

CHAPTER 8. TRADE BLOCS AND THE REST OF THE WORLD

Introduction

RIAs are, by nature, exclusive clubs. Every country in the world is excluded from nearly every RIA in the world, and every RIA excludes nearly every country. This discrimination against excluded countries is alive and well and causes significant trade diversion – of which we present new empirical evidence – and trade diversion can harm excluded countries (in shorthand, the rest of the world), particularly for large blocs. The extent of that harm depends on how much the RIA diverts trade, and on the structure of the rest of the world's economy in the sectors in which trading patterns are changed. As a rule, trade blocs harm non-members least if they are less trade diverting, liberalize their external trade, and boost global competition by increasing member efficiency and growth.

The other major issue in the intersection between RIA's and the rest of the world is whether or not RIAs are stepping stones toward globally freer trade, or millstones around the neck of progress toward that goal. Many arguments have been advanced for the benign view – e.g. that regionalism stimulates global trade negotiations, that it makes negotiations simpler, that 'open-regionalism' liberalises trade, or that blocs can advance further and faster than global negotiations. However, in truth, the world of many trade blocs is still too new to allow a definitive answer to this question, and much of the evidence shows that advances in multilateral trade negotiations have led – not followed – the formation of trade blocs. Moreover, there are also strong analytical reasons to suggest that regionalism is more likely to undermine than support full free trade, and may increase the chances of trade wars. Finally, this chapter briefly considers the WTO's rules and practices on regionalism. Its rules provide some discipline on the worst kind of trade blocs, but cannot, in the end, prevent members from creating RIAs that harm themselves or others. Moreover, the rules do not fully apply to developing countries and are not enforced very actively anyway. We can not identify rules changes that are both feasible and desirable, but we do urge that current rules be clarified and enforced. We also suggest that more attention be paid to assessing the economic effects rather than just the legal standing of proposed RIAs.

8.1 Trade discrimination is still significant

Trade discrimination against excluded countries commonly causes significant trade diversion. While this diversion is not inevitably harmful to the rest of the world, it will be under two common circumstances: when non-members tax their international trade (e.g., by imposing tariffs), and when their export prices fall as a result of falling demand. Merely examining the value of the rest of the world's exports to the RIA is not sufficient to identify harm. One really needs to consider the rest of the world's imports and the prices paid for them in terms of exports – the terms of trade. Finally, one must examine the difference between the value of a unit of exports and the resources required to produce it.

One might think that after five decades of tariff cuts and two of non-tariff barrier reforms, trade restrictions are so low that they hardly matter. While tariffs of 30% are less distortionary than tariffs of 60%, trade barriers are still high enough to impart a significant bias to international trade. Preferential reductions in these tariffs—RIAs—will further distort trade and probably impose costs; even a discriminatory tariff of 5% can have significant effects on import sourcing if goods are highly substitutable. If discrimination extends to areas such as standards testing and enforcement, or public procurement, trade diversion is likely to be even more significant.

The degree of discrimination arising from an RIA is related to the height of the “normal,” non-preferential, trade barrier – the “most-favored nation” (MFN) barrier – and the proportion of trading partners or trade covered by MFN status.¹ Only about 14% of EU members’ imports pay tariffs.² These imports, which are clearly discriminated against, include some goods from developing countries outside the ACP grouping and non-European industrial countries. Even for manufacturers, the least restricted sector, tariffs range up to 22% for motor vehicles, 18.2% for footwear and 13.4% for clothing. Tariff peaks facing non-preferred exporters are even higher in the United States (up to 25% for motor vehicles, 57% for footwear and 35.3% for apparel), and Japan (10.2%, 48.8%, and 17.8% for the same goods).

Developing country tariffs also remain high enough to distort the tradeoff between home and imported supplies – and between preferred and non-preferred sources of imports. Table 8.1 presents averages and maxima for a series of developing countries and the common external tariffs of some current or planned customs unions. They show significant discrimination against suppliers who do not receive exemptions.

¹ The term “most favoured nation” arises from the long-standing trade diplomacy practice of guaranteeing a partner treatment at least as good as is granted to the most favoured partner. If this extends to all partners, all are treated equally in a non-discriminatory fashion. Universal MFN is the cornerstone of the GATT, the treaty governing trade relations since 1947. But the term “most favored” is now ironic. Almost no country pays tariffs above MFN levels (only North Korea in the EU), and most pay less via the General System of Preferences (GSP), other unilateral preferences, or formal RIAs: only ten countries pay MFN tariffs on all their exports to the EU. All others, except North Korea, receive some sort of preference (Winters 2000).

² After allowing for imports from members, RIA partners, trade under the GSP, and goods with zero MFN tariffs. This is about 40% of the EU’s imports from non-EU sources (Sapir, 1998).

	Average	Maximum
Brazil (1997)	12.2	70
Mexico (1997)	13.4	260
Venezuela (1997)	12.0	35
SACU (1997)	8.7	78
Senegal (1996)	27.0	124
Kenya (1994)	35.1	62
Thailand (1996)	22.8	100
Indonesia (1996)	13.0	200
India (1997)	30.1	260
Mercosur (CET, 2006)	12.0	63
Andean Pact (CET)	12.8 ^a	--
UDEAC (CET, 1995)	18.6	30
UEMOA (1996)	13.2	--

^a weighted tariff from Echeverria (1998).
^b The detail CET is still under negotiation. The reported figure is an estimate from IMF sources

8.2 Trade Diversion and Excluded Countries

The cost of trade diversion has been a recurring theme of this book, usually from the viewpoint of partner countries. Here we examine whether trade diversion could be large enough to harm excluded countries seriously. Trade diversion strictly refers only to the social cost incurred by the importing countries as high cost supplies displace low cost ones. But non-member countries can also lose welfare if their exports are displaced, and not only by policy distortions, but also because member costs have fallen as a result of, say, efficiency-enhancing deep integration. In this section *alone* we interpret diversion as including these latter effects, although, as argued briefly below, such effects should not be subject to international control or redress.

8.2.1 Evidence of Trade Diversion

It used to be fashionable to argue that RIAs that did not actually raise trade barriers and that they caused only very small trade diversion. In the most studied case – the EEC and its various enlargements – trade diversion in manufactures was generally held to be slight (Balassa 1974, Truman 1975, Winters 1987 and Sapir 1992). More recent evidence, however, suggests that diversion can be significant, even when regional integration is accompanied by external liberalization.

Bayoumi and Eichengreen (1997) find that the formation of the EEC reduced the annual growth of member trade with other industrial countries by 1.7 percentage points, with the major attenuation occurring over 1959-61, just as preferences started to bite. Cumulating the decline in growth over 1957-73, and noting that total EU imports from the rest of the world were \$83.1 billion in 1973, puts the latter's lost exports at \$24 billion in that year. The formation of EFTA had similar, if smaller, effects. Frankel and Wei (1997) find that trade diversion had, by 1990, largely erased the EEC's tendency to trade unusually heavily with the rest of the world, while Sapir (1997) finds that, over 1960-72, "EFTA exports to the EC suffer[ed] from their non-preferential status," as did other European non-member countries' exports in later periods. Our own analysis, which focuses on 1980-96, finds evidence of trade diversion from the deepening of the EC and EFTA and possibly from the formation of NAFTA and Mercosur (Soloaga and Winters, 2001, Yeats, 1998) - see chapter 2 above.

NAFTA is too recent and too much confounded by the 1994 devaluation of the peso to allow a firm identification of trade diversion, but there is indicative evidence at the sectoral level. Mexico increased tariffs on non-NAFTA imports of clothing from 20% to 35% in March 1995, just as it was reducing those on NAFTA imports. US exports to Mexico increased by 47% in value terms between 1994 and 1996, while those from the rest of the world fell by 66%. The explanation for a large part of this is probably not the tariff *per se*, but the combination of the devaluation, which made assembly in Mexico very competitive, and NAFTA's rules of origin that strongly encouraged Mexican manufacturers to use US clothing parts. In the US market, imports of clothing and finished textiles from Mexico increased by 91% and from Canada by 93% over 1993-96, as they were exempted from higher tariffs and from import quotas. Imports from Asia fell. The US International Trade Commission (1997) views these changes as evidence of trade diversion.

8.2.2 Diversion can hurt the rest of the world

Previous chapters have shown that trade diversion is directly harmful to RIA members that suffer it. Diversion also has an immediate and direct effect on the exports of the rest of the world – they fall. This is frequently taken as sufficient evidence of harm, for in the traditions of trade diplomacy and the GATT, exports are "good" and imports "bad." If we are interested in economic welfare, however, we cannot draw this conclusion so readily. Indeed, if everything else – including imports – were held constant, a reduction in a country's exports would improve its economic welfare, because the goods – or the resources used to produce them – could be redirected to the domestic market!

Of course, we cannot hold everything else constant: the rest of the world's loss of exports reduces its ability to buy imports. The losses its consumers face as they cut back on imports must be balanced against their gains from consuming the resources that were to be exported. In three situations these components will not be perfectly offsetting. First, market distortions may mean that a dollar spent on imports confers more welfare than can be produced by diverting to local consumption the resources required to produce a dollar's worth of exports. Second, lower demand from the RIA may drive down the price of the rest of the world's exports – so that the rest of the world loses purchasing power and welfare because each remaining unit of exports buys fewer imports. It is the change

in the relative prices of the rest of the world's exports and imports – its terms of trade – that matters, not the loss of exports *per se*, and it is this that should be the focus of investigation.³ Third, if the loss of exports is non-marginal, some of the benefits of specialization itself will be lost.

8.2.3 Exports might be worth more than they cost

If a unit of exports generates more welfare than would alternative uses of the resources taken to produce it, losing exports is costly. For each unit of exports lost, real income will fall by the difference in the value of the exports – the imports that they buy – and their value in the domestic economy.⁴ This will happen if exporting generates super-normal profits because export markets are imperfectly competitive. Those profits will be lost on any trade that is diverted and cannot be replaced by alternative sales at the same price. Industries with economies of scale are in a similar position. If the creation of an RIA causes industry in the rest of the world to lose scale economies, the cost of all its output increases, imposing costs on other consumers of its output, and reducing its profit margins. This is the story behind predictions (e.g. by Haaland and Norman, 1992) that EFTA would lose significantly from the EU's Single Market Programme.

A major potential wedge between the value and the cost of exports is export taxes. Under perfect competition, the price of a unit of exports equals the returns to the factors used in producing it (including entrepreneurship) plus any taxes imposed. If the export is lost – and not replaced – only the former is recouped. Explicit export taxes are relatively rare these days,⁵ but implicit taxes abound. Most importantly, import taxes (tariffs) actually tax exports.⁶ If an RIA cuts an excluded country's total exports this eventually implies a cut in imports. If these imports are worth more than they cost, because they pay taxes, welfare is lost as they fall. Similar arguments apply to other implicit export taxes, such as excise taxes on inputs, excessive fees for international communications services, or an overvalued currency. With average tariffs exceeding 10% in most developing countries, real income losses equivalent to over 10% of the value of the diverted trade will be common. Trade diversion can also cause losses if exports generate positive externalities. Most relevant, probably, are exports of manufactures, which many observers believe have spill-over effects through training managers and workers, increasing marketing experience and reputation within markets, or improving

³ It is also possible that by improving efficiency or generating economies of scale, the RIA will drive down the prices of its exports – the rest of the world's imports. Then, the rest of the world benefits from the RIA, as Gasiorek, Smith and Venables (1992) predicted for the EU's Single Market Program and Flores (1997) for Mercosur.

⁴ This, of course, refers to *total* exports – if exports diverted from the RIA can be sold elsewhere at the same price, no damage is done.

⁵ Besides, one feels uneasy criticizing an RIA because it reduces an exporter's ability to levy taxes on members' imports.

⁶ Import taxes allow domestic producers to raise their prices and, thus, to bid resources away from exporters. Alternatively, think of trade as the process of swapping exports for imports: if the government requires 10% of the imports to be turned over to it as tax, the effect is the same as if it requires 10% of the exports to be turned over. Trade is discouraged and both exports and imports fall.

technological know-how in general. The evidence in favor of such externalities is mixed, (Aitken and Harrison, 1994), but if they do exist exports are worth more than the revenue they generate, and their loss is correspondingly socially harmful.

A related argument views production and employment as valuable in themselves, and holds that trade diversion reduces them. To be true, this requires both that the diverted exports cannot be replaced by other exports and that the resources released as total exports fall cannot be re-employed. Under these circumstances trade diversion causes losses, but one really needs to know why the resources cannot be employed elsewhere. Setting aside transitional unemployment as workers seek new jobs, which is real enough but limited in duration, it is not clear why aggregate employment depends on the level of exports. And if it does, is the problem the RIA's trade diversion – or the rest of the world's labor market rigidities?

8.2.4 Large RIAs worsen non-members' terms of traders

Large RIAs have an additional effect. The effect of an RIA on the prices at which the rest of the world's firms can sell their products depends largely on its size. Small RIAs will rarely matter, as they almost never affect the prices at which trade occurs. But some RIAs – the EU or, potentially, the FTAA – are large enough to affect world prices. Their behavior has implications for everyone in the market – positive for buyers if the price falls, and negative for sellers – whether or not they deal with the RIA itself. The significance of price changes is that they affect not only marginal trade, but the whole volume of existing trade (Chapter 2). If a shock means that exporters have to drop their prices to sell the last 1% of exports to member countries, this is a small misfortune if it is only that 1% that carries the lower price. But if they cannot discriminate between buyers, they have to drop the price on all sales – a pure loss on the first 99%.

