare. To illustrate his point, suppose there are two goods, 1 and 2, and labour is the only factor of production. Assume there are two identical countries with comparative advantage in good 1 and another two identical countries having a comparative advantage in good 2. Then if we divide the world into two blocs each consisting of two identical countries, welfare will be below the level attained under free trade. By contrast, if two blocs are formed by including one country of each type in each bloc, the outcome coincides with free trade without any trade between the blocs. Indeed we can form anywhere between 1 and n blocs with each bloc having half of the countries of one type and half of the other type and the outcome will coincide with the free-trade equilibrium. There is no necessary relationship between the number of blocs and welfare: the same number of blocs may yield different levels of welfare and different numbers of blocs may be associated with the same level of welfare. Drawing upon the work of Deardorff and Stern, Ronald Jones makes a similar point in his Discussion.

Results of his elegant model notwithstanding, Krugman admits that the real world is not symmetric and that, in practice, countries engaging in free-trade agreements have more in common with one another than with other countries. These countries are 'natural' trading partners in that they already trade intensively with each other. Citing evidence provided by Lawrence Summers, he concludes that within North America and within Europe trade is influenced heavily by geographic proximity and that a move to FTAs in these regions is unlikely to reduce welfare. Because intra-trade among countries of these regions is already substantial, trade-creation effects of regional integration are likely to dominate trade-diverting effects. Bhagwati disagrees, and notes that this argument is based on incorrect premises. First, citing Lipsey, he argues that the premise that an FTA is more likely to create trade the larger the ratio of a country's foreign trade with the partner relative to outside countries is incorrect. Second, there is no necessity that geographically proximate countries trade more intensely than distant countries even after we control for economic size. Africa and South Asia export 55 percent of their goods outside their own regions.

From the viewpoint of the world trading system, more critical than static effects are the dynamic time-path implications of the regional approach. Here divisions among economists are even deeper. Summers (1993) argues that the world is likely to move toward global free trade far more rapidly if the number of negotiating parties is reduced to three via bloc formation. Currently, with 105 parties negotiating at the GATT, the free-rider problem makes a substantive agreement unlikely. The flip side of the argument, however, is that large blocs also have greater market power and, in the absence of cooperation, will impose higher tariffs on each other. Taking this latter view, Bhagwati notes that larger countries often tend to be more inward-looking than smaller countries. Once a bloc is large enough, the need to be open to extra-bloc countries is reduced. Bhagwati is also sceptical of the argument, made by regionalists, that the regional approach is quicker and more certain. Depending on the relative power of different interest groups, trading blocs may turn inward over time. Interest groups within the bloc may take the view that the bloc's markets belong to them and resist extra-bloc liberalisation. Illustrative of this is the statement by the EC Commissioner for Foreign Relations Willy de Clerq, quoted by Alan Winters in Chapter 7, 'We are not building a single market in order to turn it over to hungry foreigners'.

Turning to evidence, Bhagwati argues that while the first round of regionalism was essentially a failure except in Europe, the GATT successfully oversaw the dismantling of prewar tariffs in the OECD countries. As for speed, it has taken even the European Community - the best example of regionalism - almost four decades to start talking about a single market. In agriculture, the European Community has ended up becoming an instrument for extending national protection to the regional level.

1.3. Prewar historical experiences

Can we learn something about the relative effectiveness of multilateralism and regionalism in promoting free trade from pre-World War II experiences? In Chapter 4, Douglas Irwin begins by noting that the general endorsement of the multilateral approach in the GATT owes much to the relatively free trade during the second half of the 19th century induced by a network of treaties containing the MFN clause. By the same token, the lukewarm reception for bilateral agreements is deeply influenced by the experience of the interwar period when discriminatory trade blocs and protectionist bilateral arrangements sharply contracted world trade.
After a careful look at history, Irwin finds—rather surprisingly—that the drive for an open trade regime in the late 19th century came from the bilateral Anglo-French commercial treaty of 1860. Britain adopted the unconditional MFN clause so that its tariff reductions to France became automatically available to all its trading partners. France adopted the conditional MFN whereby its tariff reductions were available to any country willing to sign a treaty similar to the Anglo-French treaty with it while the higher tariffs applied to all other nations. Other European states quickly followed suit. To seek lower tariffs for their goods, they concluded agreements with France, Britain, and each other. Thus, a bilateral agreement led to dozens of agreements culminating in the creation of a free multilateral trading system. By 1908, France had MFN agreements with 20 countries, Britain with 46, and Germany with 30.

