CHAPTER 6

# Conclusion: Tell Me the Truth about Trade Blocs

## Trade blocs are political…

DURING THE 1990S TRADE BLOCS PROLIFERATED. BY 1999 MORE regional agreements had been notified to the WTO than it had countries as members. Evidently, there were powerful forces driving this process. These forces were political: trade blocs have economic effects, but that is not why they are established. The main political objective has probably been enhanced security. International trade reduces the risks of military conflict between countries and so there might appear to be a reasonable case for preferentially promoting trade relations between neighbors. Unfortunately, whereas international trade is normally mutually beneficial, preferentially induced trade can sometimes create powerful transfers so that one partner gains at the expense of another. There are numerous historical examples of such redistributions causing conflict because they are seen as unfair. Hence, even when the objective of a regional arrangement is purely political, the economic consequences need to be understood.

Another motivation has been to enhance bargaining power. OPEC demonstrated that it was possible under some conditions to improve the terms of trade by collective action. The scope for OPEC-type trade agreements proved very limited. However, small developing countries may still find that by negotiating collectively with industrial countries on trade issues they would gain, not by increasing their power, but by enhancing their ability to get noticed in bargaining rounds, enabling them to conclude more reciprocal deals.

Regional cooperation on trade issues may help countries to cooperate on other issues. Small neighboring countries have plenty of scope for cooperation. Some infrastructure, such as power, telecoms, and railways, may be better provided regionally than nationally. If the tax treatment of multinationals is harmonized, countries can increase their bargaining power and avoid a race to the bottom. Thus, even if regional cooperation starts with trade issues, it should not stop there. The main benefit from cooperation on trade issues may be the development of a habit of trust and cooperation between neighboring governments that can then be extended to issues on which there is more scope for mutual gain.

Many developing and transition economies are in the process of reforming their economic policies and their governance systems. Regional cooperation has sometimes proved useful as a commitment mechanism, locking in the change. The most spectacular examples of this have probably been the North-South cooperation arrangements: Mexico gaining credibility through NAFTA, Eastern Europe through accession agreements with the EU, and North Africa through association agreements with the EU. Some South-South agreements have also acted as commitment mechanisms, notably MERCOSUR.

Security, bargaining power, cooperation, and lock-in are probably the main political motors for regional integration. Sometimes these motives receive a veneer of economic rationalization. Frequently there is an appeal to the benefits flowing from scale economies. Such "soundbites" of economic analysis are not usually wrong, but they are so incomplete and lopsided as to be seriously misleading: weapons casually hurled by advocates who have already decided their position, rather than serious attempts to understand the economic consequences of choices.

## The politically feasible alternative to a costly trade bloc is probably a better-designed bloc…

IN THIS REPORT WE HAVE TREATED THE POLITICAL FORCES FOR the creation of regional arrangements as largely unstoppable and have focused on choices of design. For example, only if regional schemes adopt common external tariffs, such as in the EU, can they bargain collectively in world trade rounds. Yet a common tariff precludes unilateral liberalization, and also prevents individual developing countries from joining their appropriate product-based groupings in global negotiations. Thus, schemes that do not adopt a common external tariff probably have a lower opportunity cost in terms of other trade policy options. It is therefore more reasonable to treat the effects of such schemes as being additional to whatever unilateral and global liberalization might be underway. This has been our approach in analyzing the effects of trade blocs.

## So how does a trade bloc affect people, especially the poorest?

In order to make sense of design choices, the basic economic effects of trade blocs need to be understood. The overall policy message is that the effects are very sensitive to the choices of design. It matters enormously who else is in the bloc and how preferences are implemented. We distinguish between two broad types of effect: the first is competition and scale, and the second is trade and location.

