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Framework for a New Regionalism

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Abstract

This study examines the various issues that have been brought up in the debate on the question of whether the new regionalism is a stumbling block or a building block toward establishing worldwide economic multilateralism. It reviewed the value of Most Favored Nation (MFN) status as well as some existing assessments of the trade and welfare effects of the new regionalism. It also presented some empirical examples of Regional Trading Arrangements (RTAs) that seem consistent with multilateral trade liberalization. The paper concluded that protectionism and trade diversion are threats that RTAs should constantly look out for but the trade created and investment induced by the new regionalism far outweigh them. Hence, RTAs are regarded as building blocks for multilateralism.

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Framework for a New Regionalism[*]

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I. Introduction

At the time the Uruguay Round (UR) of the General Agreement on Tariffs and Trade (GATT) was being negotiated, several policy concerns had been raised about regional trading arrangements (RTAs), broadly defined as preferential trade agreements (PTAs) among a subgroup of countries or economies. This definition includes free trade areas (FTAs) and customs unions (CUs). Beginning in the middle of the 1980s, there has been a resurgence of PTAs, a phenomenon popularly referred to as the new regionalism, alongside efforts toward multilateral trade liberalization, or for short, multilateralism.

The use of the world "new" is meant to distinguish the recent RTAs from the PTAs that emerged after World War II, which with the exception of that in Western Europe were all virtual failures (see Bhagwati 1993, Ethier 1998, and Krueger 1999). According to Krueger, the trend toward multilateral free trade from the late '‘40s to the late ‘70s dominated tendencies toward CUs or PTAs. But in the late ‘80s, she noted a change in attitude, particularly, on the part of the United States. Specifically, she pointed out that after a GATT ministerial meeting in 1982 adjourned without agreeing on a new round of trade negotiations, the US announced that it would seek a more open trading system based on a two-track approach. One track led to multilateralism, while the other pursued "GATT-plus" arrangements with other countries receptive to open trade beyond that agreed under GATT.

Subsequently, the US played an active role in the formation of some FTAs, thereby providing an impetus to the new regionalism. Consider: after successfully negotiating bilateral free trade areas with Israel and Canada, the US proposed a hemispheric FTA with the Enterprise for the Americas Initiative (EAI), and initialed the launching of the North America Free Trade Agreement (NAFTA) with Canada and Mexico. With these developments, the European Common Market (ECM), the first successful example of a PTA, expanded, bringing in Greece, Portugal, Spain, Sweden, and Norway into the ECM. In the southern cone of Latin America, an agreement was reached among Argentina, Brazil, Paraguay, and Uruguay to form a Southern Common Market (MERCOSUR). In Southeast Asia, an ASEAN Free Trade Area (AFTA) was formed among Brunei, Indonesia, Malaysia, Philippines, Thailand, and Singapore. Australia and New Zealand established the Closer Economic Relations (CER) agreement. On both sides of the Pacific, the Asia-Pacific Economic Cooperation (APEC) was launched.

The new regionalism caught the attention of both economic theorists and policy makers (see, e.g., the collection of papers in De Melo and Panagariya 1993, Bora and

[*] The paper forms part of Chapter 2 of the 2000 APEC Economic Outlook Report which deals with the issue on the new regionalism..

Findlay 1996). During the GATT-UR negotiations, one of the major concerns was whether RTAs were forces for the successful completion of an international trading arrangement based on the most-favored-nation (MFN) clause. Under MFN, tariff privileges accorded to one member country can not be withheld from other members; in other words, non-discrimination applies. The MFN principle was at the core of the various rounds of negotiation under the GATT, an arrangement that developing countries welcomed, as they were able to access even the bilateral trade privileges forged between developed countries.

There was a divergence of opinion then on whether RTAs tended to promote worldwide economic integration. Critics asserted that RTAs were stumbling blocks, and that they were inherently discriminatory since tariff privileges were not extended to non-members. Others, however, viewed RTAs as complementary to open multilateral trade governed by rules. Moreover, with costly negotiations, supporters asserted that the presence of a few major trading blocks would facilitate the move towards multilateralism. In any event, the GATT-UR negotiations were completed in 1994, giving rise to the World Trade Organization (WTO), the successor organization to the GATT. Under the various rounds of GATT negotiations, average tariffs on manufactured goods declined from more than 40 percent to about 7 percent, exclusive of the UR reductions. Once the latter are phased in, the average tariff rate is bound to go down further.

