Regional Trading Arrangements: Barriers or Stepping Stones for Global Free Trade

Jeffrey A. Frankel

Member, U.S. President=s Council of Economic Advisers

Panel: Patterns of Trade, Trade Agreements and Regional Trading Arrangements
Conference: An Agenda for the Twenty-first Century
World Bank, July 9, 1998

I. Recent history

The surge in regional trading arrangements that has taken place over the last fifteen years constitutes a break with preceding post-war history.[1] Previous regional agreements had been neither so numerous, nor so successful, as those of recent years have been. Only the European Community really worked. Perhaps most importantly, the United States had tended to oppose them until the 1980s, choosing rather to emphasize the multilateral liberalization process through the GATT.

In 1982, the U.S. Trade Representative encountered European resistance to American proposals at a GATT Ministerial Conference in Geneva for a new round of multilateral negotiations. He responded with regional initiatives.[2] He let it be known that the United States was "willing to dance" with interested partners. The outcome was the U.S.-Israel FTA, the Caribbean Basin Initiative and Canada-U.S. FTA. The logic was "if the multilateral road is obstructed, then we will just have to explore these other roads". All the "lateralisms" are viewed benignly. In other words, any progress toward removing trade barriers is progress.[3]

It has been ten years since the Canada-U.S. FTA was signed. What has changed in

---

[1] By now there are only a few countries that do not belong to any formal regional trading arrangement, according to the World Trade Organization. If APEC is counted as a planned regional trading arrangement of sorts, then virtually all countries now belong to at least one such club.

[2] E.g., Destler (1995, p.212).

[3] The new willingness to consider departures from multilateralism as a matter of policy, carried over from the Republican Administrations to the Democrats. Lawrence Summers (1991), now Deputy Secretary of the Treasury, gave what has come to be seen as a statement of Administration policy: that there should be a "rebuttable presumption in favor of all the lateral reductions in trade barriers, whether they be multi, uni, tri, plurilateral."

those ten years, and how does it affect the regional-vs.-multilateral logic? Several things. First, we successfully complete the Uruguay Round; some have argued that this achievement should have rendered obsolete the justification for regional initiatives. Second, in the meantime regionalism has made rapid progress in some parts of the world, most notably the European Union, where EMU is carrying integration to new heights, and South America, where free trade areas have grown in depth and scope [far beyond attempts along these lines in the past]. Third, the United States has suffered a bit of Congressional backlash -- of which the most-identifiable immediate impetus appears to have been the Mexican peso crisis of 1994-95 and its confusion in the congressional mind with the effects of NAFTA. Are regional initiatives dead, from the standpoint of U.S. policy?

Administration policies: the trade agenda

Before I turn to the analytics of regional arrangements, I want to elaborate a bit on Clinton Administration trade policy. From his first days in office, President Clinton has been devoted to negotiating market-opening agreements. To continue in the second term the impressive trade record of the first, the Administration last year asked the Congress to grant us the authority to undertake trade negotiations on a fast track basis. So far we have been unable to persuade it to do so.

We have some obligation to explain the trade agenda for which we intend to use fast track. The first use for fast-track authority would be to complete the "built-in" agenda that was established in the most recent Round of GATT negotiations. [At the end of the Uruguay Round, the United States, along with other countries, pushed for a timetable along which negotiations in different areas would resume. We did that because we wanted more out of the Uruguay Round than we got.] Scheduled negotiations in coming years include government procurement, intellectual property rights, agriculture, and services.

The second major item on the trade agenda is to extend the Information Technology Agreement.

Finally, on the topic of regional trade arrangements, the third area that fast-track will be used is for comprehensive market access agreements with individual countries.

Countries around the world are negotiating preferential trade agreements at a rapid pace. The United States could easily be left behind through inaction. Since 1992, other countries have negotiated 20 preferential trade agreements in Latin America and Asia that exclude the United States. The European Union has begun a process that is to culminate in a free trade agreement with Brazil, Argentina, and other MERCOSUR nations. And within South America itself, the four MERCOSUR countries may be in the process of extending their PTA to encompass the entire continent. We do not want to be left out of these trading blocs.[4] The proposed Free Trade Area of the Americas (FTAA) is in part our response.

The Administration needs to get fast-track authority from Congress in order to complete most of these negotiations (though not quite all). The failure to get it last December was disappointing.