### Competition and Scale Effects

The simple "soundbite" image of the benefits of a trade bloc is perhaps the scale benefits of having a single big factory serving the regional market. This will almost never be a good idea. Such a factory would be a protected monopoly, and such monopolies are usually inefficient and exploitative. Competition is a vital discipline on private behavior, yet there is obviously a tradeoff between the number of competitors in a market and the average size of factory. More competition means smaller factories, and so within any given market there is a tradeoff between competition and scale. Regional integration enlarges the market and so enables both more competition and a larger average scale. Instead of having two national markets, each with three firms producing 100 units, there can be four firms in the regional market, each of which produces 150 units. Both the increase in competition and the increase in scale will lower prices, as we have shown happened in MERCOSUR; so regional integration will have been beneficial, but in order to reap these gains, two of the six firms will have closed. Hence, in order for regional integration to secure the gains of competition and scale, the least efficient firms must be allowed to exit. A successful regional integration is an omelet that cannot be made without breaking eggs. Furthermore, removing tariffs is likely to be insufficient to achieve these gains that depend upon national markets becoming integrated into a single regional market. This will require many other supporting policies of "deep integration" to harmonize product standards and ensure that all firms have real penetration in all the nations within the region.

A trade bloc that succeeds in reaping these competition and scale effects will not only lower the prices of manufactures produced within the region. As a result, importers will be forced to lower their prices so the bloc will improve its terms of trade. If developing countries want to use trade blocs to improve their terms of trade, the most pertinent model is not OPEC but MERCOSUR. The policy instrument is thus not a collective increase in trade taxes, but a collective increase in competition.

## Trade and Location Effects

Competition and scale effects accrue to the region as a whole, but trade and location effects are predominantly about transfers between one part of the region and another. The key trade effect is that money, which prior to the trade bloc accrued to the government as tariff revenue, will now accrue to firms in the partner country. The government loses tariff revenue and the country as a whole loses income. This effect is known as trade diversion. We have looked to see how substantial this effect is in seven recent regional arrangements by modeling the effect on trade between the countries in the bloc and the rest of the world. In four of the seven there was no problem, but in three the problem was large enough to be visible. Hence, diversion is neither so common as to be general, nor so unusual as to be dismissable. The analysis has to be done bloc by bloc. In some circumstances the loss of revenue will be serious, notably where tariffs are high and tariff revenue is a substantial share of total government revenue. For example, in a small, poor country such as Burkina Faso, regional integration will involve a large diversion from government revenue to manufacturing firms in Côte d'Ivoire and Senegal. A price that Burkina Faso might have to pay for the political drive to regionalism might thus be fewer children in primary education. Recent research suggests that there may be a further hidden cost to diversion. One by-product of trade is knowledge: firms learn from their trading partners. Evidence shows that trade has more knowledge benefits the larger is the stock of knowledge of the trading partner, with the stock of knowledge measured by the accumulated investment in research and development. Hence, if a poor Southern country diverts its trade from a Northern country with a large knowledge stock, to another Southern country with a much smaller knowledge stock, it will reduce its learning. Since within a South-South trade bloc it is the poorest countries that experience the most diversion, they are the ones liable to suffer the largest reduction in knowledge transfer.

The formation of a trade bloc will cause economic activities to shift location. Potentially, this can create convergence or divergence between the members of the bloc. One contribution of this report has been the discovery that the conventional forces of comparative advantage have a disturbing implication for South-South trade blocs. We show that comparative advantage produces convergence in North-North blocs, but divergence in South-South blocs. We show that this is not just theory. In the EU the poorer Northern countries, such as Ireland, Portugal, and Spain, have caught up with the richer countries: there are dramatic signs of convergence. By contrast, in CACM and the Economic Community of West Africa there are symptoms of divergence: the richer Southern countries have substantially gained market share at the expense of the poorer. Comparative advantage works in this way in these trade blocs by advantaging the middle-income countries. A North-North bloc discriminates against the South and so helps those countries within the bloc that are the closest competitors with the South, namely the lowest-income countries in the bloc. A South-South bloc discriminates against the North and so helps those countries within the bloc that are the closest competitors with the North, namely the highest-income countries in the bloc. Thus, the same force produces convergence in Northern blocs and divergence in Southern blocs.

A further force for divergence within Southern blocs is industrial agglomeration. Firms within an industry gain from clustering together, and when freed from trade barriers will choose to do so. Trade blocs will thus always increase agglomeration within each industry: if they fail to do so it is because they have failed to remove the real barriers to trade. Such forces may or may not cause overall industrial agglomeration. For example, in the United States, although each industry is highly agglomerated, there is little overall industrial agglomeration because different industries cluster in different cities. The key issue is whether the big gains from agglomeration are specific to each industry or accrue to industry in general. These processes have not yet been very thoroughly researched empirically, but what seems probable is that at an early stage of industrialization the main benefits of clustering accrue for industry as a whole—for example, the provision of good infrastructure—whereas at an advanced stage the main benefits are industry-specific—for example, a skilled work force. Unfortunately, as with the forces of comparative advantage, this will also tend to produce convergence within Northern blocs and divergence within Southern blocs. These forces for divergence within Southern trade blocs have evident and serious implications for poverty. They may also make the blocs politically unviable and even become a cause of conflict.