It is more common, perhaps, for goods to be differentiated by place of production, and for different markets to be segmented. Here exporters face downward-sloping demand curves in each of their markets: they have to reduce prices to sell more units. Lower demand from the RIA market puts downward pressure on the prices of their sales in the RIA; this leads to a combination of exports being reoriented to other markets and resources switched to producing other goods. If the RIA takes a large proportion of the output of the affected goods, and if the goods account for a large share of total output, the price reductions could be significant for rest of the world suppliers: greatest on their sales in the RIA, next in other markets for the affected exports, but present in markets for all other goods. Whichever of these applies, factors of production in the exporting country earn less – their income falls.

Despite being central to the theoretical literature for over a century, the terms of trade effects of commercial policies have been almost entirely neglected by empirical economists. It has been identified by CGE modellers - for example, Gasiorek, Smith and Venables (1992) and Scollay and Gilbert (2001). The latter model many of the putative RIAs in the Asia-Pacific region and find that non-members typically lose - see table 8.2.

Table 8.2 Estimates of Possible Welfare Effects of Certain Asia-Pacific FTAs (% of real GDP)

RIA	Welfare effect for members	Welfare effect for non-members	Welfare effect for World
FTAA	0.08	- 0.02	0.01
APEC Preferences	0.58	- 0.12	0.27
Japan - Korea - China	0.50	- 0.03	0.09
Japan - Chile	- 0.03	0.00	- 0.01
Japan - Canada	- 0.02	- 0.01	- 0.01
AFTA - CER	0.44	- 0.01	0.00

Source: Scollay and Gilbert (2001)

Turning to genuine empirical work exploring actual outcomes, among twentieth century publications, we cannot identify even a single empirical ex-post study of regional integration that focuses on price effects.⁷ Recent research in the World Bank has started to fill this lacuna.

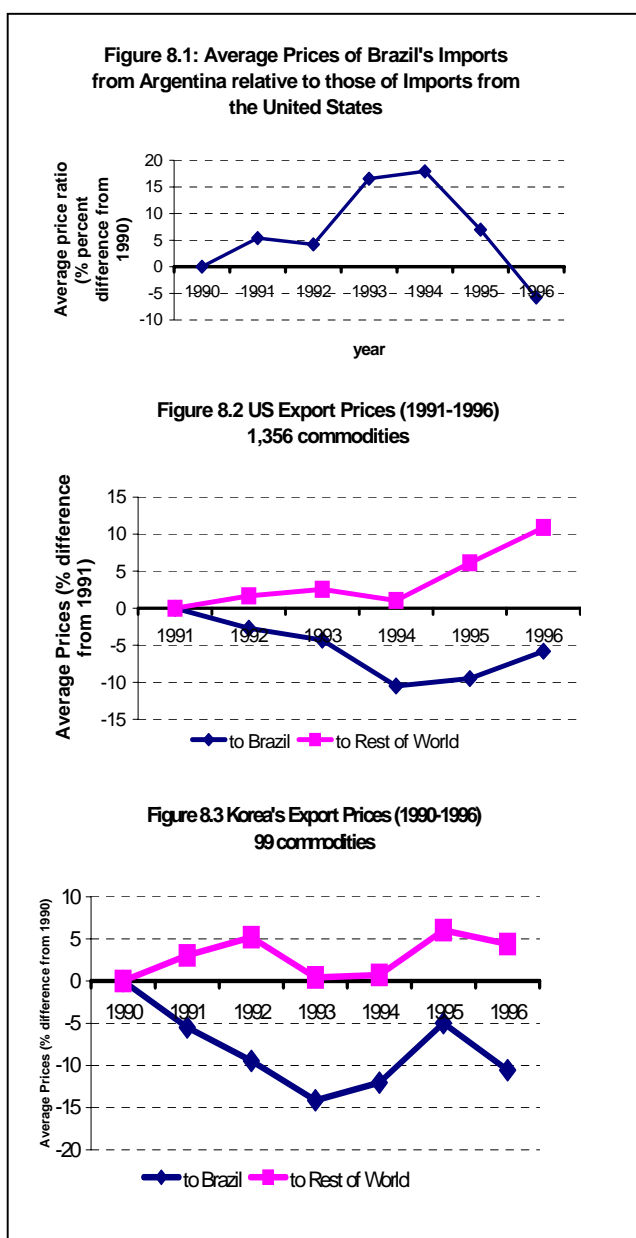
First, an example of “large market” effects with small export volumes is sales of live cattle in South America (Gupta and Schiff, 1997). Cattle are not easily transported within developing countries and are subject to rigorous veterinary regulations in most developed countries. Hence Latin America represents a natural regional market. In 1966-68, prior to the 1969 formation of the Andean Pact, Peru imported mainly from Argentina but also from Colombia (Table 8.3) and accounted for about 30% of Argentine cattle exports. By 1970, the situation was reversed with the member supplier, Colombia, displacing the non-member.

Table 8.3 Peru’s Cattle Imports and the Andean Pact

	1966-68 “Before”	1970-72 “After”
Imports from (000 metric tons)		
Argentina	32	1
Colombia	7	27
Total Imports	#	#
Premium on exports to Peru (%)		
Argentina	7	4
Colombia	-3	2

⁷ The common approach to measuring the effects of RIAs on non-members, is to consider changes in the rest of the world’s exports, which, as we have argued above, is, at best, an indirect approach to the rest of the world’s welfare.

While quantities do not necessarily indicate welfare effects, these shifts also led to price changes. Before the Andean Pact, Argentine exporters prices were 7% higher per unit in Peru than elsewhere. After the pact, this premium fell to 4%. For Colombia the change in premia on sales to Peru was in the opposite direction. In all, the loss to Argentina amounted to perhaps \$700,000 – not huge even at 1966 prices, unless you are an Argentine cattle exporter – but it illustrates that even a small RIA can have negative effects for neighbors in segmented markets.



Second, Brazil's membership in Mercosur has been accompanied by a significant decline in the relative prices of imports from non-partner countries (Chang and Winters, (2002). Figure 8.1 reports the relative price of Brazil's imports from Argentina relative to those of imports from the US averaged (unweighted) over the 323 products that Brazil imports from both in every year over 1990-96. While both price averages fell – presumably due to Brazilian macroeconomic conditions – US prices fell by much more as Mercosur came into operation. Formal econometric estimates suggest that these changes in relative price are substantially due to the differences in tariffs on the two suppliers. Similar results appear for comparisons between Argentine and developing-country export prices (Chile, Korea and Mexico), although the set of goods exported by both countries is very much smaller, making the estimates less precise.

Theory suggests that Mercosur will increase Argentine (member) prices and decrease US (non-member) prices; the results above are consistent with this view, but do not prove it. Winters and Chang, therefore, also compared non-member's export prices to the Brazilian (Mercosur) market with those to non-Mercosur markets. If exporters can charge different prices in different markets, we can take export prices to non-Mercosur markets (which are many, and collectively much more important than Mercosur markets) as a norm. Changes in the relative prices of exports to Brazil and elsewhere then reflect Brazil-specific factors, including Mercosur. Figure 8.2 plots the prices of the United States exports to Brazil and to the non-Mercosur world averaged over the set of products exported to both markets in all years. It clearly demonstrates that while non-Mercosur prices rose, those to Brazil declined quite sharply as Mercosur preferences were phased in. Figure 8.3 reports the same information for Korean exporters.

The figures are startling, but, of course, other things may have happened to Brazil besides joining Mercosur. However, Chang and Winters find that, even after allowing for costs, exchange rates, inflation and MFN tariffs, the relative prices of non-member exports to Brazil and elsewhere are significantly related to Brazil's tariffs on Mercosur members. Where Argentina also exports to Brazil, US suppliers appear to reduce their export prices to Brazil relative to non-Mercosur markets, by slightly over one fifth of the reduction in internal tariffs and other exporters by a bit more.

Schiff and Chang (forthcoming) find similar but stronger price effects. Using the same data, they distinguish between products that Argentina exports to Brazil and those it does not. For the former, they confirm Chang and Winters' results qualitatively, using somewhat different criteria to define market presence. For the latter, i.e. goods that Argentina does not currently supply, they distinguish between those which Argentina exports to no country and those which it exports to markets other than Brazil, and thus for which Argentina represents 'potential competition' to US exporters. In the first case Mercosur has no effect on US export prices, whereas in the second, Schiff and Chang find results similar to those of Chang and Winters. It is worth noting that the price changes recorded here benefit Brazil and, almost certainly, Argentina, at the expense of excluded countries. Whether the gains outweigh the losses globally depends on details of the model - specifically the nature of costs and competition - that the papers do not explore directly. The theoretical model used to motivate the empirical estimates would suggest overall gains, but other underpinnings for the same estimates would suggest the contrary. In other words, even the threat of entry by the preferred partner imposes costs on non-members. On the other hand, both Chang and Winters, and Schiff and Chang, have found that Brazil's MFN liberalization raises excluded countries' relative prices in Brazil's market. The former, however, find these effects much weaker than the adverse preferential ones.

Finally, Box 8.1 illustrates the major problems that small economies can have if their major market joins or deepens an RIA – in this case EFTA and EC-1992.

Box 8.1 Trade Diversion and Investment Switching

In the late 1980s, the five continental EFTA countries were very heavily dependent on the EU (then called the EC) market. On average, they exported 35% of GDP and 53% of their exports went to the EC – roughly 18% of income was generated directly from sales to the EC.

The EC's Single Market Programme was designed to integrate EC markets and, through increasing competition and exploiting economies of scale, raise the efficiency of EC producers (see sections 2.5 and 2.6 above). This was a direct threat to EFTA producers, especially in the sectors likely to be most affected – where the EC market was most fragmented and imperfectly competitive and thus had the most room for improvement. These were the skill-intensive engineering sectors which, because they were also imperfectly competitive in EFTA, were the sectors generating the largest labor rents and profits in EFTA members. Estimates – probably rather conservative – suggested that EFTA output in some of these sectors would fall by over 5% and GNP by nearly 0.5% as the SMP proceeded (Haaland and Norman, 1992). Shifts in investment around this time made these predictions look only too plausible. More or less as the SMP was announced every EFTA country suffered a decline in FDI inflows and an increase in outflows. These changes reversed themselves only as the European Economic Area (EEA) or full accession to the EC was embraced (Baldwin, Farslid and Haaland, 1996).

Although analysts reckoned that many excluded countries would benefit from the SMP as EC demand for their exports increased and EC export prices fell (Gasiorek, Smith and Venables, 1992), in EFTA these benefits were swamped by production losses just noted. The solution for the EFTA countries was to join the SMP and benefit themselves from the large, more efficient market. This was predicted to turn the GDP loss of 0.5 % into a gain of nearly 3%. As this is what they did, through the EEA (and eventual full accession), we never observed the costs of their being excluded. However, both the fact that they did so and the observed switches in investment flows suggest that the threats were perceived to be serious (Haaland and Norman 1992).

One of the main fears of excluded countries is that a newly formed or deepened RIA will absorb investment that they might otherwise receive. Regional integration frequently leads to temporary investment booms within an RIA; if there is a finite set of investment opportunities or a finite volume of investable funds, it is not unreasonable to fear some switching between recipients. We have not, however, found hard evidence that investment or FDI inflows have fallen in excluded countries as a result of RIA creation.

EC-92 and EFTA provide probably the strongest test of losses due to investment switching. The expected shock was large, and given that investment is forward looking, actual investment is likely to respond to these expectations. FDI fell in every EFTA country after the SMP was announced, and recovered only as these countries signed into the EEA or committed to accession to the EU (Baldwin, Forslid and Haaland, 1996). Unfortunately, however, while the cited study is suggestive, it offered no formal ex-post analysis of the situation, and so it is possible that this reflected cyclical factors rather than a structural effect.

8.3 The Road to Multilateralism: Are RIAs Stepping stones or Mill-stones?

This section switches the focus from the immediate consequences of regionalism for non-member welfare to whether it sets up forces that encourage or discourage evolution toward globally freer trade. Given the difficulties in understanding the dynamics of any reform, it is hardly surprising that there are no categorical answers yet. Chapter 3 showed that RIAs can be set up in ways that promote liberalism internally. The systemic aspects considered here, however, are less optimistically balanced. Most of the plausible systemic arguments suggest that regionalism will tend to undermine multilateralism. Even those that do not, tend to suggest that, even if regionalism helps to reduce levels of protection, it does so in ways that increase the chances of fragmenting the world economy into warring blocs.

The stakes in the bet as to whether RIAs are stepping stones to multilateral trade liberalization or millstones around its neck are truly huge.⁸ Opening trade and increasing competition have been part of virtually every sustained economic growth experience, and the unprecedented post-war growth of world output and income have clearly been allied to these factors. Moreover, systemic effects affect everybody, even bystanders. This is particularly important for small and medium-sized economies, which depend heavily on international trade and are the principal beneficiaries of an orderly and non-discriminatory trading regime.