However, Article XXIV of the GATT permitted the establishment of PTAs under certain conditions. According to Krueger, citing Dam (1970), the conditions included: (1) grant of 100 percent preferential treatment, that is, zero tariffs among members; and (2) the PTA was not to increase protection against the rest of the world. Moreover, there was to be a timetable for achieving free trade among the members. It seems that Article XXIV contemplated CUs, an arrangement involving zero tariffs for those within the union and a common external tariff for those outside, as the exception to open multilateral trade (see also Bhagwati 1993).

At this stage, the question on whether the new regionalism is a stumbling block or building block in the push for international economic integration persists and continues to be debated (see Krueger 1999). This debate is not likely to simmer down soon considering that several new FTAs are still being initiated, a reaction it seems to the failure of the Seattle ministerial meeting held last January 2000 to draw up an agenda for the next round of WTO negotiations.

At least two major strands of the debate on the new regionalism have surfaced. One uses the Viner perspective (1950) on the possibility of trade diversion, rendering RTAs a stumbling block to multilateral trade liberalization. The other strand, which considers RTAs a building block, argues that the framework for looking at the new regionalism has to go beyond mere gains from commodity trade. Ethier (1998), for instance, points out that the new regionalism is taking place in an environment that involves direct foreign investments and where the developing countries that are in the RTA are unilaterally adopting policy reforms that afford increasing returns to scale from investments, yielding dynamic gains to them that exceed those from plain commodity trade. In APEC, the dynamic gains from the new regionalism, including ”lower prices, investment in R&D, and product innovation,” have not gone unnoticed. (see Economic Committee 1997a).

This paper presents the state of the debate on the new regionalism. Does it facilitate or impede the move toward multilateralism? To set the stage for this, a review of the value of MFN is undertaken in Section 2.2. This is followed in Section 2.3 with a review of some existing assessments of the trade and welfare effects of the new regionalism from the initial insights of Viner (1950) and on to the arguments that Ethier raised in support of the new regionalism. Section 2.4 presents some empirical examples of RTAs, describing their features that seem consistent with multilateral trade liberalization. Finally, Section 2.5 makes some concluding remarks.

II. The Value of MFN

The MFN treatment or principle of non-discrimination is central to the GATT and to its successor, the WTO. As embodied in Article 1, contracting parties are obliged to grant MFN in their own markets to all other contracting countries. But at the same time, they can demand MFN rights from other contracting parties in the latter's markets. In contrast, in the absence of MFN, trading countries that resort to bilateral tariff setting can exclude non-contracting parties from enjoying the agreed-upon tariff privileges. It is MFN that developing countries have sought and endeavored to strengthen since the GATT's inception in 1947. Underlying the clamor for "trade, not aid" in the aftermath of World War II was the desire for an MFN treatment (see, e.g., Johnson 1967). Today, it is also MFN that is actively being pursued by countries that are still not contracting parties in the WTO, such as, China.

The value of an MFN to developing countries can emanate from a variety of sources. The most obvious is the improved capacity of developing countries to capture the tariff privileges that are bilaterally negotiated by developed countries and to enhance market access. The immediate likely effect of an MFN is an increase in developing-county exports to developed-country markets. Early on, Baldwin and Murray (1977) estimated the net economic benefits of MFN tariff reductions, and they were clearly positive. Similar attempts to quantify the aggregate trade effects of tariff reduction were done for the members of the Asia-Pacific Economic Cooperation (APEC) under preferential, conditional and MFN trade liberalization scenarios; the expansion in trade was largest for the MFN scenario (see Economic Committee 1997b).