## I'm the minister of trade. What bloc design should I choose?

Taking the political impetus for the formation of trade blocs as a given, it is evident that the poorest countries may find membership of the conventional South-South blocs quite problematic. While the soundbite regional economics of scale economies might seem to offer most to the poorest, smallest economies, a more serious analysis reveals much scope for loss: revenue diversion, reduced knowledge transfer, and divergence from richer partners. We now review some of the design choices that can determine whether a trade bloc is economically advantageous to all of its members, or is liable to be a source of contention.

## Which countries should I take as partners?

Table 4.1 summarizes our assessment of partner suitability. For example, a Central European transition economy may look to association with the EU primarily for the political benefits of security and policy lock-in. These political benefits are likely to be so large that the country would probably want to join the trade bloc even if the economic effects were on balance highly negative. In fact, they are likely to be positive. There will probably be some losses from revenue diversion, but the scale and competition, and trade and location effects are likely to be positive. Thus, the political impetus also happens to make economic sense. A trade bloc between two large, middle-income countries can also have very substantial political benefits. Regional security may be enhanced, there may be policy lock-in, the increased trust may facilitate other types of regional cooperation, and negotiating power may increase. The economics are less clear. The increased competition is likely to improve the terms of trade, and this can be a large benefit. If manufacturing is already well established, although there will be powerful and beneficial agglomeration effects within each industry, the bloc may avoid significant overall industrial agglomeration. Offsetting this, there may be some revenue diversion. Thus, the strong political impetus may not deliver commensurate economic benefits, but there is perhaps little danger of large net costs.

The most problematic blocs are evidently those between two small, poor countries, one of which is significantly poorer than the other. There may still be some political gains: the bloc may find it easier to get noticed than the countries individually, and if the experience of trade cooperation builds up trust, it may facilitate cooperation on other issues. However, there may also be political costs as the unintended economic transfers generate frictions. The economic effects look worrying: as discussed above, the poorer country stands to lose through several distinct processes. What else might such poor countries do? One option is for a South-South bloc to negotiate an associate agreement with a Northern bloc. Such a negotiating opportunity is currently available from the EU through the new Lomé agreement, and might also become available from the United States. Politically, membership of a North-South bloc may bring benefits of policy lock-in, as in Central Europe. Economically, it offers enhanced knowledge gains, and should at least mitigate the problem of divergence within the Southern bloc. While the forces of industrial agglomeration would still favor the more developed Southern partner, the forces of comparative advantage would favor the poorest most. Hence, small, poor countries should probably aim to rechannel the political impetus for trade blocs from expanding South-South blocs into South-North blocs. The less-poor members of South-South blocs might also benefit from such a change of strategy. Although they would lose protection in the tiny markets of the poorest countries, they would be the most likely beneficiaries of investment in industries exporting to the new Northern market.

## How many blocs should I join?

More is fine as long as they are not incompatible, although the resources spent in negotiating and administering them may be better used on other issues. At present some countries have signed multiple agreements that are not legally compatible. This is not merely bad law, it gives rise to investor uncertainty: it is simply unclear which tariffs will actually end up being applied. And even when compatible, a proliferation of agreements may leave investors confused. The existence of incompatible agreements is a classic example of political dreams colliding with practical decisions. In such cases the political impetus to regional agreements needs to be rechanneled.

### How much preference should I give?

Big preferences cause industry to agglomerate in a single location within a South-South trade bloc. This implies strong transfers within the bloc with the poorer members losing out. It is therefore in the interest of the poorer members of a South-South bloc to set their external tariff at a moderate level, and if the bloc has a common tariff, to insist that it be fairly low. Another reason for low external tariffs is that big preferences increase revenue diversion. Also, since protection in poorer members is typically higher than in richer ones, the poorer ones will lose more from opening up to the rich ones than they gain from free access to them. This can be resolved by a reduction in the poor member's external tariff.