While economists have built many theoretical models of RIAs and the world trading system, few have generated testable predictions about observable phenomena, still less, measurable ones. Moreover, even if we had testable predictions, we have very little to test them on. Few RIAs have been sufficiently effective and long-lived to allow us to draw empirical conclusions, and a world of “many” RIAs is a recent phenomenon. This has two implications. First, although we need to make all the use of empirical information that we can, ultimately, we have to rely quite heavily on *a priori* reasoning. Second, the question about regionalism and multilateral trade concerns the future, not the past. The four decades to 1986 saw remarkable progress in liberalizing trade in industrial goods multilaterally, but there was little effective regionalism. The last decade and a half has seen, in addition to continuing progress on industrial goods, a start made on agriculture and services and a huge reversal in developing country rhetoric about and practice of trade policy. This has been accompanied by a growth of regionalism, but, at least in a temporal sense, could not have been caused by it.⁹ The question for this section

⁸ Loosely, multilateral trade liberalization means nearly all countries reducing barriers on imports from nearly all partners.

⁹ Some theorists have argued, albeit in very particular models, that regionalism has sprung from the success of multilateralism. For example, Ethier (1998a,b) assumes that as the world economy liberalizes the incentive for any individual developing country to do so increases. He sees RIAs as the preferred modality for this liberalization because compared to non-discriminatory opening they appear to allow greater confidence that FDI inflows will follow reform. Freund (##) argues that as MFN tariffs come down, RIAs become easier to sustain (in a sense defined below) and trade diversion becomes less costly relative to the benefits of increased competition.

is precisely what this burst of regionalism (and any continuation of it) implies for future multilateral trade liberalization.¹⁰

Regionalism affects the progress of multilateral trade liberalization through a mixture of changing the internal incentives for trade liberalization, affecting the way in which RIA members interact, and changing the interactions between RIAs and the rest of the world. Chapter 3 dealt with the first two, noting, *inter alia*, the danger that producer lobbies can drive RIAs toward trade diversion and the beneficial dynamic that trade-creating RIAs might have in reducing protection. This section considers the interactions between members and non-members, including discussions of “domino regionalism,” multilateral trade negotiations, and “open regionalism.” Three types of argument are made. First, the behavior of the major blocs – the EU, NAFTA, APEC – will affect the multilateral system in ways that are basically exogenous for developing countries. All that the latter can do is to try to seek to influence that behavior – perhaps via international institutions – and prepare for its consequences. Second, RIAs (including their own) may affect the behavior of developing countries themselves, altering their own propensities for non-discriminatory liberalization and their willingness to support and protect the multilateral system. If enough developing countries are affected, this too will have systemic effects, in which case developing countries must themselves take some direct responsibility for the consequences of regionalism. Third, regionalism could also affect the *processes* of multilateralism as well as the outcomes (see Subsection 8.3.2).

It might seem that asking whether regionalism could reverse multilateral trade liberalization is merely an intellectual indulgence. After all, do not the WTO rules governing RIAs expressly forbid them to increase in trade barriers? For several reasons, this view is too simplistic.

For many developing countries there is a wide gulf between their actual (applied) tariffs and the maxima committed to in their formal bindings in the WTO. For example, when Mexico nearly doubled tariffs on 503 import items from non-NAFTA sources in 1995, it did so without violating any bindings. WTO rules are ambiguous and poorly enforced. A determined government can make trade policy more restrictive in ways more or less immune to WTO disciplines—say, through anti-dumping actions or health regulations. In a world edging toward general trade liberalization, any deceleration in that process is equivalent to an increase in protection relative to the original path.

Box 8.2 Stepping stones or Mill-stones? – A Summary

At first blush, regionalism looks like an important step on the road to global free trade. The recent explosion in RIAs (see, for example, Figure 1.1 on page ## above) has, after all, gone hand in hand with the greatest multilateral trade liberalization in history. But despite the large number of RIAs in the world, most are too recent, too incomplete, or too idiosyncratic to provide conclusions about a world of many RIAs, and there is little empirical evidence about the effects of regionalism on the world trading system.

¹⁰ On a broad historical canvas, of course, regionalism – which goes back to at least 1815 – pre-dates multilateralism. But the current trading system based on the GATT arose in 1947 from other forces and pre-dated significant regional arrangements between independent powers by at least a few years.

Even though regionalism and non-discriminatory trade liberalization have proceeded together over the last decade, especially in Latin America, the little evidence we have suggests that multilateral opening has led the way, and trade blocs have followed. Many countries have reformed their trade well before they joined RIAs: Mexico, Argentina, Brazil, and Turkey are salient examples (Foroutan, 1998). Many African RIA members, and some in Latin America, have not reformed. And plenty of countries have reformed without joining RIAs: Chile (in the 1970s and 1980s), Korea, Indonesia.

There is also some question as to the degree of openness that trade blocs foster. Relatively few RIAs advance significantly beyond the WTO obligation its members have taken on in difficult areas such as agriculture, services, or controlling anti-dumping actions.

The perception that the existence of trade blocs makes global liberalization easier to achieve because it reduces the number of negotiating parties is also open to question. Blocs may well find it just as difficult to achieve internal agreement – while their combined size will make it easier for them to resist global pressures to liberalise as well as grant them power to force others to liberalise. Recall the difficulty the EU has had in negotiating in previous GATT rounds – and its long obstinacy in opening up its agricultural sector.

8.3.1 Procedural Multilateralism

This section is mainly concerned with outcomes: progress toward multilateral free trade. But one also needs to ask about multilateral processes and behavior – the “ism” bit. “Multilateralism” is a much used, but little defined, term. In one attempt at precision, Ruggie (1992) sees it as a deep organizing principle of post-war international life with three defining characteristics:

- Indivisibility – the system is a whole in that the actions of one party affect all parties and each party acknowledges its allegiance to the single whole;
- Generalized rules of conduct – interactions between parties are governed by widely recognized general principles, rather than ad hoc or particularistic interests;
- Diffuse reciprocity – all parties expect to gain from the system, but do not demand precise reciprocity from every separate transaction.

The translation of these principles into concrete form in the international trading system is pretty straightforward. It is indivisible in that it permits an extremely dense and far-reaching network of trade links and of intergovernmental contacts and is viewed as having an existence separate from all the individual trade links between participants. Moreover, its separate existence is seen as valuable. The trading system’s most obvious generalized norm is non-discrimination, one element of which (MFN) immediately and automatically extends bilateral agreements to all members. Reciprocity is diffuse in that governments do accept individual actions that appear not to be in their immediate

interests, but it is generally accepted that, overall, every country has to gain from the system.

Under these criteria regionalism clearly undermines multilateralism, as it defies MFN. It is also divisive, as it exacerbates tendencies for parties to focus more strongly on some links than others. One defense is that regionalism is subject to generalized rules that all have agreed, and that indivisibility should not preclude having some links stronger than others. The former merely recognizes that the world trading system is imperfectly multilateral, while in practice the latter depends on whether governments shift their focus from general to particular trade relations. Since RIAs certainly shift foci to some degree, regionalism does corrode the multilateralism of the global trading system, if only mildly at present.

Since the multilateralism of the trading system is part of a broader multilateral order encompassing areas such as security, money, and the environment, it is conceivable that regionalism could have a broader effect on multilateralism. At present this does not seem to be a problem, but if trading frictions between, or about, trading blocs grew more strident, more than just trade could be at stake, as for example, with the break up of the EAC in the 1970s.

8.3.2 RIAs Can increase negotiating power

Many RIAs explicitly aim to increase the negotiating power of their members on the world scene. In CUs, where trade policy is common, the scope for enhancing negotiating power by coordinating the positions of several countries seems obvious. Coordination in trade negotiations is open to any set of countries, of course, but having a formal RIA makes it easier and more credible. We argue that this coordination could slow down multilateral liberalization, or even lead to increases in protection.

In 1991, Paul Krugman (1991) famously suggested that the worst number of (equal-sized) RIAs for world welfare was three! With fewer, larger, blocs, more trade is tariff free (which is beneficial), but there is more trade diversion and blocs have greater bargaining power and so raise their tariffs against each other (both of which are harmful). Obviously a single bloc is best, because it gives global free trade, but for small numbers of blocs, diversion and competitive tariff setting outweigh the benefits of intra-bloc free trade.

In fact, Krugman's result has turned out to be very fragile. While he analyzed only CUs, most RIAs are FTAs, in which members maintain their own external tariff regimes. FTA members have two good reasons for lowering their tariffs on non-members as the FTA expands: first, to reduce trade diversion and second, to compete to capture tariff revenue and boost their competitiveness by reducing tariffs relative to their partners (Section 3.4).

Also, we should recognize that countries interact more or less continuously on trade issues, and that each interaction influences those that come after it. This opens the possibility that current cooperation can be maintained by the threat of future punishment. In this context, a trade agreement is sustainable if, for each party, the value of the stream of benefits expected to arise from keeping the agreement exceeds that of the stream

arising from breaking it. Breaking it would entail choosing a policy that maximizes immediate welfare followed by a period of punishment.

This tradeoff depends on three sets of factors: first, the rate at which the future is discounted, because cheating (raising your tariff) entails higher immediate payoffs followed by lower payoffs during the punishment phase. The higher the rate of discount – the lower the relative weight placed on the future – the more likely a country is to cheat. Second, the probabilities that cheating will be punished (and how and for how long) and that cooperation will be rewarded (that the other party will not cheat, and the agreement will not be overturned by some exogenous shock). And, third, trading arrangements, such as RIAs, which affect the volumes and patterns of trade. The lower the tariff in a trade agreement, the greater the (immediate) benefits of cheating (raising your own tariffs unilaterally), and thus the stronger (more costly) the punishment needed to make it sustainable. That is, stronger punishment allows more cooperative behavior, i.e., lower tariffs in the agreement. This framework allows us to ask directly and simply whether, by changing the various incentives, regionalism fosters lower or higher tariffs on the rest of the world.

Bond and Syropoulos (1996) suggest that, starting from world-wide free trade, introducing RIAs and then allowing them to expand creates two countervailing forces: the incentive to cheat grows, but so too does the welfare loss in the resulting trade war. In their model, the former dominates, with the result that it is more difficult to maintain free trade in a bloc-ridden world, and that the minimum tariff that can be supported by this kind of cooperation increases as bloc size increases. In short, regionalism increases the pressures for protectionism.

The discount rate is crucial in the operation of these so-called trigger strategies because it trades off the immediate benefits of cheating against the eventual costs of trade war. This raises the question of the time scale over which these games are played. In terms of individual tariffs and tariff wars, the period required for retaliation is so short that there are hardly any gains to cheating. Thus, discipline seems virtually complete and the model suggests that nothing much affects the cooperative outcome.

It is, however, more plausible to view regimes as the instruments, the GATT rounds as the natural periodicity, and policies (such as the zeal with which anti-dumping policies are applied and the use of health and technical regulations) as the weapons. Then the periods required to recognize defection and retaliate become much longer. The important effect of regionalism is not on the “tactics” of trade policy, but on the “strategy.” RIAs will tend to reduce the incentive to take a world view of the broad trends of trade policy because intra-bloc trade is seen as a substitute for trade with the rest of the world. The danger is that countries in RIAs will be less willing to sustain liberal regimes. Box 8.3, which explores the issue empirically, suggests that regionalism is accompanied by neither an immediate retreat into – nor retreat from – protectionism, but rather that multilateral liberalization has tended to lead regional liberalization.

Bond, Syropoulos and Winters (2001) use a similar framework to consider the deepening of an existing regional arrangement. They observe that, as the bloc deepens, its

trade with the rest of the world tends to decline. The excluded countries then find the original agreement unattractive, and will initiate tariff increases unless the bloc

Box 8.3 Regionalism and Protection

Theory cannot determine whether RIAs will increase their protection against non-members. This box discusses one attempt to settle the matter by direct empirical observation of the behavior of blocs (Foroutan, 1998). While most empirical work necessarily considers particular case studies, this study takes a cross-developing-country approach.

As noted previously, nearly every country is in or is discussing an RIA, which makes it difficult to devise a comparator group for members of RIAs. Foroutan first exploits the fact that in the past not every country was a member, and, second, classifies RIAs according to whether they were “effective,” which she defines as having a material effect on the share of intra-bloc trade in the group’s total trade. Comparing members of effective and ineffective blocs sheds some light on the consequences of RIAs for external trade policy.

The attribution is necessarily rough and ready, but effective RIAs among developing countries (up to 1995) are defined as including: CACM (1960-75; and since 1990); Andean Pact (since 1990), Mercosur, UEMOA and SACU, while individual countries affected by their RIA memberships include: Mexico, Israel, Zimbabwe, Kenya and Cameroon. Foroutan then compares these developing countries with those that were not in effective RIAs across three dimensions. (The samples differ across the three exercises below because of data availability.)

Average applied tariffs and NTB coverage. The Latin American RIAs now have among the lowest average tariffs and NTB coverage among developing countries and have achieved the greatest liberalization since the mid-1980s. Except for Chile, the small “non-RIA” group has made much less progress. Until 1994 neither RIA nor non-RIA countries in Africa had displayed much tariff liberalization (NTB data are not available) and using latest available data the mean average tariff is almost the same between the two groups. South Asia has liberalized but remains highly protected, East Asia has always been relatively liberal but now has higher average tariffs than reforming Latin America, and MENA shows no reform and fairly high average protection. The most liberal group in the table is the members of North-South RIAs – Israel, Mexico, and Turkey.

Uruguay Round Concessions. Here the only feasible comparison is between the Latin America “RIA” group and all non-RIA countries. The former group cut its bound tariff by more and bound more of its tariffs in the Round than did the latter, but it also completed the Round with significantly higher bound tariffs.