I don't want to leave the impression that we have been dead in the water because we don't have fast track. We have made progress at both the regional and multilateral level. We are continuing an active market-opening agenda in every region of the world. In addition to the FTAA, we have ongoing initiatives with the EU, APEC, and -- for the first time ever -- Africa. Last year, we concluded major single-sector WTO agreements in three areas: information technology, global telecommunications, and financial services. Progress has also been made in such areas as civil aviation and anti-corruption. In Geneva a few months ago, at the 50th anniversary of the GATT, the President strongly made the case for trade liberalization, and invited the WTO membership to the United States for the next Ministerial.

But, clearly, if we were not to get fast-track authority in the future, our ability to pursue the market-opening agenda would eventually hit a wall (at both the regional and multilateral levels).

I think we will get fast track eventually. Meanwhile, the regional vs. multilateral logic will still be there. Global liberalization will still be our ultimate goal. There will still be some things that we can accomplish at the regional level but not at the multilateral level. And wherever people face a choice between turning inward or outward, fear that they will be left out of other countries' regional clubs will continue to operate as one added inducement to choose the latter route -- and to support the reduction of barriers at both the regional and multilateral levels simultaneously.

Regional trading arrangements: What are the issues?

In the remainder of my remarks, I would like to address two big questions regarding

[4] For example, today, every major economy in this hemisphere--save the United States--has a preferential trade agreement with Chile. This means that U.S. firms face tariffs in Chile that make their goods 11 percent more expensive than those of competing firms from other countries, such as Canada. This is a serious competitive disadvantage.

regionalism. First: how great an influence are regional arrangements having on the actual patterns of trade flows? Second: is regionalism good or bad? Here it is key to go beyond the approach of traditional customs-union theory, which takes as given the level of trade barriers *between* blocs, and to take into account the possible political effects of regional liberalization on global liberalization.

II. Observed effects on actual trading patterns

Nominal or explicit preferential trading arrangements and operational regional trading blocs are not necessarily the same thing. On the one hand, one can't be sure that explicit proclamations of regional trading arrangements *de jure* are carried out *de facto*. There is a history in the 1960s and 1970s of grandly proclaimed agreements falling short in practice. Conversely, even where explicit preferential trade arrangements do *not* exist, some observers see the same effect as if they did, through other means. Such means include foreign direct investment (FDI), overseas development assistance (ODA), currency links, and even political intervention. These tools are thought to have the effect of distorting and re-directing trade toward the regional hegemon. Certainly the hypothesis put forward by heralds of an emerging yen bloc in East Asia was not that Japan had organized an explicit Free Trade Area. Rather, they pointed to other tools, like the 1997 proposal for an Asian Monetary Fund.

Intra-regional trade shares

One wants to know what effect all the impressive-sounding acronyms have had on the actual pattern of trade. Many studies of regional trading arrangements attempt to document effects on trade by reporting simple statistics on shares of intra-regional trade. The denominator in this ratio, for a member of a particular grouping, is its total trade, and the numerator is the subset of that trade it undertakes with others members of the grouping. This is supposed to reflect tendencies for countries to direct their trade toward other members of their grouping. I begin with this measure, though I shall argue that it is unserviceably primitive. These statistics show an increase in intra-regional trade in each region since 1980.

Intra-regional trade shares

	1962	1980	1994	1996
East Asia	**.33**	.36	.50	**.50**
APEC	**.53**	.59	.74	**.74**
ASEAN-6	.31	**.14**	.21	**.24**
EU-15	.56	.58	.64	.61
Mercosur	.06	**.11**	.19	**.23**

Andean Community	.01	.05	.10	.10
NAFTA	**.36**	**.34**	.43	**.49**

The intra-regional trade ratios can be misleading. The fallacy often arises in comparisons across different groups. It is pointed out that the intra-regional trade share in East Asia has increased the most rapidly of all, by as much as **2** between the 1960s and the 1990s. The intra-regional trade share in East Asia reached .50 in 1996 (versus .74 in Europe and .50 in the Western Hemisphere). This rapid trend is cited as evidence that Japan is building a trade bloc in East Asia, even without explicit policy steps toward a preferential trading area. These inferences regarding the speed with which trade is becoming intra-regionally concentrated in Europe and Asia are incorrect. The trade shares cannot be used to assess whether trade is in any meaningful sense necessarily *concentrated* or *biased*, beyond what would be expected from the size of these countries.