### Should I press for a common external tariff?

Common external tariffs have one big advantage: they avoid the need for "rules of origin," the enforcement of which creates a large amount of bureaucracy and scope for fraud. However, they also have serious disadvantages. Neighboring countries differ as to their need for tariff revenue, and hence as to the height of tariff that is appropriate. They also differ in their chosen pace of trade liberalization and in their preferences and opportunities for tariff bargaining. Finally, the common pool of revenue has to be divided on some basis, and this may strain political cooperation. In practice, governments usually opt out of a common external tariff through exemptions, even if they sign up in principle.

### How deep should I take liberalization?

The big gains from trade blocs come from integrating markets. Removing tariffs but leaving other impediments will inflict all the costs of revenue diversion without any of the compensating benefits of competition and scale. Thus deeper is better. Potentially, agreements can preclude the use of antidumping suits, which is part of the agreement between members of the EU. Since the EU has already extended this benefit to Iceland, there would seem to be in principle no obstacle to its being included in prospective South-North blocs involving the EU. Agreements can also cover border procedures where there is often large scope for illicit protection that undermines the bloc. Finally, as in the EU, they can cover product standards. Rather than agree on common standards, which is slow and may be costly for the poorer members, the most practical step may be mutual recognition: If a product can be sold in one country, it can be sold anywhere in the bloc.

### How wide should I let negotiations range?

The focus of Southern trade blocs is primarily on trade in manufactures. However, many of the big gains to liberalizing trade are to be found in services. Services are often less exposed to competition, and a high-cost service sector can handicap all the other sectors of the economy for which it supplies inputs. It is also important to extend cooperation beyond trade. For example, in South-South blocs that fail to harmonize the taxation of foreign investment, the creation of the trade bloc weakens the bargaining power of each government relative to the investor. The investor can now serve the entire regional market by locating in that country that offers the lowest taxation, and so the trade bloc encourages a tax race to the bottom.

### I went to Seattle. How can I use the WTO more effectively?

Finally, the report has considered trade blocs in the context of the WTO. Developing countries have much to gain from continued multilateral nonpreferential liberalization as enforced by the MFN clause. MFN strengthens the weak by limiting the power of the strong to cut deals with each other that exclude the weak. The biggest exception to MFN that the GATT and WTO have permitted has been the EU, which has fully liberalized trade among its members without extending the same opportunities to other nations. Developing countries have an interest in protecting the MFN principle from further erosion, but they also have an interest in gaining access to the trade blocs that the North has already constructed. The strategy of imitating the North by constructing South-South blocs is unlikely to be beneficial for the poorest. South-South blocs cannot do for the South what North-North blocs did for the North. This is not because of a lack of political will, it is because the same economic forces will produce radically different outcomes. South-South blocs offer little to the poorest countries and may even harm them.

The poor need secure access to the North, and they can get this in only two ways: through a successful WTO, or through association agreements with the EU, Japan, or the United States. These are, in fact, the two different uses of the term "open regionalism": concerted multilateralism, and open access to membership of the Northern clubs. Fortunately, these are not alternatives. The poor can support the WTO against the menace of Northern protectionist lobbies at the same time that they pressure for the right of access to the clubs. Since this report is about trade blocs, we have focused upon the latter. We have proposed that the WTO modify its rules concerning trade blocs to create a presumptive right of association. Analogous to the MFN clause, if association is granted to one country, there should be a presumption that similar terms should be available to others. If Iceland is offered reciprocal freedom from antidumping suits by the EU, then the same option should be available to Ghana. Naturally, association is complex, and so, in practice, each accession must be negotiated. But the poor should not be denied the association rights already conferred by both the United States and the EU on several middle-income countries. The voice of the poor is not loud in global trade forums and is easily hijacked by Northern special interests. We have proposed a package-negotiating offer by the South to the North concerning the WTO rules governing trade blocs. The South would offer to extend the existing rules concerning North-North trade blocs to South-South blocs. Although this is a concession, it would strengthen the MFN principle, which is very much in the interests of the South. In return, the South would demand an open access rule, in which the right to equal treatment of applications for association in all trade blocs would be enshrined.

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