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**The New Regionalism and Asia:  
Impact and Options**

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## **The New Regionalism and Asia: Impact and Options**

### **Summary**

New regional initiatives abound, both outside Asia and within. Free Trade Areas in the West -- notably NAFTA, its possible enlargement into an FTA of the Americas, and the European Union -- have implications for Asia. Asian manufacturers will experience trade diversion, especially in textiles and apparel. Balancing such losses is the likelihood of gains from higher import demand caused by stronger economic growth in the Americas and Europe.

New estimates of the gravity model of bilateral trade confirm the presence of implicit or de facto trade blocs in Asia and the Pacific, as in Europe and the Western Hemisphere. By testing concentric groupings at once, we ascertain that the right place to "draw the line" in describing existing patterns seems to be so as to include all of Asia. (There is also an independent Pacific effect, which can take the form either of an East Asia bloc or an APEC bloc). ASEAN does not function as an independent bloc, and South Asia is actually an anti-bloc: India and Pakistan trade much less with each other than would two otherwise-similarly situated countries.

The strategic question, from the viewpoint of an individual Asian country, is whether to pursue unilateral, sub-regional, pan-regional, or multilateral routes to enhanced trade. Multilateral liberalization is much more advantageous than regional agreements. To the extent that domestic politics prevents unilateral liberalization and international politics prevents multilateral liberalization, however, regional arrangements may have some advantages. The advantages are particularly clear if the regional initiatives help to build political momentum, both domestically and internationally, for unilateral and multilateral liberalization.

The last part of the paper reviews many political economy arguments: first those that suggest that regionalism undermines support for more generalized liberalization and then those that say that regional initiatives help build political momentum for global liberalization. We return to the gravity model for a verdict on which category of political economy forces appear to have been dominant among the trading blocs of 1970-1992. The conclusion is that regionalism has in the recent experiences been politically consistent with more general liberalization, particularly in the cases of East Asia and the European Community.

## **The New Regionalism and Asia: Impact and Options**

The fever of regional trading arrangements has taken hold.<sup>1</sup> One might date the beginning of the recent trend to 1986-87, when the members of the European Community (EC) hatched their plans for a Single Market by 1992. Or, on the reasoning that serious steps toward regional integration were not a new development in the case of the EC, one might instead identify the watershed as the years 1988-89. This is when the United States agreed to and implemented the Free Trade Agreement with Canada; it thereby abandoned forty years of opposition in principle to regional initiatives on the view that they detracted from multilateral liberalization.<sup>2</sup> Or one might date the recent surge in activity to 1990-92. These were the years when a new customs union was agreed in the Eastern half of South America (Mercosur), the Andes countries agreed to form a serious Free Trade Area, and the ASEAN countries agreed in principle on an ASEAN Free Trade Area (AFTA). Since historical protectionist tendencies in all three regions had previously stymied proposals for regional integration, the spread of serious regional arrangements to these areas was noteworthy.

Subsequently, the order of the day seems to be geographic enlargement of existing trading arrangements. The European

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<sup>1</sup> Introductions to this subject include Bhagwati (1993a), Bliss (1994), De la Torre and Kelly (1992), Fieleke (1992), de Melo, Panagariya, and Rodrik (1993), Schott (1991) and WTO Secretariat (1995).

<sup>2</sup> E.g., Schott (1989), Kahler (1994, p.13), Krueger (1995, 1,23-24), Panagariya (1995, p.15) and Saxonhouse (1995).

Union in 1994 took in three new members, to reach a membership of 15. The United States has begun discussions with Chile, regarding the possibility of it joining the North American Free Trade Area (NAFTA). A hemisphere-wide trading bloc, under the (not very elegant) name Free Trade Area of the Americas (FTAA), was envisioned at the Miami Summit in November 1994. Mercosur and the Andes group are both steaming ahead, and Brazil has thoughts of combining the two into a South American Free Trade Area before bargaining with the North Americans on hemispheric arrangements.

Formal regional arrangements are much less common in Asia. The most important plans are perhaps the ones in ASEAN.

It was founded in 1967 for political purposes, and declared a preferential trading arrangement (PTA) in 1977, which amounted to little. As recently as 1989, the fraction of goods eligible for regional preferences was only on the order of 3 per cent. The ASEAN FTA agreed upon in January 1992 sounds more serious, calling for the reduction of tariffs and non-tariff barriers in phases from 1993 to 2008.<sup>3</sup>

Seven countries of the Indian subcontinent formed the South Asian Association for Regional Co-operation (SAARC) ten years ago. (The members are India, Pakistan, Bangladesh, Sri Lanka, Nepal, Bhutan and the Maldives.) Their past talks had

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<sup>3</sup> References include DeRosa (1993a,b,c), Jackson (1991), Panagariya (1994), and Jaggi (1995).

been even more fruitless than ASEAN's. In May 1995, however, the members agreed to put a preferential trading arrangement into place on December 8. How much substance there will be in this PTA remains to be seen.

When Americans and others worry about a trading bloc forming in Asia, it is generally not ASEAN that concerns them, and still less SAARC. Rather it is the possibility of an East Asia bloc. One version would be the East Asian Economic Group proposed by Malaysian Prime Minister Mohatir, more recently toned down to a proposed East Asian Economic Caucus (EAEC). Another version would be a bloc created by Japan. The "yen bloc" hypothesis is discussed further below.<sup>4</sup>

In the Pacific, the bilateral Australia - New Zealand Closer Economic Relationship [agreed in 1983] is noteworthy, particularly in that it represents much deeper integration than most FTAs. The Australians were also active in starting the Asia-Pacific Economic Cooperation forum in 1989, in an effort to make sure they were not excluded from the rapidly-growing East Asian economy. There was a danger that APEC would come to be viewed as a vacuous talk-shop. The United States was finally galvanized into action by the prospect of regional blocs forming in Asia and the Pacific without its participation. In 1993, the Clinton Administration decided to

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<sup>4</sup> Earlier research of ours has looked at the yen bloc hypothesis extensively, and given other references: Frankel (1991, 1993) and Frankel and Wei (1994a, 1995).

throw its weight behind APEC, taking advantage of the occasion of U.S. government chairmanship to upgrade the meeting of ministers that had been scheduled in Seattle into a high-profile Leaders' Meeting. The "Vision" of a future Pacific Community, which was proposed at that time by the advisory Eminent Persons' Group, was largely adopted by the APEC leaders at their 1994 meeting in Bogor, Indonesia. [It struck some as too ambitious. Nevertheless, many APEC members welcomed the renewed American emphasis on the region.]