The regime brought into existence by bilateral treaties ended abruptly in August 1914 with the outbreak of World War I. Trade restrictions of all kinds proliferated. After the end of the war, the progressive bilateralism of the 19th century was abandoned and a number of multilateral conferences were sponsored during 1920s to restore the unconditional MFN first. These were broadly aailure and with the advent of the Depression, a destructive bilateralism emerged. A malfunctioning international monetary system gave rise to the worst kind of bureaucratic control of trade flows. Import quotas, exchange control, and tariffs were used simultaneously to eliminate all bilateral trade imbalances.

From these historical episodes, Irwin concludes that history does not provide a clear guide to policies which lead to a better world trading system. Multilateral cooperation on trade policy is not necessary either for the liberalisation of trade policy or for the prevention of illiberal trade policies. Multilateralism was not a feature of the 19th century, whereas multilateral talks were repeatedly held to no avail in the 1920s and 1930s. Similarly, bilateral trade policies cannot be uniquely praised or condemned. A progressive bilateralism flourished in the 19th century... At the same time, pernicious bilateralism that emerged [in the interwar period]... prompted the bureaucratic allocation of import quotas and foreign exchange to eliminate all bilateral payments imbalances.

1.4 Reforming the rules of the game

Whether good or bad, if regionalism is here to stay, perhaps the most fruitful task for us is to reform the rules of the game in such a way that they complement rather than substitute for the multilateral approach. Three suggestions have been made. First, Bhagwati suggests that regionalism be open-ended, the kind William Brock propagated. Brock, as the United States Trade Representative, had offered an FTA to Egypt and ASEAN at the same time that he offered it to Israel. Indeed, Brock was willing to negotiate an FTA with any government interested in it. In his Round Table Discussion, Cooper makes the same point in a broader context. Recognising that with over 100 contracting parties, the MFN-based multilateral negotiations may well impede rather than foster liberalisation, he suggests reverting to a conditional MFN. This will entail forming clubs with open membership such that any nation willing to adhere to club rules can join but no nation is obliged to do so. Second, Article XXIV of the GATT should be reformed to allow only CUs. Because CUs require a common external tariff (CET) and most countries' tariffs are GATT-bound, this will force each tariff down to the lowest level prevailing in a member country. There will be minimal trade diversion and the overall change will, likely, be towards freer world trade. Finally, the GATT Articles VI and XIX dealing with AD actions and VERs, respectively, should be strengthened. This is necessary to ensure that regional arrangements which start out as trade creating on balance do not become trade diverting ex post. For example, when, in a given industry, the least efficient partner's producers are threatened by a more efficient partner, the former is likely to retaliate by subjecting the most efficient outside suppliers to AD actions or VERs. To minimise this type of trade diversion, Bhagwati suggests tightening the criteria, in Article VI, for employing AD actions and eliminating VERs from Article XIX.

1.5 Can it be done?

In Chapter 3, Michael Finger provides a rather pessimistic view of the GATT's ability to enforce its rules in general, and those in Article XXIV in particular. Despite numerous regional arrangements around the world that violated the basic provisions of Article XXIV, the GATT has not censured a single arrangement as being incompatible with its standards. This casts a shadow of doubt on whether the suggestions for reform mentioned in the previous paragraph can serve any purpose beyond the creation of more unenforceable rules. Discussing Finger, Robert Hudic provides a more optimistic assessment of the contribution of the GATT Articles. He argues that the GATT's ability to regulate governments' decisions after they have been taken is limited because these decisions require extensive bargaining and are difficult to reopen. The GATT's influence on regional arrangements must therefore come during negotiations for regional arrangements. Here, at least in the case of developed-country regional arrangements, EC, EFTA, EEC-EFTA and CUSTA, Hudic finds 'plenty of anecdotal evidence testifying that the diplomats
negotiating each of these agreements were operating under instructions to make maximum efforts to comply with GATT rules. So, there is after all hope that reforming the GATT rules may yield real results.