Openness. Treating $(\text{non-fuel imports} + \text{exports})/\text{GDP}$ as a measure of openness finds the “non-RIA” group displaying the greatest average increases between 1980-84 and 1990-94 (see table). The Latin America “RIA” countries show some increase, but still not to the levels achieved in the 1970s.

Strong trade reform appears to be mostly associated with RIA membership. Can we conclude, therefore, that it is caused by RIA membership? For five reasons we probably should not do so yet. First, a more detailed history shows that much of the trade reform precedes RIA membership: e.g., in Mexico, Argentina, Brazil, and Turkey. Second, at a detailed level, plenty of RIA countries have not reformed (CACM in its early period, Africa) and plenty of non-RIA countries have (Chile, Korea, Indonesia). Thus, general tendencies notwithstanding, there is clearly much more to reform than RIA membership. Third, many of our hypotheses about the effects of RIAs on protection operate only over fairly long time periods, whereas our data cover mostly rather recent integration. Fourth, the general results depend very heavily on Latin America experience. If we believe that other forces were at work in that region, we must be cautious about attributing too much to regionalism. Fifth, the results on actual openness tend in the opposite direction from those on policies.

On the other hand, Foroutan's results certainly refute the simple hypothesis that RIAs necessarily and immediately lead to protectionism and are consistent with the idea that regionalism helps to lock-in previous MFN liberalization. As with so much of this debate, the jury is not so much "still out," but "still listening" as sufficient evidence accumulates waiting for time to provide enough evidence to resolve the issue. Better than waiting, however, would be for RIAs to arrange their policies and institutions to ensure that they actually deliver their liberal promise rather than the opposite.

Source: Foroutan (1998)

	Average Tariffs (%)				Openness (%) ^(b)			
	"RIA" Countries		"non-RIA" Countries		"RIA" Countries		"non-RIA" Countries	
	1981-85	1990-94	1981-85	1990-94	1980-84	1990-94	1980-84	1990-94
Countries in North-South RIAs	20.6	10.2			19	22		
Latin America	31.0	13.8	25.8	15.4	26	30	174	107
Africa	35.6	31.0	30.7	24.4	47	45	40	48
South Asia			59.9	41.8			22	30
East Asia			20.5	15.0			43	68
Middle East/ North Africa			26.3	26.6			40	43

(a):

(b):

reduces its tariffs. The bloc almost certainly prefers to lower its external tariff to getting into a trade war, and so a new lower tariff equilibrium is usually feasible. It is important to note, however, that at this new equilibrium the rest of the world could be worse off than it was before the deepening. It cannot prevent the bloc from deepening its integration, and even though it finds the new equilibrium the best alternative from among the new set of feasible outcomes, this does not imply anything relative to the starting point.

Many commentators see these kinds of negotiating effects arising from the creation of the EEC in 1957. This, they suggest, led directly to the Dillon and Kennedy Rounds of GATT negotiations, as the United States sought to mitigate the EEC's potential for diverting trade (Lawrence 1991, Sapir 1993 and WTO 1995). Although perfectly conceivable, this is not a straightforward argument. First, it seems unlikely that multilateral negotiations would have stopped completely had the EEC not been created, especially given the global reach of the United States during the 1960s. Thus, at most, the EEC affected the timing and extent, but not the existence, of the rounds. Second, agriculture played an important role in the formation of the EEC, and the EEC was probably more successful in resisting that sector's liberalization in the multilateral trade negotiations than its members would have been individually. This has probably made future liberalization more, not less, difficult.

Third, suppose that the hypothesis were true, that the creation of the EEC had led to negotiations. The logic of the argument is essentially coercive: EEC members did something that their trading partners considered harmful, and then offered to mitigate it in return for concessions. Coercion may be warranted and the outcome may have been beneficial, but this is a dangerous game. It depends critically on the willingness of the partners to fold – by negotiating – rather than fight by raising tariffs, and to respond multilaterally rather than regionally. In economists' models such as we have just explored, we can work out the incentive to fold, but in the real world it is not so easy. Fourth, even if co-ercion worked for the EEC, it probably would not for smaller RIAs of developing countries.

It has also been argued that regionalism was behind the Tokyo Round. Winham (1986) reports both the first EEC enlargement (including free trade with EFTA) and the restrictiveness of the Common Agricultural Policy (CAP) as factors in the US desire for a round. The former observation seems no more compelling than those surrounding the creation of the EEC, while the latter is distinctly two-edged: it requires, first, that the CAP induced negotiations and, second, that regionalism increased trade restrictions in agriculture. Again, for this to be advantageous in its net effect on multilateral progress requires a negotiating structure in which might and countervailing power are the critical forces behind liberalization.

Finally, consider the Uruguay Round, of which the WTO (1995) says “there is little doubt that ... the spread of regionalism [was a] major factor in eliciting the concessions needed to conclude” the round. There was, indeed, a perception that the failure of the round would lead to regional fragmentation. This almost certainly encouraged the spread of “defensive” regionalism during the early 1990's, but whether this pressured the two major parties to agree is not clear. After all, they were the prime

“regionalists,” and they would certainly not have been the principal casualties of fragmentation. Some senior EU negotiators have said that the 1993 Seattle APEC Summit induced the EU finally to concede on agriculture and conclude the Uruguay Round (Bergsten 1997). Again this may be true, but there are strong counter-arguments. For example, APEC was not advertised as a discriminatory RIA, and any discrimination would, anyway, have been far in the future. Also, the principal necessary condition for the EU to complete the round was agricultural reform, which was initiated in 1990 and completed in 1992 (Hathaway and Ingco 1996).

These arguments do not inform developing country trade policy directly: no single developing country exerts enough leverage to affect global trade talks. However, developing countries have a vital interest in the world trading system and may be able to influence industrial country behavior indirectly via diplomacy or WTO rules – especially if they act together. One alarming possibility is that regionalism might undermine US or EU willingness to participate actively in the multilateral system.¹¹ Over the last three decades they have been major players, monitoring both smaller countries policies and each other’s. A loss of interest by either would reduce WTO’s overall effectiveness and could upset the current fine balance.

8.3.3 Domino Regionalism

The previous sub-section implicitly assumed that non-member countries could respond to an RIA only by MFN negotiations: a second response is to join the RIA or create a new one. This has been termed “domino regionalism” (Baldwin, 1995, 1997) on the grounds that frequently one act of regional integration stimulates the next because, the larger a bloc, the greater the costs to excluded countries of not belonging to it.¹² Baldwin (1995) coined the phrase “domino regionalism” to describe the process by which, after three decades of resistance, three Scandinavian countries decided to seek EU membership in the late 1980s. Although they were still uncomfortable with the EU politically, the economic pressures from the Single Market Programme were overwhelming, and as one Scandinavian country joined, the pressures on the next increased. The same process occurred when Canada sought access to the US-Mexican talks that eventually created NAFTA, and with several Latin American and Caribbean countries seeking accession to NAFTA afterwards; with Chile and Bolivia seeking association with Mercosur; with Mediterranean and Eastern European countries racing to get Associations Agreements with the EU; and even, perhaps, with a number of late entrants seeking membership in the Cross Border Initiative in Africa. Moreover, when multilateral progress looks less likely, domino regionalism receives a further boost. Post-Seattle, for example, Singapore, a former paragon of non-discrimination, has sought agreements with New Zealand and the USA.

The spread of regionalism is not evidence of its virtue, however: in a regionalized world a country may be better off inside rather than outside an RIA, but this tells us nothing about whether it prefers a regionalized to a non-regionalized world. A graphic

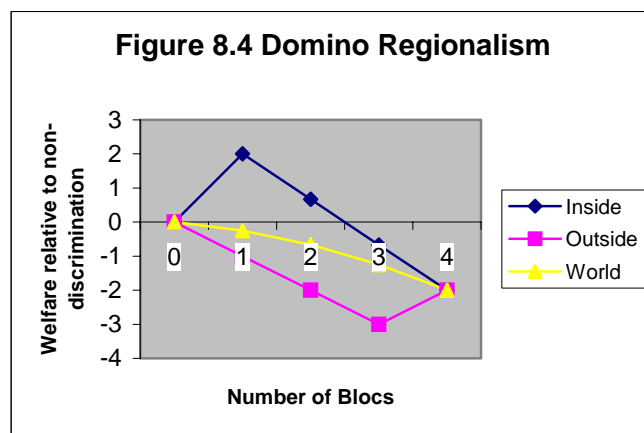
¹¹ Levy (1995) shows theoretically how acquiring fringes of FTA partners could weaken EU and US interest in mutual negotiations.

¹² The concept, although not the name, stretches back at least to ** Hufbauer (1989).

parallel would be that if there is gang warfare in your neighborhood, it may be best to belong to a gang. That does not make gangs a good thing.

A further problem with the view that domino effects necessarily render regionalism benign is that it takes two to tango. Even if excluded countries seek access to an RIA, the existing members may not wish to let them in, at least not without significant down payments (see, for example, Andriamananjara and Schiff, 2001). RIAs tend to turn the terms of trade against non-members, so the optimal bloc size – looking from the inside – is less than the whole world: there needs to be somebody outside to exploit.

Even voluntary regionalism can make everyone worse off. A simple illustrative model of these sorts of effects is shown in Figure 8.4. Frankel (1997) divides a world of many countries up into four continents, with zero trading costs between countries within the same continent and positive costs between continents. Start with each continent practicing MFN trade policy. Any one continent could then improve its welfare by forming an FTA: overseas producers would have to their lower prices to mitigate their loss of competitiveness, and would, as a result, suffer either a decline in income or the loss of part of the FTA market. From here a second continent benefits by creating an RIA, switching a loss of welfare into gain, and thence the third, converting larger losses into smaller ones. Even the fourth gains by creating an RIA, although by then all continents are worse off than under MFN policies. World welfare falls at every stage, but no continent has the incentive to undo the regionalism individually.¹³



Could such processes lead all the way to global free trade? Almost certainly not; again because insiders benefit by turning the terms of trade against outsiders and so seek to prevent unlimited expansion of their blocs. If several roughly equally sized blocs formed, it is possible (not guaranteed) that they would subsequently negotiate with each other to achieve global free trade. However, in most models it is more likely that multiple blocs will be of different sizes and that the final steps to free trade will be vetoed by the

¹³ Frankel's model is not at all robust for small asymmetries in size or changes in parameter values can change the results. However, it is sufficient to demonstrate formally the interaction between RIAs.

larger bloc(s). (Nordstrom (1995) and Campa and Sorenson, 1996). Only if RIAs were somehow obliged to accept any country that wished to join is evolution to global free trade likely, and even then in the course of achieving it, countries may suffer lower welfare than they had under MFN tariffs. Thus the speed and security of the convergence to global free trade would be critical considerations in advocating such “open access” even if it were feasible, which it is not (Box 8.4). Insider resistance to expansion certainly occurs in the real world, although probably less for consciously exploitative reasons than from a general resistance to change and a fear of budgetary consequences. Consider, for example, how long it took the EU to even admit the possibility of Turkish accession, or how tortuous the process of accession has become for the countries of Central and Eastern Europe. Similarly NAFTA has rejected overtures from many countries, and APEC had a moratorium on accession from 1993 to 1996.

Box 8.4 Is Open Access the Key to Benign Regionalism?

It has been suggested both in theoretical models (e.g. Yi, 1996) and policy discussion (e.g., Bhagwati, 1991, Serra, 1997, but dating back at least to Preparatory Meetings for the London Monetary and Economic Conference of 1933), that the key to ensuring that RIAs are stepping stones to multilateralism is “open access:” that any country willing to abide by an RIA’s rules should be guaranteed admission. To date no RIA has offered such unconditional access: most have restricted geographical domains, and even within these domains it is existing members who determine whether applicants meet the conditions. A simple rule of, say, internal free trade or “national treatment for investors” may be objectively assessable, although even then the transition period needs to be negotiated, but anything more – e.g., dispute settlement, excluded sectors or common anti-dumping policy – certainly requires negotiation and hence threatens candidates with delay and veto.

Where an RIA involves few conditions – e.g., the Cross-Border Initiative in East and Southern Africa, in which neither internal preferences nor external tariff harmonization are rigorously enforced – there is little incentive to exclude geographically eligible countries. Indeed, there is perhaps some incentive to include them in the attempt to enhance negotiating power in world trade talks and vis-a-vis international institutions. The result is expansion to include a wide range of different economies.

NAFTA, where the principal rules are completely free trade in goods and open investment, might, on that account, have automatic entry, but it doesn't. Accession is not restricted geographically but is “subject to terms and conditions as may be agreed...” This resistance is probably aimed more at avoiding adjustment in the USA, however, than because other issues such as quotas for professional migration or dispute settlement require negotiation. The EU stands ready to sign Association Agreements with many neighboring countries and with all of the middle-income members of the Africa, Caribbean and Pacific countries – but only on its own terms covering issues such as rules of origin, excluded sectors, the use of anti-dumping duties etc. Mercosur is happy to accept new members, but, given that fairly deep integration is planned, detailed negotiation is required. Association – Chile’s status – is easier, but does not offer full integration and still required several years of talks.

Full membership in the EU is anything but “open access.” The UK had to ask three times, it will take Turkey at least 30 years to get in, and there is no timetable for countries like Ukraine or Georgia. Negotiations are tortuous once accession is agreed in principle. The EU’s “White Paper” on Eastern European Accession was pages long and each of the six first wave candidates faces a formidable list of demands and requirements prior to membership. In several cases they are required to adopt policies from which some existing members are exempt – for example, the Social Chapter of the Maastricht Treaty.