In this paper we review the recent regional initiatives, focusing in particular on their impact on Asia. We begin in Section 1 by discussing what simulation models predict as the direct implications for Asia of FTAs and other arrangements in the Western Hemisphere, notably NAFTA and its possible enlargement, and in Europe, notably the European Union. In Section 2, we apply the gravity model of bilateral trade to test for bloc effects in such groupings as ASEAN, East Asia, and all of Asia, for data up to 1992. We test nested or concentric groupings, to determine the appropriate places to "draw the line." Next we consider in Section 3 the strategic question, from the viewpoint of an individual Asia country, whether to pursue unilateral, sub-regional, pan-regional, or multilateral routes to enhanced trade. Multilateral liberalization is much more advantageous than regional

agreements. To the extent that domestic politics prevents unilateral liberalization and international politics prevents multilateral liberalization, regional arrangements may have some advantages. The advantages are particularly clear if the regional initiatives help to build political momentum, both domestically and internationally, for unilateral and multilateral liberalization. The last part of the paper, Section 4, reviews many political economy arguments: first those that suggest that regionalism undermines support for more generalized liberalization and then those that say that regional initiatives help build political momentum for global liberalization. We return to the gravity model for a verdict on which category of political economy forces appear to have been dominant among the trading blocs of 1970-1992. The conclusion is that regionalism has in the recent experiences been politically consistent with general openness, particularly in the case of East Asia and the European Community.

### **1. The Impact of Western FTAs on Asia**

Later in the paper, we will review briefly the state of arguments in favor of free trade. We begin by noting that a belief in free trade, which most economists share, does not

necessarily imply a belief in Free Trade Areas. Removing trade barriers within a group of countries is on the one hand good in that it eliminates some distortions, particularly those between the goods of the members, but is on the other hand bad in that it creates new distortions, those between the goods of the members and goods of non-members. It is good in that it creates trade within the grouping, but it can be bad in that it diverts trade away from non-members.

Because of this possible conflict between trade-creation and trade-diversion, different standard models do not give unambiguous answers on the desirability of a world in which all countries are grouped into trading blocs. The models tend to agree, however, that the formation of a trading bloc can have harmful effects on the countries that are unfortunate enough to be left out of it. Even if the bloc members leave their tariffs and other trade barriers unchanged vis-a-vis outsiders [and under Article XXIV of the GATT, they are indeed prohibited from raising them], there will nevertheless be some diversion of trade away from the non-members, toward bloc members. The fall in demand for the products of the non-members will worsen the terms of trade they receive for their goods [unless the bloc in question is so small that its effects on world markets can be ignored]. This section reviews some of the projected effects from recent regional

trading initiatives in the West.

### **1.1 The Effects of NAFTA on Asia**

Studies of the Canadian-U.S. FTA (CUSFTA) show a decline in trade with third countries in general.<sup>5</sup> The developing countries of Asia potentially have more to lose from the NAFTA, in the form of the possible loss of the American market in labor-intensive manufactured goods to Mexican producers.

We begin with the effects on the two larger NIEs. Noland (1994) estimates that NAFTA could divert trade from Korea equal to 1-3 per cent of total Korean exports by the end of the decade, and that similar trade-diversion could be experienced by exporters in other Asian countries. Almost two-thirds of this estimated impact is in the textile spinning and weaving sector [where quotas under the Multi-Fiber Arrangement currently apply]. Hufbauer and Schott (1993) predict that NAFTA will divert from Taiwan and Korea only \$300 million of manufactured exports that previously went to the United States, with machinery and transport equipment the largest component (on a base-year of 1990). Estimates by Kreinen (1992, p. 17) and Kreinen and Plummer (1992) predict that diversion out of the U.S. market caused by the elimination of intra-North American tariffs will impact

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<sup>5</sup> E.g., Harris and Cox (1984) and Primo Braga (1994).

exports from Korea by 5 per cent, measured as the adverse effect on their terms of trade. [Hufbauer and Schott note the importance of using actual applied tariff rates in the analysis, which include any existing preferences, rather than MFN rates. This is one reason their results imply less trade-diversion than Kreinen and Plummer's.]

The range of estimates for effects on Southeast and South Asia is similar. The Hufbauer-Schott estimates predict that South and East Asian developing countries, excluding Korea and Taiwan, will lose only \$350 million in manufactures, with machinery and transport equipment again the hardest-hit sector, but clothing and other consumer goods also adversely affected. These countries will also lose an estimated \$100 million of primary products.<sup>6</sup> Safadi and Yeats (1993) examine the effects of NAFTA specifically on the South Asian countries. They find that trade diversion of exports is heavily concentrated in textiles and apparel, though the aggregate effect on South Asia would be small. (Industrialized countries pledged under the Uruguay Round to phase out their textile quotas; but the scheduled phase-out is sufficiently long-lived and back-loaded that NAFTA makes a significant difference to worldwide textile trade in the meantime.) The Kreinen-Plummer estimates predict that

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<sup>6</sup> GATT, "International Trade 90-91," 1992, as cited by Hufbauer and Schott (1993).

diversion out of the U.S. market caused by the elimination of intra-North American tariffs will impact exports from the ASEAN countries by 4 per cent, measured as the adverse effect on their terms of trade

These estimated effects are not especially large, especially the Hufbauer-Schott estimates. In part, this is because U.S. tariffs were already very low to begin with (and were already slightly lower against some Mexican goods than against imports from industrialized countries, under the Generalized System of Preferences). On these grounds, one might argue that the scope for both trade-creation and trade-diversion in the U.S. market was limited.

As is widely recognized, however, the major barriers remaining in the United States [as in other industrialized countries] are not tariffs, but Non-Tariff Barriers (NTBs) and administrative protection (such as Anti-Dumping Duties). Canada and Mexico are to a greater extent exempt from such U.S. protection under the NAFTA; indeed this was the major attraction of the FTA from their viewpoint. Thus concerns about diversion of trade away from East Asia, where these trade barriers are often applied, are quite relevant. The manipulation of rules of origin, so as to extend existing U.S. protection to the Mexican market, may in particular hit

Japanese auto producers and other Asian exporters.<sup>7</sup>

The rapid growth in U.S.-Mexican trade in 1993-94, across the border in both directions, initially seemed to be consistent with these concerns. There has not been time, however, to assess the amount of trade creation versus trade diversion in these early results.

At the time of the NAFTA agreement, another major concern on the part of the Asian countries was the diversion of investment from themselves to Mexico. This concern was most relevant for the case of access to capital from U.S. investors, as the CUSFTA and NAFTA included provisions to make within-bloc investors (i.e., Americans) welcome. The concern particularly applies to flows of Foreign Direct Investment (FDI), as opposed to flows of portfolio capital, on the grounds that the latter are more fungible across countries.<sup>8</sup>

Kreinen (1992) predicts that FDI may be diverted from ASEAN to Mexico in the food, chemical, textile, metals and electronics sectors, and from Korea to Mexico in the chemical, machinery, electronics and transport equipment sectors. McCleery (1993, pp.319, 325-329) argues that investment diversion is the most important impact of NAFTA on Asia, with a bigger adverse effect than trade-diversion. His (probably

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<sup>7</sup> Krueger (1993).

<sup>8</sup> Portfolio capital has more of a bilateral and regional dimension than is generally realized, however, so that it does not necessarily follow that East Asians can costlessly make up for diminished U.S. portfolio investments by borrowing elsewhere instead.

overstated) scenarios have Indonesia losing 4-5 per cent of investment to NAFTA, which contributes to a 2.2 per cent fall in GDP; Malaysia losing 5-7 per cent of its investment, which causes a 1.4 per cent drop in GDP; Singapore losing 2-3 per cent of its investment, which causes a 1.3 decline in GDP; and Thailand losing 4-5 per cent of its investment, for a 1.0 per cent drop in GDP. The effects in other countries considered are not so great as in the ASEAN cases; Hong Kong comes the closest.