Estimates from the gravity model

The key to detecting and quantifying a possible intra-regional trade bias is to establish a "norm" of bilateral trade volume based on economic, geographic and cultural factors. A useful framework for this purpose is the *gravity model*. Once the norm has been established by the gravity model, a dummy variable can then be added to represent when both countries in a given pair belong to the same regional grouping. One can check how the level of trade and time trend in, for example, East Asia compares with that in other groupings.[5]

The dependent variable in our gravity estimation is the bilateral volume of total trade, exports plus imports (in logarithmic form). The two most important factors in explaining bilateral trade flows are the geographical distance between the two countries, and their economic size. These factors are the essence of the gravity model and are the source of the name, by analogy to the formula for gravitational attraction between two heavenly bodies. Other variables that can usefully be entered into the equation include per capita incomes, and dummy variables indicating whether the pair share a common border or common language.

Findings:

C Trade is indeed concentrated regionally, whether one looks at formal RTAs such as ASEAN

[5] For more on the gravity model, the analysis of Anatural@ trading blocs and their effect on economic welfare, and the political economy of regionalism and multilateralism, see: Frankel, Regional Trading Blocs, Institute for International Economics, Washington DC, 1997.

and NAFTA, or less formal groupings such as APEC. But the question of which blocs have the greatest effect on trade patterns, and particularly the question of where the intra-regional concentration is intensifying, are discovered to have quite different answers when one uses the gravity model, as compared to standard intra-regional trade shares.

C In particular, although East Asia has a high level of intra-regional trade concentration, there has been no increase over time. That is, although intra-Asian trade has increased rapidly, this can be entirely explained by the rapid growth in the region. Malaysia and Japan, for example, loom larger in every countries' trade today than they did 30 years ago; so why shouldn't they also loom larger in each others' trade?

C Among the APEC countries, on the other hand, the rapid increase in trade (at least was until the current financial crisis) <u>cannot</u> be entirely explained by the growth of the member countries. Rather APEC has operated as an intensifying trade bloc. Its high level of trade is all the more impressive in that the distances are so large.

Three-bloc world, or two?

In my estimates, the Pacific bloc has had a more rapidly increasing effect on trade than the East Asia bloc. The suggestion is that the world can be described in terms of two blocs, Pacific and European, better than three. The same is true if one looks at monetary and financial links.

*Currency links***.** East Asia's currency links are tighter with the dollar than with the yen. While the use of the yen outside Japan, particularly in East Asia, increased in 1970s and 1980s, the trend did not keep up with the increase in the size of Japan's output and trade. Most trade in East Asia continues to be invoiced in dollars, not yen. Hong Kong is firmly pegged to the dollar, and no country is pegged to the yen. Korea, Malaysia, and Thailand -- who seek to stabilize their exchange rates, but for occasional devaluations like those of 1997 -- give weights of 10 percent or less to the yen and 80 percent or more to the dollar. It is for good reason that the currencies of Hong Kong, Taiwan and Singapore [as well as Australia and New Zealand] are called the dollar. Other measures of financial links show similarly large influences of the dollar relative to the yen, such as foreign exchange trading, central bank holdings of forex reserves, financial flows, and interest rate correlations.

A trans-Pacific bloc? Finally, while the Pacific Rim has the APEC forum, East Asian regional institutions are less well-developed. Neither Prime Minister Mahatir's proposal for an East Asian Economic Caucus nor Japan's proposal for an Asian Monetary Fund went far. Thus, whether the criterion is monetary, trade, or institutional, the evidence suggests that an American-led APEC bloc has been a more powerful force than a Japan-led Asia bloc.

III. Are regionalist initiatives good or bad for economic welfare?

Since economists are all in favor of free trade, one might suppose that they are all in favor of Free Trade Areas. But economic theory, of course, does not in fact say that FTAs are always good. It depends, among other things, on what the experiment is, and whose welfare is being considered. Let us recall five experiments.

1. Effects on all members of a single RTA, holding constant other trade policies

The traditional distinction is between trade creation, which is beneficial, and trade diversion, which can be distortionary. This distinction is more useful if it can be made operational. To the extent that transport costs matter (which they do, as the gravity model verifies), FTAs among neighbors are Anatural:@ they are likely to be beneficial essentially because trade-creation outweighs trade-diversion.