In all the cases listed here accession may be better for non-members than suffering discrimination on the outside, but it may not be better than MFN trade. Thus, since the expansion of RIAs all the way to global free trade is far from assured, one cannot necessarily view successful accessions as stepping stones to multilateralism. Moreover, negotiated accession can lead to asymmetric agreements in which benefits to developing country candidates are reduced and possibly appropriated by existing members via side conditions on issues such as the environment, labor regulations, rules of origin, etc. As the more complex aspects of RIAs – especially those with budgetary implications – *have* to be negotiated, access can never be automatic and unconditional. Hence it seems rather naive to believe that in practice the WTO could write or enforce general rules for open access. While relatively open access – e.g., APEC, which has created a slogan of “Open Regionalism” – might seem less threatening and exploitative than closed access – e.g. NAFTA – one cannot rely on this route to deliver benign regionalism.¹⁴

Most formal analysis of domino regionalism assumes equally sized countries identical in every respect except for the good in which they have comparative advantage. Thus the only significant characteristic of an RIA is its size, rather than which countries comprise it, and there is no issue about how to share the benefits of integration. Once we break free of this assumption, the compatibility of different partners and struggles over distribution start to matter – and greatly complicate the process and analysis of RIA enlargement

Given the different interests of excluded and member countries, what does the evidence show about the domino effect? The first column of Table 8.4, denoted “Strong,” lists nine RIAs that have expanded over time while maintaining the nature of the RIA or strengthening it. Among these are the EU, APEC, the expansion of CUSFTA to NAFTA, and others in Sub-Saharan Africa, Asia, Central and Eastern Europe, and the Caribbean. The second column is denoted “Intermediate” because the expansion is through a weaker form of integration. It shows the EU and MERCOSUR, two customs unions, expanding by forming FTAs, with Mediterranean and Central European countries for the EU, and with Chile and Bolivia for MERCOSUR. Note that MERCOSUR differs from other RIAs in the sense that its members wanted to expand by accepting Chile as a member but Chile

¹⁴ In November 2001 Jim Sutton, Trade Negotiations Minister of New Zealand, one of the champions of ‘Open Regionalism’ stated that it was inconceivable that any bloc would grant totally automatic rights of entry to countries willing to abide by its rules - Fourteenth Pacific Economic Co-operation Council, Hong Kong, 28-30 November 2001.

decided that it was preferable to maintain an independent trade policy and form a FTA with MERCOSUR. Finally, the “No” column lists thirteen RIAs that have not expanded.

The number of RIAs that have expanded is approximately the same as the number of RIAs that have not. However, in terms of size of RIAs, the expanding RIAs strongly dominate. This is exactly what theory would predict: it is the economic power of the bloc - to stimulate efficiency at home and to discriminate against outsiders - that encourages entry. Finally, let us re-iterate, the fact that RIAs expand over time because of a domino effect does not mean that it is necessarily a good thing..

Table 8.4 Domino Regionalism

Strong Expansion	Intermediate Expansion	No Expansion
<p>EU (ex-EC): 1957: BeNeLux, France, Germany, Italy; 1973: Denmark, Ireland, UK; 1981: Greece; 1986: Portugal, Spain; 1995: Austria, Finland, Sweden; and plan to include the CEECs and some Mediterranean island countries.</p> <p>CUSFTA: 1989: Canada, US; becoming NAFTA by including Mexico: 1994; and possible expansion to FTAA.</p> <p>APEC: 1989: Australia, Brunei Darussalam, Canada, Indonesia, Japan, the Republic of Korea, Malaysia, New Zealand, Rep. of the Philippines, Singapore, Thailand, United States; 1991: People’s Republic of China, Taiwan (China), Hong Kong (China); 1993: Mexico, Papua New Guinea; 1994: Chile; 1998: Peru, Russia, Vietnam.</p> <p>CARICOM: 1973: Antigua and Barbuda, Barbados, Jamaica, St. Kitts and Nevis, Trinidad and Tobago; 1974: Belize, Dominica, Grenada, Montserrat, St. Lucia, St. Vincent and the Grenadines; 1983: The Bahamas (part of the Caribbean Community but not of the Common Market).</p> <p>UDEAC: 1966: Cameroon, Central African Republic, Chad, Congo, Gabon; 1989: Equatorial Guinea.</p> <p>SADC: 1980: Angola, Botswana, Lesotho, Malawi, Mozambique, Swaziland, Tanzania, Zambia, Zimbabwe; 1990: Namibia; 1994: South Africa; 1995: Mauritius; 1998: Democratic Republic of the Congo, Seychelles.</p> <p>UEMOA: 1994: Benin, Burkina Faso, Côte d’Ivoire, Mali, Niger, Senegal, Togo, 1997: Guinea-Bissau.</p> <p>CEFTA: 1993:1996: Czech Republic, Hungary, Poland, Slovak Republic, Slovenia; 1997: Romania; 1988: Bulgaria.</p> <p>AFTA: 1992, Indonesia, Malaysia, Philippines, Singapore,</p>	<p>Euro-Mediterranean Agreement: FTAs between EU and Mediter. countries.</p> <p>FTAs between EU and Mexico, EU and Chile, etc.</p> <p>FTA between MERCOSUR and Chile, and between MERCOSUR and Bolivia.</p>	<p>Andean Pact, CACM, G3, CBI, EAC, ECOWAS, COMESA, IOC, SACU, CEPGL, Arab Common Market, GCC, SAARC.</p>

Thailand; 1984: Brunei Darussalam; 1995: Vietnam; 1997: Myanmar, Lao People's Democratic Republic; 1999: Cambodia.		
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8.3.4 Regionalism as Insurance

The major incentive for domino regionalism is to avoid being outside a bloc when nearly everyone else is inside, either because one's terms of trade suffer, or because one fears a trade war that will close markets that are not contractually bound open. This "insurance motive" was seen in the spread of RIAs in the 1920s and 1930s (Eichengreen and Frankel, 1995). Throughout that period, France pursued an active regional policy toward its own colonies and in Eastern Europe as a counter to British and German influence. As Germany reasserted itself, it adopted regional means, starting with a proposed customs union with Austria in 1931, which the other powers blocked only by exercising their powers over the German financial system. Thereafter, Germany built an even tighter web of regional arrangements. Britain had granted some preferences to its colonies since 1919, and in 1932 deepened and widened these as it introduced higher tariffs on other partners. The United States, which had increased tariffs strongly for essentially domestic reasons under the 1929 Smoot-Hawley Act, tried to recapture bilateral markets in the Reciprocal Trade Agreements Act of 1934. The lesson of this period is that regionalism grew up remarkably quickly to fracture a relatively evenhanded, if somewhat sclerotic, trading regime.

The process of breaking into regional blocs is potentially explosive (Oye, 1992). Not only is there an incentive for each country to join a bloc even if the result is that eventually everyone is worse off, but there is an incentive to join early. The costs of remaining outside escalate as the bloc grows and, if existing members extract an "entrance fee," that also rises,¹⁵ as we saw in Box 8.4 on the EU's social chapter.

The term "insurance motive" highlights another possible problem with developing countries seeking to defend their market access by signing RIAs. The more uncertain the world, the higher are insurance premia – and the costs of errors are lower if one is insured. In other words, large powers may gain from saber rattling – by maintaining tariffs or hostile anti-dumping regimes – while small countries are deciding whether to join them, and after they have joined, the small countries will be less concerned to preserve a global system than previously. As saber rattling is effective only if there is some chance of violence, this makes the possibility of regionalism look quite hostile to multilateralism.¹⁶ Box 8.5 explores the high incentives for "insurance regionalism" in the

¹⁵ In the 1930s it was not only terms of trade disadvantages that worried politicians, but simple mercantilist effects as countries sought to reduce imports competitively. Suppose Britain aimed to reduce her imports by £1 million. Under MFN rules each of n equal partners might expect to lose $\pounds(1/n)$ millions of exports. But if m partners were exempt because they had an RIA with Britain, each remaining partner faces losses of $\pounds 1/(n-m)$ million. If the 'entrance fee' absorbs nearly all the benefit of accession, the fee increases from $1/n$ for the first, to $1/(n-1)$ for the second, etc. The incentive to be first is obvious.

¹⁶ For any individual facing given risks, having insurance is better than not, but abolishing the insurance and the risk it covered would be better.

current world. Such problems do not look very serious at present, for developed countries have many other non-exploitative relationships with developing countries and may not find ‘insurance premia’ worth pursuing in this way. However, insurance is about ‘worst case’ scenarios, and our point is that developing countries should not complacently assume that regionalism will preserve them if a crisis arises.

Moreover, one might observe the same sort of phenomena in today’s world, albeit in a much attenuated form. One the reasons that Prime Minister Helen Clark cited for New Zealand seeking a regional arrangement with Singapore was a fear of being left outside as the world split up into blocs in none of which New Zealand fitted naturally. This fear was arguably stimulated by the stasis in APEC (which accounts for a very large proportion of New Zealand’s trade) and ‘the failure of world leaders to agree on an agenda for a new wave of trade liberalization’ (*Far Eastern Economic Review*, August 17th 2000).

Box 8.5 Insurance Policies

Signing an RIA may offer assured access to partner markets in two senses: first, avoidance of day-to-day harassment from anti-dumping or countervailing duties and other administrative means of protection, and, second, a haven if total trade war breaks out. Mercifully, the latter is a very low probability event at present and it is plainly very difficult to forecast what form it would take. However, to get a feel for the orders of magnitude at stake consider some recent results from Whalley (1998).

Whalley uses a CGE model of the world economy disaggregated into seven countries or regions; six potentially fight trade wars and the other (the rest of the world) remains completely passive. Trade wars have different outcomes according to which countries or regions have combined to form CUs. Using actual 1986 values as a base, Whalley explores trade wars in which each country or bloc fixes its tariffs to maximize its own welfare taking rivals’ tariffs as given. (Of course, this ignores WTO structures on raising tariffs, but the insurance is intended for just such a break-down). The only constraint is that if an RIA exists before war breaks out it remains in operation afterwards. The table below considers the implications of four possible configurations of customs unions measured relative to 1986 actual values.

The precise numerical results should not be taken seriously, for they are subject to a host of uncertainties, but the broad pattern is informative. In trade wars large economies suffer least, or even gain (Column 1, USA, EC); others suffer heavily especially if they are highly dependent on a large bloc that becomes very restrictive (as Canada and “Other Western Europe” are). Entering the bloc basically solves the problem: compare Canada in columns (1) and (2), Mexico in (2) and (3), and Other Western Europe in (3) and (4). As one small country protects itself, the burdens on others increase – see Japan and the rest of the world.

With losses of this size, the incentives to seek accession if the danger of trade war increases are huge. Other Western Europe has a turnaround of 43.6% of GDP from joining an American-European CU. Even a small-perceived increase in the probability of

trade war would be sufficient to persuade it to bear the trade diversion and other costs of entry to avoid this.

The table below refers to CUs: hence the blocs coordinate their external trade policies and can exploit, in so small a model, a great deal of market power to raise their tariffs. If the RIAs were FTAs, the costs of being excluded would be rather lower and would not rise monotonically as the FTA expanded (because a large FTA tends to reduce its external tariffs to reduce the costs of trade diversion). The basic idea that being outside is very costly persists, however.

LOSSES OF ECONOMIC WELFARE AS % OF GDP RELATIVE TO 1986 (Equivalent Variations)				
Trade War With:	No CUs	Canada-US CU	North America CU	North America- Europe CU
US	1.2	0.5	-0.4	0.5
Canada	-25.5	0.9	0.4	-0.7
Mexico	-8.5	-8.5	0.1	-0.3
Japan	-5.2	-5.2	-5.2	-5.4
EC (12)	3.7	3.4	3.4	2.5
Other Western Europe	-32.2	-33.1	-33.5	10.1
The rest of the world	-10.6	-10.9	-11.1	-13.4
World Total	-6.0	-5.8	-5.8	-6.2

Source: Whalley (1998)

8.3.5 RIAs and Trade Negotiations

If RIAs made trade negotiations easier, perhaps they would help the world evolve toward freer trade. Coordinated coalitions may have greater negotiating power than their members individually (Section 8.3.2) and such coalitions may facilitate progress just by reducing the number of players represented in a negotiation (Krugman 1993, Kahler 1995). But this result is not guaranteed. For example, a negotiation comprising one dominant partner and a competitive fringe of small countries might be easier and proceed further than if the fringe coalesced into a significant counterforce. However, if the blocs are genuinely unified it is probably reasonable to expect negotiations to be easier with fewer partners.

Unfortunately, however, this condition is rarely met, so that any gains from having fewer players in the last stage of a negotiation are offset by the complexity of agreeing joint positions in the first phase. This tradeoff is examined in Andriamananjara and Schiff (2001). The difficulties of achieving a European position on agriculture and cultural protection in the Uruguay Round are well known, and formulating EEC positions in the Tokyo Round proved complex (Winham 1986). Moreover, two-stage negotiations

need not be more liberal than one-stage ones (Basevi, Delbono and Mariott 1994). To be sure, Germany and the United Kingdom pressured France to agree to the agricultural deal in the Uruguay Round, but they had to make potentially trade-restricting concessions on “commercial defense instruments” (anti-dumping) to clinch the deal. The negotiating power of African countries would not be greatly enhanced by cooperation, and the benefits are not likely to outweigh the costs of combining their different interests into a single negotiating position (Wang and Winters, 1998).

