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TRADE BLOCS: BARRIERS OR STEPPING STONES FOR GLOBAL TRADE

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Should the Clinton Administration put higher priority on multilateral trade liberalization or on regional trade liberalization? Before I attempt to answer that question, I begin with the case for trade liberalization in general, and a statement of Clinton Administration policy. I will then address two big questions regarding the current regionalism. First: how great an influence are these arrangements having on the actual patterns of trade flows? Second: is regionalism good or bad? The second question in turn breaks down to two parts. Within the approach of traditional customs-union theory, which takes as given the level of trade barriers *between* blocs, is the within-bloc liberalization good or bad? Then: after, taking into account the possible effects of regional liberalization on global liberalization, I will consider the question again.

ADMINISTRATION POLICIES: THE CASE FOR FREE TRADE

From his first days in office, President Clinton has advocated an outward looking, "internationalist" trade policy. During the Clinton Administration, a large number of trade agreements have been ratified and implemented, some relatively large in scope--such as NAFTA and the Uruguay Round of GATT--others relatively small, but all important to reducing barriers to international trade.

How do trade negotiations serve to further the President's primary goals of raising living standards today and in the future? Let's go back to a fundamental and important question: why is free trade so important? What are the benefits of free trade? I will begin by addressing this issue--thus following my own comparative advantage as an international economist--before turning to the central topic of regional agreements.

Classical economic theory tells us that there are national gains from trade, associated with the phrase "comparative advantage." In recent years, scholars have developed a "New

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Trade Theory;" it suggests the existence of additional benefits from trade, which are termed "dynamic" benefits. I will discuss each theory in turn.

The classical theory goes back to Adam Smith and David Ricardo. Adam Smith argued that specialization--the division of labour--enhances productivity. David Ricardo extended this concept to trade between countries. The notion is that trade allows each country to specialize in what it does best, thus maximizing the value of its output. If a government restricts trade, resources are wasted in the production of goods that could be imported more cheaply than they can be produced domestically.

What if one country is better than anyone else at producing every good? The argument in favour of free trade still carries the day. All that is required is for a country to be relatively less skilled than another in the production of some good in order for it to benefit from trade. This is the doctrine of comparative advantage--the fundamental (if perhaps counterintuitive) principle that underlies the theory of international trade. It makes sense for Michael Jordan to pay someone else to mow his lawn, even if Jordan could do it better himself, because he has a comparative advantage at basketball over lawn mowing. Similarly, it makes sense for the United States to pay to import certain goods that can be produced more efficiently abroad, because we have a comparative advantage in other goods.

This is the "classical" view of the benefits of free trade in a nutshell. I would like to flag two key attributes of the classical theory. First, it assumes perfect competition, constant returns to scale, and fixed technology, assumptions that are admittedly not very realistic. Second, the gains from trade are primarily static in nature--that is, they affect the level of output. The elimination of trade barriers raises output, but his is along the lines of a one-time increase, as opposed to a permanent effect on the rate of growth.

I mentioned the existence of the "New Trade Theory." It is more realistic than the classical theory in that it takes into account imperfect competition, increasing returns to scale, and changing technology. It can be viewed as providing equally strong, or stronger, support for the sort of free-trade policies that the U.S. has followed throughout the post-war period, that is, multilateral and bilateral negotiations to reduce trade barriers.

Moreover, new trade theory offers reason to believe that openness can have a permanent effect on a country's rate of growth, not just on the level of GDP. Economic interaction with the rest of the world brings a variety of dynamic effects. It speeds the absorption of frontier technologies and global "best practices" in management; it spurs innovation and cost cutting; it competes away monopoly and opens larger markets. The argument has been summarized as follows:

- International trade leads to greater competition;
- Competition induces greater innovation; and,
- Innovation drives economic growth.

Citing theory is not a complete answer to the question, "How do we know that trade is good?" We need empirical evidence. Economists have undertaken statistical tests of the determinants of countries' growth rates. Investment in physical capital and investment in human capital are the two factors that emerge the most strongly. But other factors matter as well. Estimates of growth equations have found a role for openness, measured for example as the sum of exports and imports as a share of GDP. One study that I did with David Romer (1999) looks at a cross-section of 100 countries during the period since 1960. We sought to address a major concern regarding simultaneous causality between growth and trade: Does openness lead to growth, or does growth lead to openness? We found that the effect of openness on growth is even stronger when we correct for the simultaneity, as compared to standard estimates.