2. The experience with regional integration

2.1 Intra-regional trade

Regional arrangements fall under two broad categories. First, those that have modest aims at integration and seek only either a preferential trading arrangement (PTA) - lower tariffs on imports from the partners than from the rest of the world - or an FTA - which involves zero tariffs among partners and positive, but not necessarily identical, tariffs with the rest of the world. Second, those that aim at deep integration with either a CU - which imposes a CET by partner countries - or a Common Market as in the single market that is to be established by the European Community with the so-called four freedoms - movements for labour, firms, services, and capital. In any event, whatever the ultimate goal of a regional arrangement, increased intra-regional trade ranks high among the priorities. It is also the yardstick to measure how deep integration actually is.

Table 1.1 displays all the regional arrangements for which the share of intra-regional exports in total exports is at least 4 percent and sustained over time. This is a modest cut-off point. Four facts stand out. First, only five among the many South-South arrangements signed during the 1960s appear in the table, whereas all the arrangements among developed countries qualify for inclusion. Second, among the South-South arrangements, only the CACM registered a noticeable, though temporary, increase in intra-regional exports. Interestingly, from the standpoint of implementation, the CACM was just about the only South-South arrangement which implemented tariff cuts across the board rather than on a piecemeal basis by choosing a list of products exempted from tariff reductions. But even this sharp increase in intra-regional trade was not long-lived as the debt crisis of the 1980s brought back the application of quantitative restrictions (QRs) to improve the balance of payments and contributed to the decline by half in intra-regional trade. Third, in contrast, all North-North arrangements reveal much higher shares of intra-regional exports, with the European Community displaying a particularly large increase in intra-regional trade after the signing of the Treaty of Rome. Finally, there is a sharp difference between the evolution of world trade shares in the North-North and South-South arrangements; the former increased their share in world exports while the latter usually experienced a decline. As explained below, an increase in intra-regional trade accompanied by an increase in world export share is not enough to draw firm conclusions, but at least it suggests that North-North arrangements had an impact on the pattern of trade.
2.2 The ambiguous economics of FTAs

Unfortunately, one cannot go much further with the statistics in Table 1.1. In particular, one cannot infer from an increase in intra-regional exports that the members' welfare has gone up. In Chapter 6, de Melo, Panagariya, and Rodrik explore the conditions under which an FTA is likely to raise members' welfare. Starting with the proverbial three-country, two-good case, they note that if the partners import the same good initially, then they will import it from the non-partner so that an FTA will leave the pattern of trade unchanged. This scenario, where nothing happens with an FTA, explains why the outcome of Table 1.1 for the regional arrangements in Africa in particular. In Chapter 8, Foroutan notes that there is very limited trade potential among Sub-Saharan African (SSA) countries as the bulk of their trade is based on factor endowments. These being similar, there is very little scope for trade, and Foroutan concludes that 'the limited extent of intra-industry trade cannot be attributed to the "failure" of integration schemes, but rather to their ineffectiveness'.

The ambiguity of FTAs starts with the more substantive case where the partners do not import the same good. Then in the simplest case where imports are available at constant costs, the formation of the FTA has two effects: the elimination of a distortion at the border with the partner, and a loss of tariff revenue as the imports are now purchased duty-free from the partner. There is therefore ambiguity for the welfare effect of an FTA, although several common sense propositions can be derived on the conditions under which an FTA is likely to raise rather than lower members' welfare. Perhaps the most relevant case examined by de Melo, Panagariya, and Rodrik is that of designing a welfare-improving FTA in the presence of QRs, a case that prevails in virtually all South-South integration arrangements. In the spirit of Kemp and Wan (1976), they show that if post-FTA trade restrictions leave their trade with the outside world unaffected, the joint welfare of partners improves.

Ambiguity also extends to the comparison of an FTA with unilateral trade liberalisation (UTL). Following up on the discussion in section 2, suppose that the world divides into three trading blocs, each with free trade inside the bloc and high tariffs with the outside world. What should the developing countries outside the blocs do: liberalise unilaterally or join one of the blocs? Clearly, join one of the blocs if the barriers to external trade erected by the blocs are high enough.