More recently, Ghosh, Perroni, and Whalley (1998) used a computable general equilibrium model to estimate the benefits and costs of MFN tariff reductions in the EU and in the NAFTA to 7 groupings of countries all over the world, namely, ANJ (Australia, New Zealand, and Japan), RIA (Rich Asia: Indonesia, Hong Kong, Korea, Malaysia, Philippines, Thailand, and Singapore), POA (Poor Asia: China, India, Rest of South Asia), NAF (NAFTA: Canada, USA and Mexico), SAM (South America), EUR (Europe), and ROW (Rest of the World). The benefits in the form of increased trade were positive, though not large, for developing countries like Poor and Rich Asia, as well as for ANJ. EU and NAFTA countries lost from a worsening of their terms of trade. The relatively small magnitudes of the trade benefits to developing regions and the costs to the developed were attributed to the choice of 1992 as base year for the simulations; at that point in time, the external tariffs of the NAF and EU were already quite low.

Ghosh, Perroni, and Whalley, however, further explored the value of MFN by considering the impacts of two MFN constraints. One is a constraint on retaliatory actions should they occur in WTO; the other is a constraint imposed on trade bargaining. Under the first constraint, a developing country cannot be singled out for retaliation. As for the second, developing countries cannot be forced to negotiate bilaterally with developed countries since MFN is multilateral. In view of this, developed countries cannot threaten developing economies into making concessions. Based on the authors' quantitative estimates, the benefits from MFN are the largest when large countries are restrained from negotiating bilaterally with developing countries, a bargaining situation that often involves side payments, say, intellectual property rights and domestic tax treatment. The writers conclude that this constraint on bilateral bargaining is valued more by developing countries than the direct trade creation effects of MFN.

Though the evidence stems largely from quantitative simulations, it is widely accepted that an MFN treatment yields gains not only from improved market access on the part of both developed and developing countries but also from the restraints MFN puts on bilateral negotiations that tend to extract maximal concessions from developing countries. Krueger (1999) has noted that once the tariff reductions from the GATT-UR are phased in, average ad valorem tariffs are expected to go down further to 3-4 percent in the European Union, Japan, and the US, thereby expanding again the opportunities for market access. In assessing the value of an MFN treatment, therefore, some writers have proposed the use of competitive equilibrium models where these gains from MFN matter theoretically.

Bagwell and Staiger (1999), for example, assessed the efficiency and welfare implications of MFN in conjunction with preferences, production, endowments, and exchange structure. They used as starting point the inefficiencies from unilateral trade setting, such as, those that are created when a country seeks improvements in its terms of trade at the expense of foreign exporters. In this environment, governments have an incentive to go for an MFN, given the opportunities for remedying terms-of-trade inefficiencies. Down the road, MFN sets limits on acceptable behavior during bargaining, with salutary effects on the outcomes. Recalling Ghosh, Perroni, and Whalley, similar restraints imposed by MFN deliver the greatest benefits to developing countries. Bagwell and Staiger's competitive equilibrium model may be viewed as an analytical effort toward capturing the widely accepted gains from an MFN treatment, permitting reciprocity and non-discrimination to emerge as a matter of choice.

Theoretically, a physical environment can be described where unilateral or bilateral tariff setting policies result in multiple equilibria, some of which are inefficient. For instance, Maggi (1999) showed that the value of MFN lies in the coordinative efforts countries undertake to achieve efficient equilibrium outcomes. In addition, since contracting parties have to deal with asymmetric information, the WTO through its Dispute Settlement Procedure (DSP) can reduce the monitoring or verification costs to small countries if and when WTO violations are committed.

In view of the gains from MFN, contracting parties endeavor to protect and strengthen it. Meanwhile, countries that are not yet contracting parties aggressively seek it. Any effort to weaken MFN is thus resisted. Under WTO, the forces that tend to dilute MFN include anti-dumping (AD) measures and voluntary export restraints (VERs). In addition, Article XXIV, by allowing PTAs, is viewed by some as potentially damaging to MFN, although others consider PTAs complementary to a rules-based multilateral trade system. This debate is dealt with in the next section.