U.S. investment in Mexico indeed grew rapidly in 1993-94, foreign direct investment as well as portfolio investment. There was moreover the possibility that enhanced trade and liberalization generally in Mexico would touch off a growth boom there, and attract capital also from Japan and elsewhere in addition to attracting American investors. [Of course a growth boom in Mexico or other NAFTA members would have led to increased imports from Asia and elsewhere. These are the dynamic effects of FTAs, to which proponents often appeal when they wish to argue that the FTA will have large benefits for everyone.]

The Mexican crisis that broke in December 1994 changed everything, at least in the short run. The large and growing trade deficit that Mexico ran in 1993 and 1994 will have to disappear in 1995, since the private capital flows to support

it dried up in February 1994 and the central bank's reserves virtually ran out in December. The unexpectedly large peso devaluation that took place at that time will of course be the principal instrument of this adjustment. An effect of North American economic integration will now be that the United States experiences in 1995 a larger share of the decline in Mexican demand for goods and Asia experiences a smaller share of that decline, ironically, than would have taken place in the absence of NAFTA.<sup>9</sup> Given the small size of Mexico, however, this effect on Asia is small.

Another implication of the December 1994 crisis is that less capital will be flowing into Mexico for the next few years. Some of it may flow to the Asian emerging markets instead, as they came through the crisis relatively intact. Nevertheless the worldwide contagion effect of the Mexican crisis was sufficiently great that we will probably see somewhat less capital going to all emerging markets for awhile, as compared to the boom years of 1991-1993.

## **1.2 The Effects of an Enlarged Free Trade Area of the Americas**

Anticipating the Miami Summit, Hufbauer and Schott (1994, p.163-64) made estimates of the effects of a hemisphere-wide

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<sup>9</sup> This is not to say that Americans should view NAFTA as having been a mistake in light of the Mexican crisis. The standard argument in favor of NAFTA, that it helped to lock in the recent beneficial Mexican trade liberalization, has already shown its virtue in this crisis.

FTA. They calculate by commodity groups how much of the increased U.S. imports from the rest of the hemisphere would represent diversion of trade that would otherwise come from other countries. Their estimates indicate East Asia experiencing diversion of \$7.3 billion of exports annually by 2002, equal to 2.6 per cent of projected East Asian exports to the United States. Over 40 per cent of this diversion is concentrated in the textile and apparel sectors (\$3.4 billion). The next largest categories affected are leather products (diversion of \$0.9 billion), primary metals (\$0.6 billion) and amusement and sporting goods (\$0.4 billion). They show South Asia suffering diversion of about \$3.2 billion by 2002, or 2.8 per cent of its projected exports to the US market. The two sectors that experience the most diversion are textiles and apparel (\$1.2 billion) and food products (\$1 billion).

These numbers, while calculated to be somewhat biased upward, represent a small effect. One reason already noted is that U.S. tariff barriers are already low, and will be even lower after the Uruguay Round: below 3 per cent by the year 2000. The estimates do not include the loss of exports to Latin America. If tariffs in Latin America were currently as high as they were ten years ago, the trade-diversion there might be substantial. But tariffs in these countries have

already come down a lot, and will probably come down a lot more. This fact, together with the fact that the Latin American market is not as large as the United States, implies that trade diversion should not be that large.

### **1.3 Effects of the European Union on Asia**

Studies of the earlier stages of regional integration in Europe, such as research by Kreinen (1972, 1982) on the formation of the European Community and on its enlargement, found trade creation five to seven times larger than trade diversion.

The relatively few studies of the effects of 1990s European integration on outside countries tend to predict small gains for East Asian developing countries and Australia/New Zealand, though some find negative effects on Japan from diversion of skill-intensive manufactured products.<sup>10</sup> The Japanese auto industry has been particularly hit by the spread of import quotas from France and Italy to other EU members after 1992, and the application of local content requirements. The EC has also used rules of origin against Japanese makers of photo-copiers, electric scales, electric typewriters, and semi-conductors.<sup>11</sup>

Gundlach, et al (1993, p. 212-219) summarize some recent

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<sup>10</sup> Anderson (1992), Stoeckl, Pearce and Banks (1990), and Haaland and Norman (1992).

<sup>11</sup> Gundlach, et al (1993, p. 208).

studies of the effect of the 1992 Single Market. Within the category of primary commodities, very little trade diversion is expected, because EC countries do not produce them or close substitutes. Koekoek, Kuyvenhoven, and Molle (1990), Matthews and MacAleese (1990), and Page (1992) conclude that the effect on developing countries' commodity exports should be positive (though small), because of the greater demand arising from faster European growth.

Despite the past importance of commodity exports in Southeast Asia, manufactured goods now constitute 86 per cent of exports from East and Southeast Asia to the EU. Here there is more scope for trade-diversion, particularly at the hands of producers in Spain, Portugal and Greece. Davenport (1990), using low estimates of the elasticity of EC import demand with respect to European income, estimates that negative effects from trade-diversion will be large enough to cancel out the positive effects from faster European growth.

Davenport (1991) and Page (1992) estimate that the total net trade effects of EC 1992, as percentages of each region's existing exports to the EC, will be -0.3 for ASEAN, -6.1 for the Asian NIEs, and -0.3 per cent for South Asia and China. Kreinen and Plummer (1992) estimate diversion effects of 8 per cent for ASEAN exports and 5 per cent for Korean exports. Gundlach, et al (1993, p. 218) are more optimistic. They

argue that the Single Market is likely to open up substantial new export opportunities that outweigh trade-diversion. The argument is that EU productivity gains are not likely to be concentrated in those manufacturing industries where European firms have already lost competitiveness to Asians in the past, and that Asian producers can exploit their proven ability to adapt to new patterns of demand for goods and services in the EU.<sup>12</sup>

The 1994 enlargement of the EU -- to take in Austria, Finland and Sweden, formerly members of the European Free Trade Area (EFTA) -- should impact skill-intensive Japan more than the other East Asian countries. If there is in the future another enlargement to include the poorer Czech and Slovak Republics, Poland, and Hungary, trade-diversion should be felt more by the labor-intensive East Asian developing countries. This would be a repeat of the earlier assimilation of Spain, Portugal and Greece into what was then the 9-member European Economic Community.

The studies cited above follow studies of the effects on income within Europe in that they allow dynamic effects on European growth. This approach tends to yield a rosier outlook for everyone. The dynamic effects, in contrast to earlier static (and generally small) estimates, are maximized

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<sup>12</sup> They cite Verbiest and Tang (1991), Page (1992), and Dicke and Langhammer (1991).

under the assumption that the investment rate will be stimulated. The classic references, the Cecchini Report (1988) and Baldwin (1989), estimated that EC GNP by the end of the century would go up on the order of 2.5 to 6.5 per cent as the result of the 1992 Single Market. This higher European income would raise imports from all trading partners. If the elasticity of import demand is about 2, then exports from Asia to Europe would go up at least 5 per cent. This effect is to be netted against the negative effects of trade diversion.