2.3 South-South integration

The review of integration efforts in Africa and Latin America in Chapters 8 and 9 reveals that, in general, the treaties sanctioning these arrangements remained a dead letter. More often than not, the treaties were not implemented. And when there was implementation, the terms proved to be too ambitious for the members' limited administrative capacities. It proved extremely difficult to devise equitable compensation schemes that did not nullify the intent of integration in the first place.

A typical example is the ambitious Treaty of Brazzaville that called for the formation of a CU and full monetary integration for the former French Central African countries. In the end, the CET was de facto abandoned, and free trade was extended only to a limited range of industrial products. Worse, as documented by Foroutan, a complex system of compensation schemes was implemented both to compensate for the loss of tariff revenues resulting from intra-regional trade, and for the 'cost' of trade creation. Community-financed development projects were promoted according to complicated formulae that were tailored to the protection needs of the poorest members and the financing was raised through a highly distorting and unpredictable tax (the Taxe de Coopération Régionale). Though compensation was less prevalent in the case of Latin American regional arrangements, Nogués and Quintanilla in Chapter 9 report arbitrariness in the limited implementation of industrial development projects.

In the case of trade integration among members of the Council for Mutual Economic Assistance (CMEA) countries, much more trade occurred than would be suggested by comparative advantage. The welfare losses from trade integration and other forms of cooperation were likely to be larger. In Chapter 10, Josef Brada suggests that trade diversion occurred not only because of considerable differences in resource endowments and levels of development, but also because none of the members (including the Soviet Union) were low-cost suppliers of industrial goods.

Were there any notable successes in these regional arrangements? On purely economic grounds, no. But there was some limited cooperation in the form of joint projects as in the successful Beira project in the Southern African Coordinating conference, and the relative stability brought about by monetary integration in the CFA Franc zone. Yet, these examples of cooperation are few, and it is likely that political and cultural differences as well as the prospects of small benefits from economic integration all contributed to the limited cooperation among South-South arrangements.

In the final analysis, until recently, South-South regional arrangements were used to promote an import-substitution industrialisation strategy. It is now widely accepted that this strategy was the wrong one and that South-South regional arrangements were a contributing factor, even if the scope for diversionary trade was often small. At the same time, they contributed to the distraction of policy thinking from the needed UTL
which would have had large pay-offs since trade restrictions of developed countries were falling.

2.4 North-North Integration

Here, low transport costs, large markets among partners, and the large scope for variety-producing specialisation among partners considerably raised the potential for economic benefits from integration. Furthermore, relatively similar levels of development and within-industry specialisation considerably reduced the need for compensation. This applies as much to the EFTA as to the European Community, both of which fully liberalised trade among partners while simultaneously substantially reducing their overall level of protection through participation in several rounds of multilateral trade negotiations. And when one considers the added benefits from reduced political tensions and the strategic advantages of size in trade negotiations, there is no doubt that North-North integration was immensely successful.

But what would have happened without the 'deep' integration given that multilateralism was pushing the world towards greater market integration? We will never know. However, in Chapter 7, Alan Winters suggests that European Community integration was not an unmitigated success, a view that is strongly challenged by André Sapir in his Discussion. Winters argues that not only did the European Community bring with it the very costly Common Agricultural Policy (CAP) that is now proven to be difficult to dismantle, but that the EC Commission has often 'commodified' its members' restrictive policies, as for instance in the case of VERs on imports of Japanese autos. Also, the European Community has suffered from the 'restaurant bill' problem, as each member has often been successful in having the Commission add its restrictive measure to those that are adopted at the Community level. He also notes that the European Community has been increasing its use of non-tariff barriers relatively more rapidly than other countries. He is also sceptical of the net impact of successive enlargements on the accession countries, as they have had to join a club with existing rules and a tradition of what he calls 'managed liberalisation'. Newcomers could not modify community rules.

In his Discussion, André Sapir reaches diametrically opposite conclusions. To him, European Community integration has been overwhelmingly successful, and he points out that countries like Sweden and Switzerland that did not join the European Community had even more restrictive agricultural policies. He also notes that the second (Southern) enlargement was strongly liberalising for the newcomers, as Greece, Spain, and Portugal all had higher tariffs than the CET.