III Assessing RTAs

Do RTAs impede or facilitate the move towards a multilateral trading system anchored on MFN? If they impede, under what conditions can they be made effective instruments for multilateralism? These questions have endured in view of the resurgence of RTAs in the second half of the 1980s. The USA played an active role in the new regionalism, its encouragement of the launching of new FTAs spurred, according to Bhagwati (1993), by frustration over the slowness of the GATT-UR negotiations. The delays in the latter were attributed to negotiation costs that had gone up greatly with the entry of several countries and the complexity of the issues dealt with in the newly enlarged bargaining space (see, e.g., Krugman 1993). The number of contracting parties increased from about 40 to more than 100 countries. Issues like free riding were more difficult to sort in the aftermath of the large increase in the number of participants.

The analysis of the trade and welfare effects of RTAs is typically at two levels. At one level, the trade, production, and consumption effects of RTAs on individual countries are studied; second, the effects of RTAs on the time path of the multilateral trading system are explored. Most of the issues constantly being raised by developing countries pertain to the latter, reflecting apprehension about the dangers posed by RTAs on MFN.

Trade and Welfare Effects

The starting point in the analytical assessment of the trade and welfare effects of RTAs is Viner (1950). Viner has stressed that the key issue about RTAs is whether they are trade creating or trade diverting. Suppose from an initial equilibrium position with non-discriminatory tariffs, countries A and B decide to form an FTA. Assume that a differentiated commodity y is produced through a constant returns production function in several countries. Suppose after the formation of the FTA, country B is able to export y to A. Is this good or bad? Using Viner’s arguments, it depends on the pre-FTA supplier of y to A. If A is a high-cost producer of y and it used to supply y, then a shift to the low-cost producer B is trade creating. However, if before FTA, y is supplied to A by a third country C, then this means that C is a low-cost producer of y and a shift to B as supplier of y means a shift from a low-cost producer to a high-cost producer. This is trade diverting and it leads to a decline in global welfare. When NAFTA, for example, was being formed, developing countries like India warned about the risks of trade diversion to Mexico. If the increase in trade among NAFTA countries were at the expense of trade with the developing world, then worldwide welfare, some developing countries complained, would decline.

Krugman (1991) has proposed a framework for assessing the trade creating or diverting effects of RTAs based on a theory of trading bloc formation. The world is assumed to be divided into several production units, each one producing a distinct good. The analysis shows that global welfare is maximized in two extreme cases. In a world of several trading blocs—one for each country—a competitive equilibrium with its usual efficiency and optimality properties is reached. As the number of trading blocs decreases, a mix of trade creation and diversion takes place, causing welfare decline. Welfare is minimized for 3 trading blocs and rises again, reaching a peak when there is only one trading bloc, which may be viewed as a case of global free trade. Krugman's theory of trading bloc formation and its welfare effects also incorporates a concept of "natural" trading blocs. Transportation and communications costs provide incentives among neighboring countries to form RTAs. Krugman argues that any reduction in welfare is likely to be small in this case. The gains from freeing intra-regional trade are large, while the costs of reduced inter-regional trade are small. Bhagwati (1993) has disagreed with Krugman on "natural" trading blocs, citing empirical foreign trade data showing that much trade takes place between and among very distant countries; trade diversion is thus likely to be huge. Krueger (1999) has also taken issue with Krugman on this point. She says trade is still based on factor endowments and if neighbors like the USA and Canada are similar in this sense, it is difficult to conclude that trade between them would be "natural."

Notwithstanding this difference of opinion on "natural" trading blocs, the theoretical analysis of the trade and welfare effects of RTAs shows a wide area of agreement among economists, particularly, when set in a competitive equilibrium situation. Differences in opinion resurface when the discussion shifts to monopolistic competition and issues about economies of scale and the distribution of rent are opened up. And when normative issues about RTAs crop up, the divergence of opinion widens further.

Stumbling Blocks or Building Blocks?

Krueger (1999) and De Melo and Panagariya (1993) in their introduction have done comprehensive survey of the arguments on this point; the discussion here is greatly indebted to these works.

Bhagwati (1993) considers RTAS as stumbling blocks to multilateralism citing empirical data. He notes the trade diversion that ensues even when tariffs are low in the case of US imports from Mexico under NAFTA. Levy (1997) then adds that as trade is created among the partners, stakeholders who are apprehensive about a dilution of their exports from further liberalization emerge. The greater the political power of vested interests, the higher would be the tariffs set against non-members. Trade diversion, under this line of argument, becomes pervasive with adverse welfare effects.