The CUs that attend the next round of global trade talks will need to establish procedures for determining their negotiating positions. SACU’s previous practice of delegating all responsibility to South Africa begins to look less tenable as divisions emerge between members, and Mercosur has yet to devise really robust internal decision-making capacity. Thus, at least into the foreseeable future, RIAs do not seem likely to facilitate even a traditional trade negotiation. Moreover, if RIAs are being extended or new ones created, they can completely swamp developing countries’ limited negotiating capacity (Box 8.6).

Moreover, as WTO has extended its reach, it has embraced subjects in which most central CU authorities have no mandate to negotiate. Mixing national and CU responsibilities seems unlikely to simplify matters, and it is not realistic to expect member countries to surrender sovereignty on sensitive issues to regional bodies just because trade negotiations are in train.

Box 8.6 The Overburdened Negotiator

Reserves of administrative skill, political capital or imagination are finite; if they are devoted to an RIA they are not available for multilateral objectives. These arguments were advanced – somewhat implausibly – to explain both EU and US behavior during the Uruguay Round, but they must be several times more important for developing countries. Negotiating an RIA, especially with a major power that has its own objectives, will absorb a huge proportion of the scarce policy-making skills of a developing country. Such skills are typically so scarce that many developing countries have the same negotiator dealing both with the EC in Brussels and the WTO in Geneva. In fact, the governments of a number of smaller European countries have asked the WTO to postpone its Trade Policy Reviews exercises on their countries because they are wholly absorbed in negotiating Association Agreements with the EU.

Moreover, flying to Brussels or Washington to undertake regional negotiations is altogether more gratifying than working quietly at home to reduce arbitrary tariff peaks, or improve customs administration. This, of course, is part of the reason why policy makers and private-sector groups are prepared to grasp the painful nettles of reform that RIA negotiations call for and to stick to the agreements they make. However, it also shows that the process can be harmful if the RIA does not deliver benefits commensurate with the opportunity costs of negotiation.

The importance of developing country capacity constraints is illustrated in the recent discussion of multilateral trade policy, where the lack of capacity has become a prominent theme. For example, the WTO’s Doha Ministerial Declaration has 19 mentions

of capacity building and 21 of technical assistance for developing countries in its approximately 5000 words – see Winters (2002).

8.3.6 Do RIAs Make it Easier to Tackle Tough Issues?

One of the strengths that is frequently claimed for the regional approach to liberalization is that it makes it easier to handle the tough cases (Kahler 1995) – that there are areas in which regional liberalization/harmonization between like-minded countries is feasible when multilateral progress is not.

This seems most likely for activities that are highly restricted (agriculture, trade subject to anti-dumping measures, some services) and areas that are highly technical and/or sensitive (standards, competition policy or services regulation). Thus, for example, NAFTA and the Group of 3 have tackled investment, Brazil has free trade in information technology goods within Mercosur but refused to sign the global Information Technology Agreement in 1997, and Chile and Canada have eschewed anti-dumping actions on mutual trade but not on third countries.¹⁷

But until recently, even RIAs among developed countries, let alone those among developing ones, had not advanced much further with liberalization than the multilateral system, (Hoekman and Leidy, 1993). Thus, for example, agriculture frequently remained restricted (e.g. in EFTA); transport, culture and other “sensitive” services were excluded (CUSFTA); and government procurement was ignored de facto if not de jure (EEC). The EU – especially in its SMP – has advanced broadly beyond the GATT, but this took 30 years to initiate and is, to date, unique. More recently there have also been other advances, such as NAFTA ultimately liberalizing agriculture and tackling procurement, but overall, RIAs have not led multilateral liberalization to the extent that is sometimes supposed.

Second, there is the question of whether regionalism is actually more effective in liberalizing deeply than multilateralism. Has global liberalization actually been ruled out or, if RIAs were not an option, would a little more time and effort yield global progress? Having got the ball rolling, will RIAs later slow it down for all the reasons discussed above? On a prescriptive note, to the extent that RIAs are justified in terms of opening up otherwise closed sectors, it is important to ensure that the subsequent switch from regionalism to the multilateral track can be managed effectively. The necessity for, and the means to achieve, this switch should be written into the initial terms of RIAs.

An extension of the “tough cases” argument is that RIAs help to develop blueprints for subsequent multilateral negotiations (Bergsten, 1996; Lawrence, 1996). For example, the EU pioneered “bulk” mutual recognition for industrial standards and services harmonization, and NAFTA’s investment chapter may inform a multilateral

¹⁷ Oye (1992) argues that the 1930s also fit this description. He argues that regional arrangements, such as US bilateral arrangements, under the Reciprocal Trade Agreements Act were politically feasible because they almost guaranteed export expansion in partner markets in return for import liberalization. In this way they started to relax restrictions that were immune to multilateral efforts.

negotiation (if there is one). On the other hand, the EEC also suggested the CAP as a model for agriculture in the Kennedy Round! (Preeg, 1970, p.152)

But the major powers could also seek to use RIAs to reinforce their initial positions in future multilateral negotiations. If major players have greater politico-economic power within their own regions than in the world in general, it is easy to imagine their building up coalitions for their own policies before taking issues into a multilateral round. Arguably, the United States used approaches by potential partners in the Americas and Asia to broaden the negotiating agenda for its relations with Europe (Ostry, 1998), while Europe did the same with the EEA and its Europe Agreements.

The benefits of developing regional blueprints depend heavily on whether they are liberalizing (Bhagwati, 1993), and whether they are otherwise well suited to developing country needs and capacities. Major powers already use access to the GSP to promote environmental and labor conditions in developing countries; the EU looks for action in such areas and on intellectual property in the Europe Agreements and the US has used NAFTA as a tool for enforcing Mexican labor and environmental standards. By negotiating singly with the major powers, developing countries are essentially placed in competition with each other and lose a good deal of their (small) reserves of negotiating power. The deals they can achieve could be much less favourable than those that might emerge from multilateral talks under the WTO. They may be less open and liberal as well.

Moreover, there are dangers in such tactics. First, even if the majors' aspirations are desirable in their own terms, building up rival teams can make final negotiations more, rather than less, difficult. Second, even when only one regional bloc is advocating a policy, other countries might sufficiently resent the pressure to adopt it that they pull back. Developing country *de facto* rejection of the OECD draft Multilateral Agreement on Investment in 1998 contained at least elements of this. Third, the time it takes to build regional coalitions can delay multilateral talks. Fourth, coalitions rooted in formal RIAs are here to stay: if multilateral processes fail, the blocs remain. This is quite different from a negotiating coalition, which dissolves if it fails to gain its objectives.

To be sure, progress is required in "new" areas such as standards, but as was noted in Chapter 6, it is frequently better pursued independently of tariff preferences. Thus, while we may as well learn from RIAs about how to tackle particular aspects of liberalization, this is not a convincing reason for pursuing regionalism per se.

8.3.7 *Open regionalism: little more than a slogan*

Open regionalism was the idea of the 1990s. Crafted to describe APEC's original aspirations and to convey their complete consistency with multilateral objectives, the accolade has been applied to many blocs at some point in their history. Unfortunately, however, it is difficult to pin down exactly what "open" means.

Before trying to clothe the concept of "open regionalism" with meaning, we should remove its fig leaves. First, while there is a presumption that greater openness makes RIAs more benign, nothing can guarantee that they do not hurt the rest of the world. Second, the main reason for pursuing "open regionalism" is to benefit the

members themselves, but none of the definitions that have been proposed absolutely guarantees such benefits.

Srinivasan (1998) has called “open regionalism” an oxymoron – and that is surely true at the limit of its range: a perfectly open economy could not discriminate in the way that regionalism in the trade sense requires. However, once we come in from the edge, it does make sense to ask whether some RIAs are more open than others.

Writing on APEC, the group for which the term was coined, Bergsten (1997) offers five definitions of “open regionalism”:

- (a) “*Open Access*” whereby any country willing to abide by its rules may join an RIA. Bergsten argues that, strictly interpreted, this is not realistic, because RIAs have restricted geographical domains, but easy access to countries within their domains would be one acceptable definition. Bergsten defines the EEC as open in this respect.
- (b) *Unconditional MFN (or Concerted Unilateralism)*: this was the definition of the early APEC advocates, who saw the coalition as a means of encouraging countries to liberalize together and so provide for each other some of the terms of trade and political economy benefits of a full GATT round. While some members of APEC still adhere to this aspiration, Bergsten is doubtless correct in saying that it is quite unacceptable in the US, where reciprocity is seen as an essential part of liberalization.¹⁸ It would, of course, also not be regionalism in the terms of this report.
- (c) *Conditional MFN* would extend intra-APEC liberalization to any country that reciprocated. Given APEC’s size no country would be likely to reject the offer of an FTA, Bergsten says, but it might take time for others to come on board, during which there would be trade discrimination. There might also be resentment at APEC making take-it-or-leave-it offers. Of course, this is very similar to “open access” but requires an operational definition of “reciprocity.” Bergsten would threaten conditional MFN – indeed says APEC has already implicitly done so – as a means of obtaining (nearly) global deals such as the ITA, which started with APEC in 1996.
- (d) *Global Liberalization* through traditional unilateral and multilateral trade liberalization on an MFN basis. It is possible that APEC could lead a movement to remove all trade barriers, by its own internal free trade deadline of 2010 for developed and 2020 for developing countries.
- (e) *Trade Facilitation*: is APEC countries reducing border frictions and pursuing policy integration, but with a focus on elements that operate multilaterally.

APEC has yet really to decide between these alternatives, as there has not yet been any “APEC liberalization.” Members have certainly not yet introduced any discriminatory trade policies (with the minor exception of the APEC business visa), but neither have they yet moved beyond implementing their Uruguay obligations and, for developing members, their own unilateral reforms.

¹⁸ It now seems likely that Japan would be unwilling to pursue unilateral approaches - Scolley and Gilbert (2001).

For the future, Bergsten recommends a combination of (b) through (e) above, to make clear that APEC's objective is global liberalization, that it will achieve internal liberalization by 2020, that it – or at least its larger members – will discriminate in a WTO-consistent fashion if other countries do not reciprocate, and that it welcomes other countries proposing sectors and timetables for liberalization – i.e., that APEC would negotiate, rather than dictate terms, for its extension to the rest of the world.

Although perhaps more positive in its approach and timetable, this manifesto is not very different from the EEC's 1957 statement that “by establishing a customs union between themselves, member states aim to contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers.” (Article 110 §1, Treaty of Rome).

Other commentators have taken up the cry of “open regionalism.” Echavarría (1998) sees “open regionalism” in the Andean Pact on the grounds that it lowered tariffs relative to the 1980s and Brazilian Foreign Minister Luiz Felipe Lampreia proclaimed “open regionalism” in Mercosur on the same grounds and those of its enlargement (to the UN General Assembly in September 1996). The CEA (1995) defined US policy as laying the foundation for “open, overlapping plurilateral trade agreements as stepping stones to global free trade,” while Pelkmans and Brenton (1997) see recent EU policy as “open regionalism” in the sense of “GATT compatibility” and as having gone “some way” toward “open regionalism” in the non-preferential sense! Past WTO Director General Renato Ruggiero declared “The answer [to marrying regionalism and multilateralism] is ... ‘open regionalism’,” which he then defined as “in practice...the MFN principle” (quoted in Srinivasan 1998).

Openness is an important component of development and a valid objective for all developing countries; if countries feel they must have regionalism, let it be genuinely open. But “open regionalism” is a slogan rather than an analytical term. It is defined in so many different ways that it conveys no information about an RIA other than that its members are embarrassed to be thought of as protectionist. In particular, a claim of “open regionalism” should confer on a bloc no presumption of economic value and no immunity from analysis to see if it is acting in either its own or in other countries' interests.

8.4 Regionalism and the WTO

The previous analysis suggests that international policy toward regionalism should aim to:

- Encourage RIAs to achieve trade creation and avoid trade diversion, both for the sake of members and to minimize harm to excluded countries;
- Permit deep integration, including nation building, between members;
- Preserve the effects of previous liberalizations and provide credibility for any liberalizations that form part of the RIA; and

- Support a liberalizing dynamic within member countries and in the world trading system as a whole.

8.4.1 *GATT, and all that.*

The instrument we have for international policy on trade blocs is the WTO, and this section explores how it manages regionalism and whether its rules could be reformed to help it do better.¹⁹

RIAs are an officially sanctioned – but conditional – exception to the GATT’s rules on non-discrimination. The conditions imposed on RIA formation doubtless constrain and mold the pattern of regionalism in the world, but they are neither adequate nor adequately enforced to ensure that regionalism is economically beneficial for either its members or excluded countries. However, although improved adherence to current rules is desirable, no feasible reform can guarantee that only beneficial RIAs are created. The responsibility for good outcomes falls on governments themselves; outside a complete ban, they cannot tie their own or each other’s hands sufficiently tightly in the WTO to preclude the possibilities of signing harmful RIAs.

The world trade system works pragmatically and consensually. The GATT was created in 1947 as a temporary body to assist countries in trade liberalization. Its role was to codify and record a series of tariff reductions that its members wished to make, and to provide a structure to give credibility to those reductions. It discouraged the reversal or nullification of tariff cuts by restricting the use of policies that impose duties on trade on an *ad hoc* basis, such as anti-dumping duties and emergency protection, and equivalent policies, such as internal taxes on imports. It also defined important mechanics of trade, such as the valuation of trade for customs purposes.