The estimate of the effect of openness on income per capita ranges from 0.34 to 2.0. The increase in U.S. openness since the 1950s is .12. Multiplying the numbers together implies an effect of 4 to 24 percent on U.S. income. The fact that trade can affect a country's growth rate--as opposed to affecting the level of its GDP in a "one-shot" fashion--makes the case for trade liberalization even more compelling.

ADMINISTRATION POLICIES: THE TRADE AGENDA

The Administration has asked the Congress to grant the authority to undertake trade negotiations on a fast track basis. 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 the European Union and 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 single-sector, but multilateral, agreements, such as a plan to extend the Information Technology Agreement. The recently concluded ITA will reduce to zero tariffs on a range of information technology products: semiconductors, computers, telecommunications equipment, faxes, phones, and integrated circuits. Asia's tariffs in these areas averaged 30 percent. In the ITA, the United States agreed, along with 43 other countries, that tariffs on information technology products should be brought to zero across the board in all countries, by roughly the year 2000. We already have agreement among our trading partners for an ITA-2--which would expand the scope of the products, countries, and kinds of barriers encompassed by this extremely ambitious initiative. We are also considering seeking similar kinds of agreements in a number of other individual sectors -- such as, environmental equipment and services, medical equipment and technology, and transportation equipment.

Finally, and relevant for the topic of regional trade blocs, the third area that fast track will be used is for comprehensive market access agreements with individual countries. Thus far, Chile has been identified as the first and most likely country for this kind of arrangement. 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. This is a serious competitive disadvantage.

Countries around the world are negotiating preferential trade agreements at a rapid pace. We could easily be left behind through inaction. Between 1992 and 1997, other countries 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. The Administration's response was the Free Trade Area of the Americas, proposed at the Miami Summit of December 1994.

The Administration needs to get fast-track authority from Congress for most of these negotiations (though not all). The failure to get it has been disappointing.

RECENT HISTORY OF REGIONAL TRADING ARRANGEMENTS

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

The surge in regional trading arrangements that has taken place over the last ten years constitutes a break with preceding post-war history. Previous regional agreements had been neither so numerous, nor so successful, as those of recent years have been. Perhaps most importantly, the United States had tended to oppose them, choosing rather to emphasize the multilateral liberalization process through the GATT. In the 1990s the United States moved to the forefront of some of the largest regionalist initiatives. Why the change, and why now? Late-1980s developments in four essentially independent arenas seem to have come together to create a movement toward regionalism: the example set by successful European integration, U.S. strategy, developments in Canada, and attitudes toward trade in the developing world.

- EC enlargement to 12 in 1981 and ratification of the Single Europe Act in 1986-1987.

[1] WTO (1995, p.27).

- In 1982, Trade Representative William Brock 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 swift outcome was the U.S.-Israel FTA and the Caribbean Basin Initiative. (Negotiations with Canada took longer.) The logic was "if the multilateral road is obstructed, then we will just have to explore these other roads".

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), destined to be Secretary of the Treasury, gave what has come to be seen as a statement of Administration policy: that there should be a "reputable presumption in favour of all the lateral reductions in trade barriers, whether they be multi, uni, tri, plurilateral." All the "lateralisms" are viewed benignly. In other words, any progress toward removing trade barriers is progress. This has remained the policy even after the successful conclusion and implementation of the Uruguay Round and the establishment of the World Trade Organization.[3]

- U.S. frustration with the lack of multilateral progress happened to coincide with an independent development, the third link in the chain. Canada instigated negotiations on a Free Trade Area with the United States. In doing so, Canada reversed over 100 years of explicit rejection of proposals for such links with its larger neighbour. An important motive was the development of a view among Canadian businessmen that their domestic market was too small to exploit economies of scale.[4]

- The fourth component of the new regionalism, and the one that has made it a worldwide phenomenon, is the spread of serious regional initiatives to the developing countries. Most dramatically, the Mexican President in 1990 reversed 150 years of active resistance to the yanqui embrace, and asked to follow the Canadian precedent in forming an FTA with the United States. The resulting NAFTA was concluded in 1992 and ratified in 1993. But there has also been a simultaneous proliferation of regional trading arrangements among developing countries themselves, far more serious than failed attempts along these lines in the past. In 1991 alone, MERCOSUR was inaugurated among four countries in the eastern half of South America; Venezuela and Colombia

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

[3] The language was repeated as recently as Summers (1996, p.48): "...it is important that the march towards lower trade barriers -- unilaterally, regionally, and multilaterally -- continues." See also Council of Economic Advisers (1995, 217-231).