In sharp contrast, Ethier (1998) considers RTAs as building blocks for multilateral trade liberalization. RTAs, in his view, emerge from the success of global trade liberalization among developed countries. While he acknowledges that both trade diversion and protectionism are a constant threat, developing countries willingly join RTAs in order to lock in their trade reforms, thereby ensuring the continuous flow of trade and investments from developed countries. Ethier proposes a framework that goes beyond trade creation and trade diversion. He observes that the new regionalism is taking place amid deep structural reforms that matter not only for trade in commodities, but also for investments, knowledge transfer, and technological progress. Ethier's model captures elements of real economies like multi-stage production with increasing returns, foreign direct investments, technological progress, and factor mobility. Seen in this light, RTAs yield welfare gains that extend beyond mere gains from trade.

As the world gets reduced to a few trading blocs, bargaining costs decline. With only a manageable number of trading blocs negotiating, the process of multilateral trade liberalization can be speeded up. Strategically, the acceleration of multilateralism can be accomplished by organizing blocs committed to open regionalism, under which the trade privileges of the members are not withheld from non-members.

In the context of the GATT-UR, the US, as Bhagwati (1993, p.45), De Melo and Panagariya (1993, p. 5, 10-11) have observed, took this approach. After noting the slowness of the GATT-UR process, the US endorsed organized blocs like the European Community and saw them as helpful instruments for completion of the UR negotiations. This was in line with the open membership that, according to Bhagwati, William Brock, the then US Trade Representative, had proposed. Brock had offered an FTA to Egypt and ASEAN simultaneous with the offer to Israel.

In addition, RTAs can help secure further liberalization of global trade to the extent producers are induced to lobby for reduction when tariffs on intermediate goods are higher than those of the other member countries prior to the formation of the RTA. The incentive emanates from the dictates of international competitiveness; producers' lobby drives down the tariffs on intermediate goods, forcing multilateral tariffs to the level of the RTA tariffs. Moreover, RTAs do not maintain a common external tariff for non-members. And so they have the flexibility to go beyond what is taking place multilaterally; the GATT-plus in the APEC process is consistent with this notion.

Another argument for why RTAs can be a building block for multilateralism comes from the demonstration effects of being a participant. The observed trade creation and the investments it induces may lead other countries to soften their resistance to multilateral trade liberalization.

It seems clear that there are strong arguments backing the proposition that RTAs can be building blocks for multilateralism. Nonetheless, the fact remains that trade diversion and protectionism against non-members are credible threats. As Krueger (1999) emphasized, protectionists may espouse RTAs to avoid further multilateral liberalization. In addition, members benefiting from the trade creation may not want their gains dampened by further multilateral liberalization. In any event, it seems fruitless to say that RTAs should not be allowed under WTO. So how can the threats to multilateralism be dampened? And how can the new regionalism be a potent instrument for further multilateral trade liberalization?

De Melo and Panagariya suggest reforming the rules of the game so that regionalism complements multilateralism. As suggested by Bhagwati (1993, p.45), open-ended regionalism that is not geographically circumscribed is a sound principle. At this stage, there are several types of RTAs, some with higher potentials for trade diversion and risks for protectionism than other arrangements. Lastly, Bhagwati also proposed the elimination of voluntary export restraints (VERs) and the tightening of the criteria for anti-dumping (AD).

IV Concluding Remarks

This chapter has sought to address the issue on whether the new regionalism is a building block for multilateralism based on WTO rules. The questions posed here are certainly not original, having been raised in at least two previous reports of the Economic Committee (1997a, b). The objective of this chapter is quite modest. The Asian financial crisis that was triggered in the second half of 1997 has proved to be distracting. Now that a region-wide economic recovery appears to be on the way, it is refreshing to be able to discuss in depth trade and investment issues again and keep up with APEC’s vision of “trade and investment liberalization and facilitation” and of “economic and technical cooperation.” The assessment done here shares the main conclusion of the abovecited EC reports: Under certain conditions, the dynamic trade-creating and investment-inducing impacts of the new regionalism outweigh the trade-diversion effects.

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