The grounds for the dynamic estimates are unusually uncertain however. Kreinen (1992, p.17) and Kreinen and Plummer (1992), who do not allow for dynamic effects, predict that diversion out of the market by the elimination of intra-North American tariffs would negatively impact exports from the ASEAN countries by 8 per cent (measured as the adverse effect on their terms of trade) and impact exports from Korea by 5 per cent. [Again, only tariffs are included. The estimated effect on ASEAN is greater for European integration than for North American integration, in part because the European tariffs are higher than U.S. tariffs.]

## **2. To What Extent do Implicit Trading Blocs Already Exist in Asia?**

### **Estimates from the Gravity Model**

Most of the estimates cited above are *ex ante* projections, derived from feeding into econometric models the assumption that a given formally-announced Free Trade Area would in fact entail the removal of all tariffs among its members. Based on past history, there are grounds for suspicion that formal proclamations of FTAs are not always followed by full implementation. In the 1960s and 1970s, announced groupings that did not turn out to lead up to their advanced billing were numerous. Besides ASEAN, they included the Latin American Free Trade Area (LAFTA) and the Economic Community of West African States (ECOWAS, launched in 1975), and many others. There is often a failure to translate generalities into specifics, to keep to timetables, or to enforce agreements. The question therefore arises: How can we tell that the more recent round of regional trading arrangements is indeed more serious?

If some suspect that formal arrangements do not always lead to meaningful trade blocs, others suspect that important *de facto* trade blocs can arise even in the absence of *de jure* trading arrangements. It is often noted that the economies of Asia and the Pacific, despite their rapidly increasing pace of interaction, have adopted fewer explicit public mechanisms of integration or cooperation. Only the Australia-New Zealand

Closer Economic Relationship is a formal, deep, arrangement to foster integration. [It even prevents the two members from bringing Anti-Dumping actions against each other, and substitutes an integrated competition policy.] As already noted, SAARC and even AFTA have not really yet gotten off the ground, and the larger EAEC is presently at most a Caucus.

Yet reports abound that an East Asia bloc is forming, centered on Japan. Sometimes the emerging grouping is called a "yen bloc" especially when it is seen as including the growing financial and monetary influence of Japan in the region. Those seeing a yen bloc do not claim that Japan maintains formal discriminatory trading arrangements with East Asian countries. They claim that Japan is bringing about a bloc using means that are indirect, invisible, and implicit, rather than direct, visible or explicit. They have in mind Japan's use of Foreign Direct Investment and Overseas Development Assistance to redirect the Asian trade flows toward itself.<sup>13</sup> To test the hypothesis that such a bloc is forming, it clearly won't do to look at explicit preferential tariffs on the part of Japan, since the proponents of the bloc

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<sup>13</sup> Examples include Arase (1991), Dornbusch (1989), Encarnation (1992), Kwan (1994), and Thurow (1992, pp.16,65), among many others. For various perspectives on the hypothesis, see papers in Regionalism and Rivalry: Japan and the U.S. in Pacific Asia, edited by Jeffrey Frankel and Miles Kahler (University of Chicago Press, Chicago), 1993.

hypothesis concede that this is not the instrument.

## **2.1 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.<sup>14</sup> 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.

It has been frequently observed that the magnitude of intra-regional trade within such groupings as the European

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<sup>14</sup> References with more of a European emphasis include Linneman (1966), Hamilton and Winters (1992), and Wang and Winters (1991).

Union and East Asia is disproportionately high. It is plausible that a large part of the apparent bias toward intra-regional trade is due to simple geographical proximity. Most obviously, proximity reduces shipping costs; it also reduces other costs associated with time lags (interest charges, spoilage, obsolescence, etc.) and costs associated with what Linneman called psychic distance (ignorance of foreign customs, tastes, etc.). Indeed Krugman (1991b) and Summers (1991) assert that most of the observed tendency for countries to trade disproportionately with their intra-regional neighbors is due to proximity. Krugman uses this proposition to argue that the three trading blocs are welfare-improving "natural" groupings (as distinct from "unnatural" trading arrangements between distant trading partners such as the United Kingdom and a Commonwealth member). The argument is that natural intra-continental trade blocs are likely to be more trade-creating than trade diverting, because transportation and other distance-related costs inhibit trade between continents anyway, so that there is less trade to be diverted.

Theoretical models and empirical studies alike surprisingly often neglect to take into account distance and transportation costs. Our measure is the log of distance between the two major cities (usually the capital) of the

respective countries.<sup>15</sup> We also add a dummy "Adjacent" variable to indicate when two countries share a common land border.

Entering GNPs in product form is empirically well-established in bilateral trade regressions. It can be easily justified by the modern theory of trade under imperfect competition. Intuitively, one will choose to trade more with a larger country than a smaller country, because it has more varieties to offer, and consumers like variety. There are reasons to believe that GNP per capita also has a positive effect, for a given size: as countries become more developed, they tend to specialize more and to trade more; furthermore, more developed countries have better ports and communication systems that facilitate goods trade.

A common language can facilitate trade partly because it directly reduces transaction (translation) costs and partly because it enhances exporters' and importers' understanding of each other's culture and legal system, which indirectly promotes trade. To capture this effect, we also include a dummy that takes the value of one if the country pair in question share a common language or has a previous colonial connection. We consider nine languages: English, French,

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<sup>15</sup> We have also tried our tests with a more thorough measure of distance that takes into account land and sea routes, the data generously supplied by Winters and Wang (1991). The results tend to be similar: Frankel, Wei and Stein (1994).

German, Spanish, Portuguese, Dutch, Arabic, Chinese and Japanese.

A representative specification is:

(1)

$$Y_{it} = \alpha + \beta_1 X_{1it} + \beta_2 X_{2it} + \dots + \beta_k X_{kit} + \epsilon_{it}$$

$$\epsilon_{it} = 0$$

The last five explanatory factors are dummy variables. *W.Europe* (Western Europe), *W.Hemisphere* (Western Hemisphere), and *E.ASIA* (East Asia) are examples of the dummy variables we use when testing the effects of membership in a common regional grouping. They are defined as 1 for a given pair when both countries are members of that grouping, and 0 otherwise. We use the technique of Ordinary Least Squares (OLS) regression, which is capable of testing the effect of each independent variable while holding constant the effects of the others.

Our data set covers 63 countries (or 1,953 country pairs) for 1970, 1980 and 1990 (and 1992 later in the paper as well). The source is the United Nation trade matrix for 1970 and 1980, and the International Monetary Fund's Direction of Trade Statistics for 1990 (and 1992).

We employ the panel regression technique that allows for year-specific intercepts. Unlike usual panel regressions, we do not include country pair dummies unless there is a specific reason for doing so, since the loss in degrees of freedom would undermine our effort in detecting possible intra-regional biases.

## 2.2 Implicit and explicit trade blocs in East Asia

As our first application (beyond our earlier studies<sup>16</sup>), we carry out a full

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<sup>16</sup> Frankel (1991, 1993), Frankel and Wei (1994, 1995), and Frankel, Wei and Stein (1994). The chief

examination of possible blocs in Asia Pacific. Specifically, by bringing South Asia and Middle East Asian economies into our analysis, we examine to what degree Asia and its subregions are integrated in terms of goods trade. We consider a sequence of nested country groupings in Asia: ASEAN, East Asia, East and South Asia and the whole of Asia.