[4] And among economists; e.g., Wonnacott and Wonnacott (1967) and Harris (1991).

reinvigorated the Andean Pact in the western half of that continent, agreeing to establish a common market within two years; and Southeast Asian countries agreed to form the ASEAN Free Trade Area. Many more agreements followed as well, in virtually all parts of the world.

There was a logical prerequisite for successful regionalism among developing countries. The prerequisite was that countries in Latin America and elsewhere had ditched the import-substitution model, which had dominated thinking in the 1960s and 1970s, in favour of the market liberalization model.

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 long history of grandly proclaimed agreements falling short in practice. It is a story of failure to translate visions into specific plans, of delays in implementation, of rampant sectoral exclusions or escape clauses, and of poor enforcement of nominal agreements.

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, or modern "Greater Asia Co-Prosperity Sphere," is not that Japan has organized an explicit Free Trade Area. Rather, they point to other tools, like the recent proposal for an Asian Monetary Fund.

INTRA-REGIONAL TRADE SHARES

We want to know what effect all these 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.

	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	.3
Andean Community	.01	.05	.10	.10
NAFTA	.36	.34	.43	.49
Africa	.04	.03	.03	NA

The most serious problem with this measure shows up right away. The share is very high for large groupings like APEC or Western Europe, and very low for small groupings like the Andean Pact countries. Is this because APEC has been very successful at promoting trade among its members and the Andean Pact has not? No, not necessarily. Rather, it reflects I part that APEC is a large group of countries, both in the sense of the number of members that belong and in the sense that many of them are quite large trading countries, while the Andean Pact represents a relatively small group of small countries. It is a necessary property of the intra-regional share measure that the bigger the set of countries around which one throws the lasso, the higher will be the apparent concentration of trade within. In the limit, if one throws the lasso around all countries of planet Earth, one would find a ratio of 100 percent.

The fallacy often arises in comparisons across different groups. Boosters of APEC, for example, sometimes point to its intra-regional share of 74 per cent, forgetting to acknowledge that members of *any* grouping that comprises a large share of the world economy will inevitably trade a lot with each other. Only after one takes into account APEC's share of world trade (41 per cent) can one consider its intra-regional trade to be noteworthy.

Similarly, it is pointed out that the intra-regional trade share in East Asia has increased the most rapidly of all, by as much as ½ between the 1960s and the 1990s. The intra-regional trade share in East Asia reached .50 in 1994 (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. We shall see that 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*, toward the United States or Japan, or toward all the members of APEC, 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*.[5] 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.

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 shares a common border or common language.

The findings are easily stated: trade is indeed concentrated regionally, whether one looks at formal RTAs such as ASEAN 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.

- 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 country's trade today than they did 30 years ago; so why shouldn't they also loom larger in each other's trade?

- Among the APEC countries, on the other hand, the rapid increase in trade cannot 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 great, and the institutions so informal.

- Intra-regional trade among geographic groupings of poor countries, such as sub-Saharan Africa, which is widely thought to be unusually low, is seen to be far

[5] Frankel (1997) gives an explanation of the gravity model, references, and details on the estimation reported here. It is also the source of the arguments in the latter part of this paper regarding the implications of regional trade arrangements for economic welfare.

closer to normal, when one properly accounts for the low incomes of the countries in question.[6]

THREE-BLOC WORLD, OR TWO?

In short, 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. While the use of the yen outside Japan, particularly in East Asia, has increased since the early 1970s, the trend has not kept 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 the recent ones -- 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.

A trans-Pacific dollar bloc? The finding that East Asia's currency links are tighter with the dollar than with the yen are mirrored on the trade side. Trade within the APEC, like trade with East Asia, is very high and growing. Unlike with East Asia, the increase in trade exceeds what can be explained by natural determinants such as income growth. The level of intra-APEC trade is all the more striking when one takes into account the large distances involved.

Finally, while the Pacific Rim has the APEC forum, East Asian regional institutions are less far advanced. Prime Minister Mahatir's proposal for an East Asian Economic Caucus did not go far. The recent Japanese proposal for an Asian Monetary Fund has also met stiff resistance.