2. Effects on U.S., when partners dismantle higher barriers

U.S. barriers are to begin with lower than those of most other countries. For this reason, when the U.S. dismantles barriers in exchange for Mexico doing so, we are reducing tariffs less than they do. The result is that their demand for our goods goes up more than our demand for theirs. There is a shift in the terms of trade in our favor, which adds to the benefits of the FTA from our viewpoint. This should have made it especially clear that NAFTA was in our interest: Anot only was it good economics, it was even good mercantilism.@ The same applies to the FTAA.

3. Effects on those left out

Those left out of an FTA may be adversely affected, as trade is diverted away from them. We Americans should worry that we will be left out of the RTAs forming without us in the Western Hemisphere: MERCOSUR, possibly expanding into a SAFTA; Mercosur making a deal with the EU; Chile making deals with everyone.

4. The case of worldwide symmetry: Effects when everyone joins a regional bloc, holding constant inter-bloc barriers

If the world breaks up into two, three or more large blocs, then nobody is left out (though some poorer countries, as in Africa and South Asia, fear being left out of a three-bloc world). This can be good or bad; it again depends on trade diversion vs. trade creation.

5. Effects when taking into account political economy effects on inter-bloc barriers

The most important determinant of welfare is what happens to barriers between the blocs. If they are reduced, even though not as much as barriers are reduced within blocs, the effect will be beneficial for everyone. Regionalization has political economy implications for multilateral liberalization, which in practice are often important. But the effects can go either direction: stumbling blocs or building blocs, to use the classic phrase popularized by Robert Lawrence.

Stumbling blocs

- Blocs' market power is enhanced when a number of countries join into one customs union, so they may be tempted to raise their external tariff to a higher level in order to exploit that market power. Fortunately, Article 24 of the GATT/WTO, which governs the formation of FTAs, rules out such protectionist behavior. This principle has now been extended to services, under the GATS.

- Special interests may be able to manipulate technical aspects of an FTA (such as exemptions, phase-outs, and Rules of Origin, to their own advantage). Such manipulation must be resisted.

- Negotiating FTAs can use up scarce negotiators' time or leaders' capital, which might otherwise be available for multilateral initiatives.

Building blocs

- An FTA can lock in liberalization. One of the goals of NAFTA was to lock in recent Mexican trade liberalization. This plan was tested successfully after the peso crisis hit in December 1994. Whereas Mexico had raised trade barriers against the United States and Canada after its earlier debt crisis of 1982, it did not do so in 1995, thanks to NAFTA.

- Negotiating among 150 countries, over dozens of sectors, can be inefficient and difficult. It is more efficient if smaller countries can join into customs unions and thus negotiate as larger units. Also it can be easier to test out agreements in special areas -- such as services, investment, dispute settlement mechanisms, and competition policy -- among a subset of countries. Examples include the Canada-U.S. FTA and the Australia-New-Zealand Closer Economic Relationship.

- Regional initiatives can sometimes help build export constituencies to create domestic political momentum for liberalization more generally.

- Fred Bergsten speaks of competitive liberalization . Here are four historical examples where regional initiatives led to multilateral progress.

  - In the 1960s, EC-widening gave impetus to the U.S. push for the Kennedy and Tokyo Rounds.

- C In the 1980s, the US-Israel and -Canada FTAs succeeded in helping convince the Europeans to agree to launch the Uruguay Round.

- C In November 1993 came the ATriple Play.@ The combination of President Clinton=s victory in Congress to approve NAFTA and the Seattle APEC Summit (which he upgraded in importance by inviting the leaders for the first time, leading to plans for free trade in the Pacific by 2010-2020) convinced the Germans that they had better push for a conclusion to the Uruguay Round notwithstanding the objections of French farmers.

- C In November 1997, at the APEC Summit in Subic Bay, President Clinton managed to obtain agreement from the other leaders to support the Information Technology Agreement. A few weeks later in Singapore, at the first WTO Ministerial, the momentum from APEC helped carry the ITA through to multilateral acceptance.

Which political forces appear to dominate in practice?

To answer the question, *which political forces appear to dominate in practice?*, I return to the econometrics of the gravity model. It turns out that for most RTAs (e.g., MERCOSUR, NAFTA, ASEAN,...) there is little evidence of trade diversion. To the contrary, barriers against non-members often fall at the same time that barriers within the bloc fall, even though to a lesser degree. Political support for regional liberalization and political support for multilateral liberalization tend to stand or fall together. We saw an example in Washington last year. When the Administration couldn=t get the votes for fast track, it was a setback for both kinds of liberalization. Hopefully, next time the outcome will be different.