A key concept of the GATT, indeed the cornerstone of the present world trading system, is non-discrimination between different sources of the same imported good, which is achieved by requiring members to give each other most favored nation (MFN) treatment, except in specified circumstances. With an assurance of non-discrimination, when A negotiates a reduction in one of B’s tariffs, it knows that the commercial value of its effort will not be undermined by B then offering C an even lower tariff. This, in turn, makes A more willing to “buy” the concession by reducing one of its own tariffs on B, and so encourages trade liberalization.

Over 50 years of operation the GATT continued in a low-key, consensual, member-driven, fashion. It did not “adjudicate” trade disputes, but had a dispute settlement process, less concerned with law than with solving disputes in a way that preserved the previously negotiated balance of benefits, maintained consensus and

¹⁹ The rules of international commerce are embodied in three main agreements: The General Agreement on Tariffs and Trade (GATT), The General Agreement on Trade in Services (GATS) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs). They are administered by the World Trade Organization (WTO), two of whose major tools are the Trade Policy Review Mechanism (TPRM) and the Understanding on Dispute Settlement. The WTO has 145 members; the major non-member economies, which are seeking accession, are Russia, Ukraine and Saudi Arabia; the other major group of current candidates are the countries of Eastern Europe and Central Asia. ##

allowed the liberalizing bandwagon to continue to roll. The WTO, which was created in 1995 to oversee the GATT and certain other agreements, is more legalistic, but still focuses heavily on pragmatic and mutually acceptable solutions to problems. The WTO administers a set of rules for behavior, not a set of outcomes – it is concerned with meeting agreed obligations and claiming rights rather than with economic outcomes *per se*. The WTO/GATT has undoubtedly been a force for economic good, but its role has not been defined in those terms.

The GATT traditionally did not intrude into domestic politics. It had no ability to force member countries to liberalize if they did not wish to, and was extremely light – handed in its requirements about the shape of domestic legislation. The WTO is rather more far reaching. Its greater breadth and its “single undertaking,” under which members must subscribe to (virtually) all its rules – rather than, as previously, treat some as optional extras – constrains governments more tightly. Nevertheless, the WTO can still be effective only if it proceeds more or less by consensus.

Given this background, the WTO can enhance the economic wellbeing of developing countries in four ways. First, if sufficient members wish, it can organize periodic rounds of tariff negotiations that offer opportunities and incentives to members to reduce their barriers to trade. Second, it provides guidelines for domestic policy – directly in some cases, but more importantly indirectly by shaping the terms of the debate. Governments resisting pressures to protect particular groups are immeasurably strengthened if they can point to prohibitions in the WTO agreements. Similarly, advocates are strengthened if the WTO explicitly permits the policies they want, even if only conditionally: “after 144 countries have debated and confirmed the legitimacy of policy X, what right,” they ask, “has the government to deny us its benefits.” (The answer is, “almost every right,” for the WTO defines minimum standards of behavior not norms; but it is a hard case to make²⁰).

Third, the WTO can protect the rights of members against certain rules violations by other members. It cannot, however, guarantee members against harm.²¹ Fourth, it provides a forum and a mechanism for governments to manage the spill-overs from members’ trade policies onto their partners. Bagwell and Staiger (1998) show how the GATT traditions of reciprocity and non-discrimination combine to solve such spill-over: reciprocity because two members offering mutual tariff concessions are likely to generate (at least partially) offsetting terms of trade effects, and non-discrimination by preventing aggressive coalitions from forming. These four links provide the framework for assessing the WTO’s current rules about RIAs and exploring whether they can be improved.

8.4.2 *The rules for RIAs: useful, but not infallible*

²⁰ The parallel is that the law permits me to smoke subject to some conditions. That does not make smoking good for me, and neither does it help me stop my kids from smoking.

²¹ For example, if a country is harmed by another’s breaking into its export markets, there is – properly – no redress under the GATT.

Article XXIV of the GATT specifies the conditions under which countries can violate the MFN clause by forming RIAs. It imposes three principal restrictions (see Annex I to this chapter). An RIA

- Must not, “on the whole” raise protection against excluded countries,
- Must reduce internal tariffs to zero and remove “other restrictive regulations of commerce” other than those justified by other GATT articles, and
- Must cover “substantially all trade”.

The GATT’s logic is essentially mercantilist, stressing the rights of trading partners to market access, rather than economic, which would focus on the economic costs and benefits of policy. From the former perspective, the first two conditions make sense. The first preserves the sanctity of tariff bindings by ensuring that forming an RIA does not provide a wholesale way of dissolving previous bindings. It is supplemented by the requirement that compensation is due to individual partners for tariff increases induced by the RIA if other reductions to keep the average constant do not maintain a fair balance of concessions. Together with the 1994 Uruguay Round Understanding on the Interpretation of Article XXIV on how to measure tariff barriers for RIAs, these provisions offer reasonable assurances about the barriers facing non-members.

The second condition helps to defend the MFN clause by making it subject to an “all-or-nothing” exception. If countries were free to negotiate different levels of preference with each trading partner, binding and non-discrimination would be fatally undermined. No member could be sure that it would receive the benefits it expected from negotiating and reciprocating for a partner’s tariff reduction. Also, if a customs union is a first step toward nation building, it is inappropriate that an international trade treaty should stand in the way of such progress. Thus, internal free trade, such as one (usually) achieves within a single country, would seem to be an acceptable derogation of MFN, whereas preferences would not. The third condition reinforces this by requiring a serious degree of commitment to an RIA in terms of sectoral coverage.

Article XXIV also makes sense when viewed as a guide to economic policy. Its requirement not to raise the average level of protection against excluded countries’ exports not only honors the latter’s market access rights, but also removes one otherwise available route to increased protectionism. This is desirable on any account, but in the context of RIAs the danger and costs of trade diversion will be greater if members can increase their external tariffs.

The second and third conditions – no internal tariffs and substantial coverage – are important in heading off pressure to use tariffs to fine-tune political favoritism toward either domestic industries or partner countries; they help to prevent governments from restricting RIAs to swapping trade-diverting concessions and, thus, avoiding politically more painful trade creation. These conditions essentially require a serious commitment to integrating member markets as a condition for proceeding.

Article XXIV is generally an aid to better RIAs, but it is certainly not sufficient for good economic policy. Even if the conditions were applied without exception they

would not preclude harmful RIAs: even wholly GATT-compatible RIAs can be predominantly trade diverting, excluded countries can suffer terms of trade declines, protection can increase and institutions can arise that make liberal policies less likely.

Moreover, there are major difficulties in interpreting the WTO conditions on regionalism. Even following the Uruguay Round Understanding there is no agreement about what “substantially all trade” means – nor even whether it refers to the proportion of actual trade covered or the inclusion of all major sectors of the economy. Similarly the treatment of non-tariff barriers in assessing the overall level of trade restriction is not defined, nor is that of rules of origin. The requirement that “other restrictive regulations of commerce” be removed between members is ambiguously worded: several exceptions to this requirement are identified explicitly but other barriers, including anti-dumping duties and emergency protection, are not. Complete integration between members of an RIA would abolish all of these barriers and so their continuation – as for example in NAFTA or the Euro-Med agreements – suggests an unwillingness to proceed too far in that direction.

Perhaps because of its ambiguities, Article XXIV has been notoriously weakly enforced. RIAs have to be notified to the GATT and until 1996, each was then reviewed by an *ad hoc* working party to see if it was in conformity with the Article. WTO (1995, p. 16) reports that of 69 working parties reporting up to and including 1994, only 6 were able to agree that an RIA met the requirements of Article XXIV, of which only two – CARICOM and Czech-Slovak CU – remain operative. However, the remainder did not conclude that agreements were not in conformity; they merely left the matter undetermined.

This agnosticism is essentially the product of the GATT’s consensual nature. The first major test of Article XXIV was the Treaty of Rome establishing the EEC. The political pressure to permit it was enormous: EEC countries would almost certainly have put the EEC before the GATT in the event of conflict and the US strongly supported the treaty. The treaty, however, clearly violated Article XXIV, and so the only feasible solution was not to push the review to conclusion.²² Given a start like this, the EEC’s willingness to support more or less any RIA in the GATT, the need for working parties to reach consensus, and the GATT’s inability to make an adverse determination without the acquiescence of the party at fault, it is hardly surprising that future reviews proved little more demanding.²³ Nor have matters improved with the establishment of a single Committee on Regional Trading Agreements to conduct the reviews. The inability to rule on conformity does not mean that the rules have had no effect, for we do not know the extent to which they have influenced the structure of RIAs that have come forward, nor

²² For example, in reviewing the treaty, the head of the GATT secretariat expressed ‘the view, with which he thought there was no disagreement, that the incidence of the common tariff was higher than that of the rates actually applied by the member states at the time of entry into force of the Treaty of Rome’ (GATT Document C/M/8 p.6; cited in GATT, 1994, p. 750).

²³ Under GATT procedure, finding a party in violation of its obligations required unanimity, i.e. including the violating party. This is not true of WTO.

which potential arrangements they have discouraged.²⁴ It is not an encouraging record, however, either from the point of view of enforcing current rules or from that of rewriting the rules to increase their ability to distinguish good from bad RIAs.

Finally, Articles XXIV.10 and XXV of the GATT can be used to grant waivers to make otherwise inadmissible policies GATT-legal. This was done for the European Coal and Steel Community (1952) and the US-Canada Auto Pact (1965). Under WTO, waivers are still feasible but are time limited.

8.4.3 *The rules are much weaker for developing countries*

As if all this were not enough, a further complication for developing countries is the “Enabling Clause²⁵”, which significantly relaxes the conditions for creating RIAs that include only developing countries. It drops the conditions on the coverage of trade, and allows developing countries to reduce tariffs on mutual trade in any way they wish, and non-tariff measures “in accordance with criteria which may be prescribed by the” GATT members. It then supplements the first condition with the non-operational requirement that the RIA not constitute a barrier to MFN tariff reductions or cause “undue difficulties” for other contracting parties.

In practice, developing countries have had virtual carte blanche. Twelve preferential arrangements have been notified under the Enabling Clause, including LAIA, ASEAN and the GCC. Internal preferences of 25% and 50% figured in ASEAN’s trading plans and also in many of the arrangements concluded under the LAIA and in the GCC. There is little sign that internal preferences have undermined MFN agreements with other trading partners, but then, until recently, these countries did not make many MFN agreements. Indeed, until the late 1980s, the Latin American and African countries’ frequent use of regional arrangements and weak participation in the multilateral rounds might suggest a substitution of one form of liberalization for the other. More worrying were the sectoral agreements that abounded in Latin America. Nogues and Quintanilla (1993) argue that there is little doubt that the 17 agreements that Argentina and Brazil had signed by 1986 generated significant trade diversion.

The Enabling Clause further dilutes the weak discipline that Article XXIV imposes. Even if Article XXIV does not actually stop many harmful practices, it does at least avoid automatically giving them the respectability of legal cover. Thus, while the GATT knowingly and willingly permitted LAFTA (1960) and the initial notification of ASEAN (1977) to violate Article XXIV (Finger, 1993b), at least it required continuing

²⁴ Within the GATT there was a feeling that the article had influenced the structure of US-Canadian and US-Israeli agreements (private communication from senior staff member). We can also identify cases where WTO rules, or their equivalent, have prevented RIAs. For example, in 1932 Britain and the US refused to waive their MFN rights, preventing the implementation of the Ouchy Convention, a forerunner of Benelux, Viner (1950). Similarly, negotiators of the draft Multilateral Agreement on Investment found no way of preventing some concessions on services among members from also applying to non-members via the GATS MFN clause. Hence, they held back such concessions. GATS Article V permits regional arrangements, but the MAI was far too narrowly defined to qualify as one.

²⁵ “The Decision on Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries” (1979).

consultation with partners and left open the possibility of challenge in the dispute settlement process. The Enabling Clause offers more cover in various areas, and thus erodes even this discipline.²⁶

8.4.4 *New rules for services repeat the same problems*

Article XXIV and the Enabling Clause of the GATT refer to trade in goods. The equivalent for services in Article V of the GATS, which is modeled closely on them. The requirement not to raise barriers to third countries is rather tighter: it is applied sector by sector rather than “on the whole,” and third country suppliers already engaged in “substantive business” in an RIA territory before the RIA is concluded must receive RIA treatment. The “substantially all trade” ambiguity is only slightly abated, with an explicit note that “substantially” be “understood in terms of number of sectors, volume of trade, and modes of supply.” For covered sectors “substantially all discrimination” is to be removed, but as this is defined as comprising elimination of barriers and/or prohibition on new or more discriminatory barriers, it need amount to very little.²⁷ Developing countries receive “flexibility” on “substantially all discrimination” and exemption from the need to give RIA treatment to third country firms with “substantial business” in member countries.

8.4.5 *‘Feasible’ and ‘desirable’ don’t overlap*

The WTO rules on RIAs are not exactly broken, but they are creaky, and it is worth asking what might be done about them. We focus here on their economic content – as defined in the introduction to this section – and on the feasibility of reform. We also require that any reforms be clear and operational, removing ambiguity rather than adding to it. Feasibility depends on the attitudes of member countries and the need to remain within the GATT’s basic pragmatic and consensual framework. Feasibility seems to us a more binding constraint than devising economically sensible rules.²⁸ Few countries within RIAs appear to seek tighter discipline, and as the EU continues its Mediterranean agreements and looks to implement the Cotonou Agreement and as the US contemplates the FTAA, major political backing for tightening looks improbable. Neither the EU nor the USA submitted proposals to the 1999 Seattle Ministerial Meeting of WTO. (WTO document JOB (99)/4797/Rev.2).