Conclusion Thus, whether the criterion is monetary, trade, or institutional, the evidence suggests that-- so far, at least--an American-led APEC bloc is a more powerful force than a Japan-led Asia bloc.

ARE REGIONALIST INITIATIVES GOOD OR BAD FOR ECONOMIC WELFARE?

Effects on all members of an RTA, holding constant other trade policies

The traditional distinction is between Trade diversion vs. Trade creation. The theoretical distinction needs to be made more operational. Krugman made the argument: to the extent

[6] Foroutan (1993) and Foroutan and Pritchett (1993).

that transport costs matter (which they do), FTAs among neighbours are "natural:" they are likely to be beneficial essentially because trade-creation outweighs trade-diversion. Thus some degree of regional preferences can be beneficial.

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

When the U.S. (or Canada) 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 favour, which adds to the benefits of the FTA from our viewpoint. This should have made it especially clear that NAFTA was in our interest: "not only was it good economics, it was even good mercantilism." The same applies to Chile.

Effects on those left out

Those left out of an FTA may be adversely affected, as trade is diverted away from them. The countries that have the greatest grounds for concern are those -- such as in Africa and South Asia -- that run the risk of being left out of any of the large trading blocs,. But even Americans have reason to 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; and Chile making deals with everyone, including Canada.

Effects when everyone joins a regional bloc, holding constant inter-bloc barriers

If the world breaks up into three or more large inclusive blocs, then nobody is left out. This can be good or bad; it depends on the specifics. (This leaves aside the point that some poorer countries fear being left out of a three-bloc world and properly so.)

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

The most important determinant 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 can have political economy effects on multilateral liberalization. But the effects can go either direction: stumbling blocs or building blocs.

STUMBLING BLOCS

There are at least four respects in which regional liberalization can divert political support away from more general liberalization.

- Trade blocs can be tempted to raise tariffs to exploit monopoly power. The bigger the bloc the more the market power. Fortunately such behaviour by FTAs is ruled out by Article 24 of the GATT, which in the Uruguay Round was extended to cover services in the GATS.

- Regional agreements can be manipulated by special interests, with respect to such features as exemptions, phase-outs, rules of origin, etc.

- Negotiating regional agreements can use up the scarce time of trade representatives, or the scarce political capital of leaders, so that there is less left for negotiating multilateral agreements.

- Once export-oriented firms have won free trade with similarly endowed partners, they will have less incentive to press for free trade with the rest of the world.

BUILDING BLOCS

There are also at least four respects in which regional agreements can help build political momentum for more general liberalization.

- They can lock in liberalization, as NAFTA did for Mexico, or mobilize regional solidarity, as the Andes Pact did for its members.

- It can be more efficient to negotiate with larger units, and to test out at the regional level agreements in special areas. Examples for the issues of services, investment, and competition policy include the Canada-US FTA, NAFTA, and the Australia-New Zealand Closer Economic Relationship. As issues of the environment and social standards force their way into the context of trade negotiations, countries may find that they have an easier time reaching agreements among like-minded or similarly endowed regional neighbours than worldwide.

- Regional agreements can help building export constituencies, and thereby create domestic political momentum for further liberalization.

- Under competitive liberalization liberalization in one region can spur liberalization in others. There are many possible examples. The original EC widening helped inspire the U.S. push for the Kennedy and Tokyo Rounds. The US agreements to form FTAs with Israel and Canada in the 1980s helped spur European agreement to launch the Uruguay Round. In the “Triple Play” of November1993, the combination of Senate approval of NAFTA and the Seattle APEC Leaders Summit spurred Germany to make sure the Uruguay Round was finally completed. In the “Double Play” of November1996, the momentum from the APEC leaders meeting at Subic Bay carried over to the WTO Ministerial in Singapore and helped finish the ITA.

It is hard to predict whether the pattern of the 1990s will be repeated in the coming decade. In the United States, support for trade initiatives, whether regional or multilateral, appears for the moment to be stymied by an ill-informed anti-globalisation backlash. Since the world depends on US leadership, the unfortunate danger is that progress in the WTO will be stymied. Other countries are eager to proceed with economic integration, having observed the benefits in terms of economic growth. In this context, if multilateral liberalization is stalled, I would not be surprised if other countries chose to pursue some combination of regional and unilateral liberalization in its place.

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