For a complete list of countries in various groups that are in our sample, readers are referred to the list that follows Table 1. In all of our estimations, we control for possible bloc effects in Western Hemisphere and Western Europe. As our previous work has shown, both groupings exhibit intra-regional bias.

First in Table 1 we note that our control variables behave very much the same way as in our previous studies. The coefficient on GNP is 0.7 and statistically significant, indicating that larger economies trade more, but trade increases less than proportionally as GNP expands. Per capita GNP also has a positive and statistically significant coefficient: richer economies trade more.

As predicted, geography matters as well. Distance has an economically and statistically large effect on trade: as distance increases by one percent, trade declines by 0.5 percent. The significance of the "adjacency" dummy shows that

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extensions of the econometrics in the present paper are the tests for various Asian groupings, the tests for openness versus trade diversion, and the updating of results through 1992.

two countries with a common land border have a larger amount of trade than two otherwise identical countries. A common language or past colonial connection facilitates trade. In our estimation, this brings in 50% more trade than otherwise.

Trade in both Western Hemisphere and Western Europe exhibits intra-regional biases. However [as in our previous studies], the relative magnitude of bloc variables is different from conclusions that others have reached based on simple magnitudes of intra-regional trade. The latter do not attempt to take into account the factors of the gravity model.

For example, once we take into account the contributions of economic size, level of development, geography and linguistics, the intra-regional bias turns out to be higher in Western Hemisphere than in Western Europe.<sup>17</sup>

Now we come to the central issue of this section of the paper, the degree of integration within Asia. In Column 1 of Table 1, we append a dummy ASEAN-Bloc to denote trade among members of the Association of the Southeast Asian Nations. The dummy is extraordinarily large and statistically significant. Interpreted literally, two ASEAN economies trade 600% [=exp(1.97)-1] more than two otherwise identical economies.<sup>18</sup>

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<sup>17</sup> If we estimate the bias in the EC alone, it shows a higher inward bias than Western Europe considered as a whole.

<sup>18</sup> Hamilton and Winters (1992) also find a strong effect for ASEAN, without testing for broader Asian effects at the same time.

We know that Singapore plays an entrepot role: its imports and exports are more than 100 per cent of GDP. It is possible that the apparent intra-ASEAN bias is partly or wholly a reflection of the extreme openness of Singapore. To examine this, we add a Singapore dummy (any bilateral trade involving Singapore) to the regression in Column 1. (The results of this test are not reported, to save space.) The Singapore dummy does indeed have a positive and very significant coefficient (1.51 with a standard error of 0.09).

The coefficient on the ASEAN dummy is reduced to 1.40 but remains quantitatively large and statistically significant (with a standard error of 0.16). This suggests that Singapore's extreme openness does not explain all of the apparent inward bias among the ASEAN countries.

It is possible that all East Asian economies tend to concentrate their trade with each other, and ASEAN countries are not special in this regard. To examine this possibility, we add an East Asia dummy to the regression. Indeed, the new dummy has a positive and statistically significant coefficient: two East Asian economies trade 700% [=exp(2.12)-1] more than two random economies in the world. Once we take this into account, ASEAN economies no longer exhibit an abnormal amount of trade among themselves relative to their East Asian neighbors.

Again, we may control for the extreme openness of Singapore, and now also Hong Kong which has a similar role as entrepot. We add two dummies to represent bilateral trade pairs that involve Hong Kong and Singapore, respectively (not reported). The coefficients for Hong Kong and Singapore are 0.87 and 1.40, respectively, both significant at the one percent level. After controlling for the openness of these two city economies, the East Asia dummy continues to have a large and significant coefficient (1.70 with a standard error of 0.10).

We have tried testing whether some linguistic links are stronger than others. As of 1990, two Chinese-speaking countries appeared to trade an estimated four and a half times as much as other similarly-situated countries. The apparent magnitude of the Chinese language term raises the possibility that the influence of the Chinese diaspora is a dominant source of East Asian intra-regional trade. There is an important possible objection that must be registered however.

Taiwan-China trade does not appear in the statistics, because it is officially non-existent. Such trade is in reality thought to be large and rapidly-growing, and heavily to take the form of trade routed indirectly through Hong Kong. If Taiwan-China trade is routed through Hong Kong (or Singapore), then it is counted twice in our data, and thus may be

exaggerating the estimate of the influence of the Chinese variable. We have attempted to correct for this double-counting of Taiwan-China trade. The governments of Taiwan and China each report estimates of their true bilateral trade. To err on the side of caution, we took the larger of the estimates, and treated it as if it were all counted twice in the form of Hong Kong trade. We re-ran the gravity estimates with trade among "the three Chinas" adjusted in this way. The independent Chinese-language effect is no longer significantly stronger than other linguistic links around the world.

### **2.3 Broader Asian and Pacific Groupings**

South Asians wonder if they should not be included in Asia. [The habit of speaking of Asia-East-of-Burma as a separate region called East Asia, almost as a separate continent, has not always prevailed. It has become standard only in the last few decades, in response to the superior growth performance of most of these countries.<sup>19</sup>] In the third column, we consider South and East Asia collectively as one candidate trading group. The coefficient for the East-and-South Asia group is 0.65 and significant, indicating two countries in this group trade 90% [=exp(0.65)-1] more than a random pair of otherwise identical countries. If we add the

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<sup>19</sup> Easterly (1993) and Easterly, Kremer, Pritchett, and Summers (1993) see the drawing of the line that separates East Asia from the rest of Asia as having been endogenous.

Hong Kong and Singapore dummies to the regression, the coefficients on East Asia and East-and-South Asia dummies remain quantitatively large (1.36 and 0.37, respectively) and statistically significant.

In our sample, the term "South Asia" refers to two countries, India and Pakistan. One conjectures that the trade between these two countries is negatively impacted by their historical animosity. The last column of Table 1 shows that this is indeed the case: their trade is 70% lower than two otherwise identical economies.<sup>20</sup> This finding suggests that the positive coefficient on the East-and-South Asia bloc in column 3 mainly reflects higher-than-average trade between East and South Asian economies.

Unfortunately Bangladesh, Sri Lanka, and Nepal are not in our sample of available bilateral trade data. But Srinivasan and Canonero (1995, p.29) do have data on trade between these countries and other major trading partners. They note that Bangladesh and Sri Lanka trade very little within the South Asia region. (Much of Nepal's trade is with India; but then Nepal has few alternative routes to the outside world.) It seems possible that the "negative bloc" effect reported in the table for South Asia would generalize, even if all the members were represented.

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<sup>20</sup> Dhar and Panagariya (1995, p.12-13) find a negative effect for India-China trade as well as India-Pakistan trade.

A few of the most eminent international trade economists are skeptical of the notion of natural trading blocs. Specifically, Bhagwati (1992, 1993a) is suspicious of the claim that proximity is an important determinant of trade. He asserts that the high levels of intra-regional trade that are already observed in such areas as Europe must be the result of FTAs and other preferential trading arrangements that are already in place.<sup>21</sup> The issue becomes an important one for policy when other economists, such as Krugman and Summers, argue that proximity does promote trade, and propose that regional trading arrangements be pursued on the grounds that it is *natural* for neighbors to trade with each other.<sup>22</sup> The gravity equation estimates convinced many of us some time ago that distance is in fact a very important determinant of trade. But special historical attractions or repulsions also matter, independently of distance. In South Asia, it is in fact true that neighbors do not necessarily trade more with each other. Historical enmity has reduced trade between India and Pakistan, as we have just seen in the last column of Table 1. Perhaps the root of Jagdish Bhagwati's skepticism

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<sup>21</sup> Panagariya (1995, pp. 9-10) echoes Bhagwati's suspicions. He attacks Summers' argument that an FTA among natural bloc partners is less likely to be trade-diverting, with "natural" defined by a low level of trade with countries outside the group. To the extent that a low observed level of trade reflects natural barriers, such as distance, the model in Frankel, Stein and Wei (1995) supports Summers and Krugman.