3 The new regionalism and new initiatives

3.1 Institutional dimensions

The bulk of the literature on regional arrangements has emphasised the effects of adopting preferential tariff concessions. This emphasis reflected the negotiations that were carried out during the first wave of regionalism. Now that world-wide protection has been greatly reduced, the nature of tariff reductions is no longer an overriding concern. Negotiations for "EC 92" dealt with harmonisation of a wide range of policies that would eliminate remaining market segmentation, and much of the discussions in the recently initialed NAFTA agreement concerned establishing common legislation or standards, as in the case of labour and environmental standards. In any event, the second wave of regionalism has an added focus on coordination at the institutional level, as it is increasingly recognised that regional integration goes beyond trade in goods, services, and factors.

The implications of having to adopt common institutions when there is deep integration or when partners with very different institutions integrate—as in the case of NAFTA and the recent Europe Agreements—are explored by de Melo, Panagariya and Rodrik in Chapter 6. Recognising that any regional arrangement worth its name entails the imposition of some common rules of conduct and is often used to commit to desirable policies, they explore within the framework of the rules-versus-discipline literature the channels through which the adoption of regional institutions can alter economic outcomes. They adopt a setup in which non-cooperative lobbies influence policy decisions at the national level. (The assumption of non-cooperation by lobbies across countries is questioned by Ronald Findlay in his Discussion and by Winters in his discussion of the behaviour of lobbies in the European Community.)

Within that non-cooperative setup, they show that a regional arrangement with a larger political community dilutes the role of politically important groups which may enhance economic efficiency, and that if a negotiation of a regional arrangement opens the possibility for setting up a new institutional forum, the resulting greater flexibility in institutional design may also increase economic efficiency. Their analysis also shows that when members have different objectives and preferences, compromise will have an ambiguous effect on economic efficiency, and reaching an agreement will be more difficult. This leads them to conclude that the conditions for meaningful North-South integration were not met until recently because of large differences in objectives. Now, there is evidence of convergence in economic objectives reflected in the greater outward-
orientation of Southern states, suggesting that the road is open for meaningful North–South integration.

3.2 North–South integration

The Europe Agreements signed with Czechoslovakia, Hungary, and Poland, the preferences accorded to the Mediterranean states through the Mediterranean agreements, and the recent US initiatives all involve arrangements between countries with substantially different income per capita levels. In the case of the Mediterranean states, benefits for the Southern states came from preferential market access to the EC market. But in all the other cases, a key perceived benefit was the cementing of recent reforms and economic institutions (including democracy for the East European states).

In Chapter 11, John Whalley analyses the rationale for Mexican integration with the United States. The broader benefits for the Mexicans are difficult to measure since they are mostly institutional: binding the recent trade liberalisation initiatives, and added pressure for sound macroeconomic policies. From a trade perspective, given the low levels of protection for manufactures in both countries, the main benefit for the Mexicans is one of a safe haven in case the world turns into trading blocs, and of less harsh treatment in the case of AD and countervailing duty (CVD) actions initiated by the United States. At the same time, he notes that some components of the agreement, such as the purchase of US automotive parts have the potential for being strongly diversionary as American car manufacturers are seeking high domestic content requirements that would prevent transhipment through Mexico.

Besides the systemic issues raised above in section 2, what are the objectives and benefits for the Northern partners? The objectives are mostly non-economic, so the benefits are harder to evaluate. Whalley and Winters emphasised state that containment of migration is the main objective. Subsidiary objectives are extending the sphere of political influence, and the adoption of institutions by Southern partners (e.g., environmental protection legislation).

Will North–South regional agreements be successful? Although this question is not directly addressed, the chapters in the volume suggest several lessons. First, the new initiatives, unlike the old ones – such as the Lomé convention – are reciprocal so the opportunity for the acceding countries to maintain high protection barriers is avoided. Second, the experience of the European Community shows that the adoption of common rules (institutions) is not easy to achieve. Third, substantial compensation was a key to the success of the second (Southern) EC

enlargement. Compensation turned out to be an unsurmountable barrier for South–South integration. It could still foil the success of new initiatives if the need for some redistribution is not directly addressed.