An RIA that does not reduce external barriers almost inevitably causes trade diversion. One counter to this would be to require RIA members to liberalize, both to reduce diversion and to induce external trade creation with non-members. Finger (1993) views these reductions as a “price” to be negotiated to persuade non-members to forego their MFN rights. How far the parties are prepared to go in a negotiation, however, is determined by the prevailing rules and enforcement mechanisms, which define the

²⁶ There is also an unresolved dispute about whether Article XXIV can be applied to an arrangement notified under the Enabling Clause, as the US demands for Mercosur.

²⁷ Together these requirements seem to impose no discipline on the sectors that are excluded from the RIA, although they may still be covered by the members’ GATS obligations.

²⁸ Schott (1989) offered an early analysis of these sorts of points. ##

outcome if negotiations fail; unfortunately, these currently leave non-members almost no negotiating power. Hence other authors have made more concrete proposals.

Bhagwati (1993) suggests requiring that for each tariff heading a CU's common external tariff be bound at the minimum tariff for that heading among all members. This does not guarantee the elimination of trade diversion – suppose the tariffs of three members were 98%, 99% and 100% – but it will clearly reduce it. It would impose a high (mercantilist) price on RIA formation, so only “serious” integrators would pay it, and would, overall, be quite trade-liberalizing. As a reform it is admirably clear, and if feasible, it would be desirable economically. Its demanding nature, however, makes it very unlikely to succeed in the present circumstances.

Related is Serra, *et. al's* (1997) proposal that members of FTAs be required to bind their tariffs at actual applied rates on the eve of the RIA. Apart from what this might do to pre-FTA applied rates, this suggestion is random in its liberalizing effect, which reduces its moral force. Bhagwati on the other hand would just ban FTAs. This is also consistent with seeking to restrict RIAs to those that are committed to far-reaching integration, but again faces severe feasibility constraints, especially since some FTAs proceed quite far in other directions and they have become the more popular form of regional integration.

Tied up with the FTA question is that of rules of origin. Serra et al. (1997) suggest a requirement that they be no more restrictive than before the RIA; this is laudable, but in practice it is difficult to determine, *ad hoc* in nature, manipulable in intent, and potentially very complex in the face of technological changes. Better would be a requirement precluding the manipulation of such rules for protectionist purposes, such as that countries should adhere to a single set of rules of origin agreed internationally, or that a country's preferential rules should be the same as its non-preferential ones. Wonnacott (1996) suggests a number of milder reforms in this direction: for example, that rules of origin be banned where tariffs differ between members by less than, say, 2 percentage points, or that for each commodity they be banned for the FTA member with the lowest tariff. These might be acceptable, but would only scratch the surface.

One proposal has been made to adopt *ex post* reviews to determine whether non-member exports have fallen since an RIA was created, and demand changes in policies if they have (McMillan, 1993). Although frequently taken seriously (e.g., Frankel 1997), the proposal is wrong in virtually every respect. Exports are the wrong criterion (welfare is related to imports not exports), quantitative targets are the wrong way to formulate trade policy (they create more rents and market power than tariffs), economic modeling is still too imprecise to identify causes with any credibility, and *ex post* adjustment after five years is no basis for the policy predictability sought by investors.

8.4.6 So enforce current rules more vigorously

Two arguably more feasible proposals entail enforcing current rules more rigorously. Even they, however, currently encounter fierce opposition and will require major political commitment by many WTO members to be implemented. To be acceptable to the major powers, they will certainly need to be accompanied by a

grandfathering clause to assure current RIAs that they will not be undermined by new interpretations.

A precise definition and enforcement of “substantially all trade” would be a useful innovation. A quantitative indicator would be clear, but it would need to be high given that the kinds of trade restrictions countries wish to maintain typically constrain existing trade quite fiercely already. The frequently cited 80%, which dates from consideration of the Treaty of Rome is not adequate. Even 90%, which seems to inform current EU-Mercosur talks, is not indicative of serious integratory intent. We would advocate 95% after 10 years and 98% after 15.

Similarly, a more constraining view of “other restrictive regulations of commerce” would be useful – ensuring that they include the effects of rules of origin on excluded countries, and that obvious barriers such as safeguards actions and anti-dumping duties are abolished internally. The latter requirement would increase the degree of trade creation, as these policies are explicitly aimed at preserving domestic output levels. Thus they would raise the political bar for “serious” regionalism.

There are three major proposals for creating a “liberal dynamic.” Srinivasan (1998) proposes that RIAs be permitted only temporarily by requiring all RIA concessions to be extended to all countries within, say, five years. This is effectively a ban on RIAs; and certainly foregoes any gains that they might offer in terms of deep integration or nation building. It is not a serious contender.

Second, stretching back at least to the US submission to the Preparatory Committee of London Monetary and Economic Conference of 1933, scholars and policy makers have argued that requiring RIAs to admit any country willing to accept their rules both reduces their adverse effects on excluded countries and establishes a liberal dynamic (Viner, 1950). While this may be true if admission can be guaranteed, virtually every RIA extant has geographical restrictions on membership and has features that require negotiation. The latter vitiate the promise of “open access” (Box 8.4).

Third, Bagwell and Staiger (1998) suggest that FTAs necessarily undermine the ability of the WTO to address the spill-overs from one country’s trade policy to another’s welfare through reciprocal tariff negotiations. This might lead to fewer such negotiations or worse outcomes in those that occur. The case against CUs in this dimension is weaker, especially if the partners have “similar” trade policy objectives. The implication is to ban FTAs.

The Committee on Regional Trading Agreements (CRTA), which reports to the WTO’s General Council, was established in February 1996 to increase the transparency, efficiency, and consistency of the WTO’s treatment of RIAs. It was seen as a means of ensuring more rigorous review of new RIAs because a single group would review all of them using the same criteria and with more searching notification and information requirements. It would also undertake periodic review of existing RIAs, and could resolve some of the systemic issues that remained after the Uruguay Round. The more thorough review was seen as a route to better compliance with WTO requirements, while the consideration of conceptual issues was a step toward refining and codifying the rules more precisely.

Unfortunately the CRTA has still not got into its stride after six years. Its assessments of particular cases have been stymied by the lack of clear systemic rules and its discussion of rules stalemated on exactly the same “substantially all” and “other regulations” issues as bedevilled the Uruguay Round discussions. By December 2000 the Committee had initiated consideration of 86 RIAs (including 32 inherited from previous working parties). It had completed factual analysis of 62 of these, but had been unable ‘to conclude any examination referred to it’ (Report by Chairman of CRTA to the WTO General Council December 2000).

The CRTA is the key to improved near-term management of RIAs by the WTO. Although RIAs are open to dispute if third countries feel aggrieved (at least until the CRTA has formally certified their WTO-conformity), the rules seeking “serious” intent to integrate are not really vulnerable to this process. Third countries are unlikely to press RIAs to include more sectors when they expect this to increase trade diversion. Similarly, why would a third country seek to free RIA members from the threat of each others anti-dumping legislation? Members do not normally bring internal disputes to the WTO.²⁹ Hence if issues concerning the coverage of sectors or the depth of integration are missed at the outset they are missed forever.

Recently an RIA has figured in the WTO’s Dispute Settlement procedure. As part of the EU-Turkey Customs Union, Turkey imposed quotas on imports of certain textiles and clothing, in order that the EU’s quotas (under the Multi-Fibre Arrangement) should not be undermined by deflected trade. India complained and won a ruling against the quotas on the grounds that the quotas were not fundamental to the customs union. Rather, the Dispute Panel said, alternative means should be found to meet Turkey’s objectives such as using tariffs (for which India could demand compensation), phasing out the EU restrictions, or rules of origin to control the movement of third country goods from Turkey to the EU. This ruling suggests a willingness to subordinate Article XXIV to other parts of the GATT, which could have significant implications for new CUs or expansions.

The WTO’s rules on regionalism are far from perfect, but it is impossible to devise rules that reliably sort beneficial from harmful RIAs. If that process is to be done at all, it would have to be done case-by-case by the CRTA. But the CRTA faces a serious timing problem. Unless agreements are submitted to the WTO early in the process of negotiation – in which case they will be very provisional – reviews will generally be too late to influence their initial form. Otherwise, reviews will be too late to affect public debate and will, if they call for changes, upset carefully negotiated compromises. For that reason they will be resisted and resented by members, which is bad news for a consensual organization. Thus considerable political courage will be called for to enforce CRTA findings, until their requirements are sufficiently understood and respected by members to be met *ab initio*. This process of review and response would be aided by detailed economic studies of RIAs stretching well beyond the legalities of Articles XXIV and V.

²⁹ The USA and its partners still use the WTO dispute settlement, but there has never been a formal GATT dispute between the EU and any country with which it has a formal RIA.

Both immediately and ultimately the responsibility for good RIAs lies with governments themselves.

8.4.7 Conclusion: Rules are not the answer

Rules are not the answer, nor even a large part of the answer, for ensuring that regionalism is beneficial. The need is for understanding, for in the end, subject only to imperfect constraints on the effects on excluded countries, governments will act in what they believe to be their best interests. Rules can help to define this, mainly by informing parties to the debate about perceived norms, but on topics that are as case specific and *sui generis* as RIAs, advocates will always be able to find plausible exceptions to norms. No set of rules seems likely to be very effective at distinguishing beneficial from harmful RIAs. Thus it seems unlikely that great effort to rewrite the WTO's rules on RIAs will be adequately rewarded.

None of the fundamental reforms to Article XXIV and V proposed to date seems likely to command enough political support to make any progress. None of the minor ones seems worth the effort. Thus our recommendations are:

- extend the disciplines of Articles XXIV and V to RIAs between developing countries,
- enforce these disciplines rigorously in the CRTA, especially those on coverage and depth of liberalization, and
- use the dispute settlement procedure to enforce the rights of third countries not to face increases in protection either directly or indirectly through the use of tools such as rules of origin.

Even these steps will require major expenditure of political capital by many countries. We also, therefore, suggest continuing studies of particular RIAs, not just in terms of Articles XXIV and V disciplines, but also in terms of their overall effects on economic performance. This will help policy makers and the public understand what they may and may not expect from regional integration.

Appendix I: WTO Provisions on Regional Integration Arrangements (Extracts)

Article XXIV of the GATT

4. The contracting parties...also recognize that the purpose of a customs union or of a free trade area should be to facilitate trade between the constituent territories and not to raise barriers to trade.

5.(a) With respect to a customs union...the duties and other regulations of commerce imposed at the institution...shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union...

(b) With respect to a free-trade area...the duties and other regulations of commerce maintained in each of the constituent territories and applicable at the formation of such free-trade area...shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free-trade area...

(c) Any interim agreement...shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time.

7.(a) Any contracting party deciding to enter into a customs union or a free-trade area, shall promptly notify the CONTRACTING PARTIES and shall make available to them such information...

8.(a) A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that: (i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Article XI, XII, XIII, XIV, XV and XX) are eliminated with respect to...substantially all the trade in products originating in such territories...

8.(b) A free trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories.

The Enabling Clause

1. Notwithstanding the provisions of Article I...contracting parties may accord differential and more favorable treatment to developing countries, without according such treatment to other contracting parties.

2.(c) The provisions of paragraph 1 apply to the...regional or global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which may be prescribed by the CONTRACTING PARTIES, for the mutual reduction or elimination of non-tariff measures, on products imported from one other;

The Uruguay Round Understanding on the Interpretation of Article XXIV

2. The evaluation...of the duties and other regulations of commerce...shall...be based upon an overall assessment of weighted average tariff rates and of customs duties collected... For this purpose, the duties and charges to be taken into consideration shall be the applied rates of duty. It is recognized that for the purpose of the overall assessment of the incidence of other regulations of commerce for which quantification and aggregation are difficult, the examination of individual measures, regulations, products covered and trade flows affected may be required.

3. The “reasonable length of time” referred to in Article XXIV 5(c) should exceed ten years only in exceptional cases.

The GATS Article V

1. This Agreement shall not prevent any of its Members from being a party to or entering into an agreement liberalizing trade in services between or among the parties to such an agreement, provided that such an agreement:

(a) has substantial sectoral coverage³⁰ and

(b) provides for the absence or elimination of substantially all discrimination, in the sense of Article XVII, between or among the parties, in the sectors covered under sub-paragraph (a),...

3.(a) Where developing countries are parties to an agreement of the type referred to in paragraph 1, flexibility shall be provided for regarding the conditions set out in paragraph 1, in particular to sub-paragraph (b), in accordance with the level of development of the countries concerned, both overall and in individual sectors and sub-sectors...

4. Any agreement referred to in paragraph 1 shall be designed to facilitate trade between the parties to the agreement and shall not in respect of any Member outside the agreement raise the overall level of barriers to trade in services within the respective sectors or sub-sectors compared to the level applicable prior to such an agreement.

³⁰ This condition is understood in terms of number of sectors, volume of trade affected and modes of supply. In order to meet this condition, agreements should not provide for the *a priori* exclusion of any mode of supply.

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