<sup>22</sup> Frankel, Stein and Wei (1995) derive the idea of an *optimal degree* of regionalization that can be justified by natural geographic factors. Although the approach builds on that of Krugman, the conclusion is that the world trading system is currently becoming more regionalized than can be justified, that it has entered what we call the *super-natural* zone.

regarding the role of proximity in trade is that he has been unduly influenced by this one observation.<sup>23</sup>

To repeat, the gravity model clearly shows that proximity is in general an important determinant of bilateral trade around the world, notwithstanding exceptions like India-Pakistan and other cases. Ideally, one would use a dummy variable to represent all pairs with a recent history of strong political or military conflict, especially including embargoes and boycotts. This variable would in essence be the antithesis of the dummy variable for linguistic and colonial links. The distance and adjacency effects are so strong however, that they show up as highly significant statistically even when no account is taken of the antagonist pairs.

The next question to arise is whether the right place to draw the line dividing up Asia, if not between Burma and Thailand, is between Pakistan and Iran. In column 4, we include in the regression the whole of the continent of Asia (i.e., adding Asian countries in the Middle East to the above

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<sup>23</sup> Here is Bhagwati (1992, p.544-545) attacking the proposition that geographically proximate FTAs (natural blocs, in Krugman's language) are better than far-flung ones (unnatural ones): "If I had access to captive research assistance and funds, I could examine whether, for all conceivable combinations of countries and distances among them, and for several different time periods, the premise is valid [that proximate countries have higher proportions of trade than countries further apart]. As I do not, I must rely on casual empiricism and *a priori* arguments. Compare for instance the trade through the 1960s between India and Pakistan with that between India and the UK or the USSR. The former trade has been smaller than the latter. Borders can breed hostility and undermine trade...Again, even if the premise is statistically valid for any set of observations, it may be a result of trade diversion itself: proximity may have led to preferential grant of concessions..." We believe that our statistical results using the gravity model show that the premise regarding proximity is indeed true, even when one also holds constant for existing preferential trading arrangements, and notwithstanding such special cases as stunted India-Pakistan trade.

list) as a potential bloc. Two results are noteworthy. First, East Asian economies continue to show certain inward bias among themselves. Second, even after controlling for a special East Asia effect, Asian economies as a group appear to trade more among themselves than one would expect based on their economic and geographic characteristics. There is no reason to draw a line between South Asia and the Middle East.

Part of the pan-Asia trade concentration undoubtedly has to do with the fact that many Asian economies have to import a substantial amount of oil from the Middle East. Adding the Hong Kong and Singapore dummies does not change the qualitative features of the picture (not reported here).

We complete our investigation by considering all members of the Asia Pacific Economic Cooperation (APEC) forum as another potential bloc. We use the criterion of membership as it was up to 1992, i.e., not including Mexico or other new members of APEC. The result is reported in Column 5 of Table 1. We can make several observations regarding this most comprehensive regression. First, of all possible implicit trade blocs in Asia-Pacific, the one that shows the strongest intra-regional bias is in fact the APEC group that includes the United States as its member. Two APEC members trade 200% [=exp(1.14)-1] more than two otherwise identical economies. The American fear that it may be excluded by trade integration

among East Asian economies is largely unfounded. Second, once we have controlled for an APEC effect, the coefficient on the East Asia bloc is greatly reduced and becomes only marginally significant at the ten percent level. This suggests that East Asian economies, though trading a lot among themselves, do not trade substantially more than other APEC countries. Evidently there is an independent Pacific effect that can be represented either by an East Asia bloc or an APEC bloc. Third, even after we have controlled for an APEC effect, there continues to be a pan-Asia bloc that exhibits a strong inward trade bias. Again, controlling for the openness of Hong Kong and Singapore does not alter the basic picture. In that case, the coefficients on East Asia, Asia and APEC blocs are 0.30, 0.38 and 1.06, respectively. (The regression results are not reported here, to save space.)

### **3. Strategies from the Viewpoint of Asian Countries**

Individual countries need to choose on what level to seek integration, or what priorities to give to the different levels: unilateral liberalization<sup>24</sup>; integration with a small group of immediate neighbors [in such groupings as ASEAN and

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<sup>24</sup> Such economies as Singapore and Hong Kong have already pursued the road of unilateral liberalization much more fully than other economies located anywhere in the world.

SAARC, or even an EAEG]; integration in a Pacific-wide grouping (APEC); or, at the highest level, multilateral negotiations through the WTO.

It is worth restating the point that integration in general is to be desired. Isolation on the Myanmar model, or less extreme (but messier) versions on the Indian model, are no longer a viable option for a country that wishes to grow. The literature on the connection between trade and growth is huge, even if one stays within the Asian context. To summarize briefly, econometric estimates of cross-country growth equations show that trade, while ranking behind such determinants of growth as rates of saving and education, is nevertheless important.<sup>25</sup> Critics question how one can be sure, when looking at the correlations, that trade causes growth, rather than growth causing trade, or both responding to some third variable such as investment or good macroeconomic policies. This is the problem of simultaneous causality.<sup>26</sup> One way to get around the simultaneity problem is to focus on the variation in trade that can be attributed to the exogenous determinants of the gravity model: distance from one's trading partners, common borders, common languages, and the size of one's trading partners. This exogenous component of trade turns out to be an even stronger correlate of growth

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<sup>25</sup> Examples include Feder (1982) and Edwards (1993, p.9-11).

<sup>26</sup> E.g., Rodrik (1994b), Bradford and Chakwin (1993), and Sala-i-Martin (1991).

than in the simple tests that do not correct for simultaneity.

In other words, trade is indeed a determinant of growth.<sup>27</sup>

For those countries that historically have had high trade barriers, and have had domestic economies that are highly directed and distorted as well, there is little reason not to begin the process of liberalization unilaterally [with the help of the multilateral development banks, of course]. This advice is most relevant for South Asia and Indochina, though tariffs remain very high in such supposedly trade-oriented economies as Indonesia. Unilateral liberalization is also desirable for other countries as well. But issues of strategy in dealing with ones trading partners arise in addition. Unilateral liberalization might be viewed as a necessary prelude to multilateral negotiations in that the large industrialized countries are unlikely to wish to bargain with a non-market economy.<sup>28</sup> This leaves the question whether to pursue local regional FTAs like AFTA and SAARC versus larger blocs like APEC, or whether to eschew regionalism entirely for the sake of multilateralism.

The ultimate goal should be worldwide liberalization, in which the industrialized countries agree to curtail their

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<sup>27</sup> Frankel, Romer and Cyrus (1995) elaborate on the idea, present the results, and give many citations to the extensive literature.