3.3 New initiatives: Middle East, East Asia and Eastern Europe

Though not yet concretised, new initiatives are on the table in every region of the world. Perhaps the most interesting are those in East Asia, a region that had been spurned from the first wave of regional integration (ASEAN focused mostly on political and security issues). In Chapter 12, Gary Saxonhouse looks into the new initiatives in the region. First, based on econometric estimates, he concludes that there is no evident bias in the pattern of East Asian trade – as for instance there was in the case of CMEA trade. Second, he draws on the results of pricing equations of Japanese firms suggesting the presence of strategic behaviour to argue that there is scope for a beneficial reduction in intra-regional trade barriers. At the same time, the strong opposition from the United States to the recent initiatives around an East Asian Economic Group (EAEK) suggest that perhaps regional cooperation will have more success on a Pacific-wide basis. Nonetheless, Saxonhouse concludes that the rapid growth in intra-regional Asian trade, the revival of ASEAN calling for the establishment of an FTA within fifteen years, and the successful Shenzhen Free Trade Zone between Hong Kong and Guangdong Province in PRC all suggest that there could be trade-creating effects from region-wide liberalisation.

Prospects for regional integration in the Middle East are reviewed by Stanley Fischer in Chapter 13. Here economic attributes of the countries in the region substantially limit the scope for trade-creating effects and Fischer concludes that there is no realistic prospect of Middle East–wide regional integration either on the NAFTA or EC models in the near future. However, even though there is the possibility of free-trade agreements among a subset of countries, any resulting benefits would at most be small. The more promising – but perhaps difficult to achieve – integration would be cooperation in functional areas such as water management, and agreements on the creation of regional infrastructure. Fischer also points out that any regional cooperation would have the added benefit of reducing the region's high level of military expenditures.

In the rapidly changing economic and political scene in Eastern Europe, economic disintegration has considerably blurred any assessment of future prospects. In Chapter 10, Brada argues that, although the collapse of CMEA trade owed more to the illiquidity and collapse of the Soviet economy than to the ending of the CMEA trading system, it is a move in
the right direction. He observes that 'monetary and economic disunion may prove more beneficial than misguided efforts to preserve a domestic market that, in fact, was no market at all'. Alan Gelb and Gábor Oßlath in their Discussion, while agreeing that the move is in the right direction, argue that it is too rapid. They suggest that one should consider temporary measures to arrest the crisis in intra-regional trade during the transition to market-oriented economies.

4 Concluding remarks: the new regionalism and smaller countries

A priori, it is difficult to predict whether the current bilateralism will help the cause of multilateralism as in the second half of the 19th century, or prove pernicious as in the 1920s and 1930s. We can, however, take steps to maximise the benefits and minimise the damage from it. As suggested by Bhagwati and Cooper, a key to preserving the openness of the world trading system while pursuing the regional approach is to ensure that membership of regional arrangements is kept open via the application of a conditional MFN. This is not an easy task and, according to Winters, quite an unrealistic hope. The European Community has not been, and will not be, an open club; expansion of membership will continue to be as carefully 'managed' as in the past. The message then is that regionalism is as likely to be as destructive of an open global trading system as it is likely to be a positive force.

In the meantime, what are the options of smaller countries who do not have a great deal of bargaining power to open the markets for their goods under the auspices of the GATT? As far as South-South integration is concerned, there is no future in it. In the Round Table Discussion, Corden puts it succinctly: 'It is far better for Argentina to go for the world markets - i.e., to liberalise unilaterally and in a non-discriminatory fashion, as she has been doing - than to just go for the Brazilian market. Brazil has the largest economy in the Third World and yet it is smaller than Canada's... And this applies even more to Brazil'.

As regards North-South or North-North integration, the regional approach is likely to be justifiably attractive to small countries; rising uncertainties with respect to the openness of the world trading system will induce them to look to regionalism as an instrument of securing future market access. As Whalley notes, traditionally, small countries have been staunchest advocates of non-discriminatory trade rules. Yet, in the case of CUSTA and NAFTA, it is the smaller countries (i.e., Canada and Mexico) which have been the initiators of regional arrangements. Whalley views this as a vote of no confidence by smaller countries in the present trading system's ability to protect their interest. 'What they have sought have been safe-haven agreements with larger trading powers, seen by them as helping them avoid being side-swiped by protectionist barrier increases by their larger trading partners even if directed at other countries [i.e., United States against Japan, for instance].

NOTE

1 During 1960s, proposals were made to create a North Atlantic Free Trade Area extending all the way to Great Britain, but the United States was quick to reject them.

REFERENCES