<sup>28</sup> Hufbauer and Schott give Latin American countries scores on various economic and political criteria, to evaluate whether they are ready to join a FTAA with North America. [Panagariya (1995, pp.32-34) argues that a high-tariff country like India must reduce its tariffs before hoping to join a major FTA; otherwise the partners' producers will simply come in and reap the benefit of India's high tariffs.]

restrictive practices at the same time as the developing countries liberalize. The most relevant restrictive practices of the industrialized countries are agricultural quotas [and textile quotas, which the Uruguay Round is supposed to phase out], Voluntary Export Restraints, the misleadingly-named Anti-Dumping duties, and other aspects of managed trade.

Economists continue to believe that worldwide free trade is the first-best strategy. New economic theories have ultimately done little to change the bottom line. New economic arguments are made that in the presence of imperfect competition, increasing returns to scale, and endogenous technology, an individual country can theoretically raise economic welfare by imposing just the right tariffs or subsidies. But the introduction of imperfect competition does at least as much to strengthen the arguments for free trade as to weaken them. In most of these models, intervention works only if the foreign country fails to retaliate. In reality countries do retaliate, and emulate. An equilibrium in which all countries are effectively prevented from intervening, e.g., by means of the GATT or the World Trade Organization, is better for all than the non-cooperative equilibrium in which everyone intervenes.

Model simulations support the idea that the strategy of forming regional FTAs is not as desirable, from the viewpoint

of Asian countries, as pursuing free trade itself. Various authors have looked at various possible FTAs in Asia.

What would be the effects of the ASEAN Free Trade Area, if it came to full fruition? DeRosa (1993b, pp.5-6; 1993c) uses a Computable General Equilibrium (CGE) model to find that an AFTA would be trade-creating, expanding intra-bloc trade as much as 21 per cent. But MFN liberalization on the part of ASEAN members (even non-reciprocal) would raise trade by three times as much. The problem with purely intra-regional liberalization is that the Southeast Asian countries mostly produce the same sorts of things; it is necessary to promote trade with outsiders, especially developing countries, to get larger welfare gains. "Overall, the findings...cast substantial doubt on the desirability of pursuing regional economic arrangements..."

Srinivasan and Canonero (1993, 1995) look at possibilities for South Asia. They use a more stylized model, along the lines of our gravity equation in the preceding section, but broken down by commodity. They add explicit measures of tariffs in the gravity equation, and use those coefficients to infer what would be the effect of various changes in trading arrangements. For all countries in the region, the most important effects come in the sector of textile fibers and manufactures, particularly textile yarn and

clothing. They find that SAARC would promote trade substantially for the smaller members. Bangladesh's estimated new trade within the region would amount to a very large 21 per cent of GNP, more than doubling its current level of total trade. Nepal's estimated new trade amounts to an even larger (proportionately) 56 per cent of GNP, almost three times its current level of total trade. For these countries, the benefits of regional integration are likely to be large, because their initial levels of trade are small, and India and Pakistan are large enough partners to make a big difference to them.

For the two larger countries themselves, SAARC would not do as much. Srinivasan and Canonero find that integrating with Europe or with the United States would be far more attractive to India and Pakistan than regional integration. An FTA with the EC would raise India's bilateral trade by an amount equal to 30 per cent of GNP, twice its current total trade. It would raise Pakistan's trade with the EC also by 30 per cent of GNP, 95 per cent of its current total trade. Like Panagariya (1993) and DeRosa (1993b, 1993c), Srinivasan and Canonero (1995, p.32) conclude -- assuming reciprocal liberalization with Europe and the United States is not an option -- that coordinated liberalization of countries within an Asian region on an unconditional MFN basis is probably

preferable to the formation of a discriminatory FTA within that region.

Brown, Deardorff, and Stern (1995) study the implication of an East Asian FTA linking Japan with major NIEs. They find welfare gains ranging from 0.2 per cent to 1.2 per cent of GDP. They find that excluded countries or regions gain as well, positive spillovers arising from realization of scale economies and increased product varieties. But the welfare gains to the East Asian is greater when it is assumed that the United States joins in.

What would be the effects of a full-fledged Asia or Pacific trading bloc? Lewis, Robinson, and Wang (1994) use a CGE model to estimate what would be the effects of an APEC Free Trade Area. They find that there would be some trade diversion [away from the EU, in particular], but a lot of trade creation. They conclude that all countries gain (except for the EU, which loses slightly). They also find that omitting one region, whether China, the ASEAN4, or the United States, would hurt the excluded countries, and lower the gains for the members as well. The loss is particularly great if the United States is excluded, as it would be under an Asia-only FTA. Gains for everyone are much greater if the EU is included in the liberalization, as under multilateral agreements. Results in Martin, Petri and Yanagishima (1994)

and Martin and Yanagishima (1995) are similar: positive welfare gains from regional liberalization that are relatively small in most cases, but larger for more inclusive and non-discriminatory liberalization.

From the viewpoint of Asian or Pacific countries, there is an argument for forming an Asian or Pacific grouping to safeguard their interests in the global process. Whether it is a Caucus or a Customs Union, a regional grouping has some potential advantages: it can help its members speak with one voice in global negotiations, it can pose a threat to other countries that they will be left out if they do not "play ball," and -- as a fall-back position in case global progress is stymied -- it can constitute an area in which gains from reciprocal liberalization and economies of scale can be achieved even without other countries.

Unsurprisingly, there are fears among Asian developing countries that an Asia bloc would be dominated by Japan, and other fears that an APEC bloc would be dominated by the United States. Here such sub-groupings as ASEAN and SAARC might play a role. Currently the individual members of these clubs have very little bargaining power vis-a-vis the world's two biggest economies. But a more unified and integrated ASEAN, perhaps even with a common external tariff and speaking with a common voice, would command more attention. The idea, for Southeast

Asian countries, would be to use AFTA as leverage in order to be taken more seriously in APEC, and to use APEC as leverage at the global level. The game is a tricky one.<sup>29</sup>

The danger, of course, is that the world ends up split into a number of warring trade blocs. The formation of blocs in the 1930s was associated with a sharp fall in worldwide trade and with the Great Depression. The postwar multilateral trading system founded on the GATT was associated with a dramatic increase in the volume of world trade and with worldwide economic growth. It is thus natural to worry that the re-emergence of regional blocs might lead to a resumption of less satisfactory growth performance like that of the 1930s and be harmful for economic welfare. In the remainder of the paper, we examine whether regional trading arrangements are likely to help build political momentum for global liberalization, or whether they are more likely to detract from multilateral efforts.

#### **4. Regionalism as a Possible Vehicle for External Liberalization**

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<sup>29</sup> DeRosa (1993b) and Panagariya (1994, 825-826) argue that ASEAN countries would be better off liberalizing unilaterally or multilaterally than via an AFTA.

Although the multilateral system has made large strides toward freer trade, most recently in the form of the successful conclusion of the Uruguay Round negotiations in December 1993, political constraints inevitably prevent the immediate attainment of the economist's nirvana. Since influential producer interest groups in each country typically stand to lose from free trade, full unilateral liberalization rarely occurs, and the world must instead await the outcome of step-by-step multilateral negotiations. In these negotiations, countries trade concessions with each other in such a way that at each step the percentage of the population that stands to gain is sufficiently high to overcome the political opposition.

In this light, the case in favor of regional trading arrangements is a second-best argument that takes as given the impossibility of further most-favored nation (MFN) liberalization. The uninitiated might assume that free-trade economists would under these circumstances necessarily support Free Trade Areas (FTAs). But from the standpoint of static economic welfare, trade economists are in fact ambivalent about the desirability of FTAs, as noted earlier.<sup>30</sup> So long as

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<sup>30</sup> Since the phrase "Free Trade Areas" contains the magic words "free trade," the general assumption is that economists must be in favor of them. Indeed many mainstream American economists signed a public letter of support for the NAFTA, and virtually none publicly opposed it. [Those who rejected their advice most often did so under a misunderstanding regarding both the case for Free Trade Areas and the case for free trade: that they rely on either a naive assumption that other countries will reduce its barriers as much as the domestic country (the United States) or on a naive willingness to incur domestic costs for

tariffs and other barriers against third countries remain in place, the elimination of barriers between two FTA members can as easily intensify distortions as eliminate them.<sup>31</sup>

As already noted, the classical distinction is between the harmful trade-diverting effects of FTAs and their beneficial trade-creating effects. Although modern theories of trade have gone beyond the diversion/creation distinction, it is still a useful intuitive guide to likely welfare effects.<sup>32</sup> Grossman and Helpman (1993), for example, find in a median-voter model that a free trade area is most likely to be adopted when trade diversion outweighs trade-creation, which unfortunately is also when it is most likely to reduce aggregate welfare.

#### **4.1 Negative Political Implications for Multilateral Trade Liberalization**

There are a variety of arguments as to how the adoption of a regional trading area might undermine movement toward unilateral or multilateral liberalization for political

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the sake of the trading partners' gain.]

<sup>31</sup> On the grounds of such trade-diversion effects, and other considerations discussed below, Bhagwati, Krueger, and Panagariya generally oppose regional trading arrangements. Bhagwati (1995, p.11) and Panagariya (1995, p.20, fn.8) have confessed that they were prepared to oppose the NAFTA publicly, if asked. They are now skeptical of other ongoing initiatives, including APEC.

<sup>32</sup> Stein and Frankel (1994) show in a model of imperfect competition that a simulation comparison of the magnitudes of trade creation and trade diversion provides the right answer to the question whether FTAs raise the welfare of the representative consumer, under many plausible parameter values, though not all.

reasons: these fall under the headings "incentive to protect," manipulation of the process by special interests, scarce negotiator resources, and political dead-end. We consider these anti-regionalization arguments first, before considering some arguments that go the other way.

### **Blocs' incentive to protect**

The standard experiment presumes that the level of trade barriers against outsiders remains unchanged when a customs union is established. However, Krugman (1991a) shows how, in a world consisting of a few large blocs, each unit will have more monopoly power and thus will be more tempted to seek to shift the terms of trade in its favor by raising tariffs against the other blocs. This is the "incentive to protect."

This temptation will be minimized in a world of many small trading blocs (or in a world of MFN, i.e., each country its own bloc). A world of a few large blocs is thus one in which the noncooperative equilibrium features a higher level of interbloc tariffs and a lower level of economic welfare. In Krugman's simulation, three turns out to be the worst number of blocs to have.<sup>33</sup> Haveman (1992) gets essentially the same result, with expected world welfare minimized in a world of

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<sup>33</sup> We have already noted that, even when inter-bloc tariff rates are held constant, the distortions created by free trade areas can reduce world welfare. But preferential trading areas drawn along continental boundaries can raise welfare, if the degree of preferences does not exceed a specific natural level justified by inter-continental transport costs (Krugman, 1991b; Frankel, Stein and Wei, 1994; and Stein, 1994, p. 84-93). If the margin of preference is so great as to reduce welfare, we call this a "super-natural" trade bloc. Full-fledged FTAs are likely to be supernatural.

only two customs unions, using a model where trade arises from comparative advantage rather than from product differentiation (following the Deardorff-Stern critique of Krugman). Froot and Yoffie (1993) point out some implications of foreign direct investment for blocs' incentive to protect.

The Krugman model assumes that members of a trade bloc set their external tariffs together, that is, that the arrangement is a customs union. The "incentive to protect" story would be different for a standard Free Trade Area, in which each country is able to set its tariffs with respect to non-members independently. Sinclair and Vines (1994) argue that in the FTA case, there is actually an incentive for each country to *reduce* its external tariffs, just the opposite of the customs union case. Panagariya and Findlay (1994) assume that protection is the endogenous outcome of lobbying, and derive the opposite results regarding the FTA/customs union comparison from Sinclair and Vines: the lobby chooses a lower external tariff under a customs union than under an FTA. The customs union is more effective at diluting the power of interest groups.

In reality, governments in one sense are less capable of national economic optimization than the Krugman model presupposes, and in another sense they are more capable. In both respects, large trading blocs are less vulnerable to the

incentive to raise tariffs against each other than under Krugman's assumptions. Governments are less capable of optimization, in that maximum exploitation of the terms of trade (through imposition of the "optimum tariff") is in practice one of the *less* prevalent determinants of trade policy. More commonly seen are arguments regarding infant industries, protecting the scarce factor of production, increasing employment, and adjustment costs. Governments are *more* capable of optimization in that they have already instituted the cooperative international regime of the GATT, as Bergsten (1991) pointed out in his comment on Krugman (1991b). Article XXIV of the GATT explicitly rules out Krugman's concern. This provision allows deviations from the MFN principle only for FTAs or customs unions that do not raise the average level of their tariffs against nonmembers.

There are several reasons to worry that blocs' "incentive to protect" survives despite the existence of Article XXIV. First, and most obviously, Article XXIV is often disregarded, as Bhagwati (1992) reminds us. Second, as Bagwell and Staiger (1993, fn 25) point out, exacerbation of the incentive to protect in customs unions can take the form of "grey-area" measures when explicit tariff increases are ruled out. Third, one hopes that the multilateral process is on a path whereby worldwide tariff rates are gradually reduced through

negotiation, and that this path is the relevant benchmark, not unchanging tariffs. Bond and Syropoulos (1994) show that arriving at the cooperative equilibrium of an agreement for inter-bloc liberalization in a repeated game, which it is seen as GATT's role to facilitate, becomes more difficult as the size of the blocs, and therefore their monopoly power, rises.

#### **Manipulation by special interests**

The special-interests argument points out that the process of instituting a regional trading arrangement features abundant opportunities for trade-sensitive industries to manipulate the process, particularly those sectors that might be adversely affected. Examples abound. First, Wonnacott and Lutz (1989, p. 65-66) emphasize that negotiators frequently seek to exclude from regional FTAs precisely those of their sectors that would be most threatened by welfare-enhancing trade creation. The members of ASEAN, for example, have until now exempted almost all the important sectors from the system of preferences that they are supposed to grant each other.<sup>34</sup> Grossman and Helpman (1993, p. 34-43) have used their median-voter model to understand how the possibility of such industry exclusions increases the chances of FTAs being adopted. This was the primary reason for another restriction that the GATT Article XXIV places on FTAs, that "substantially all" barriers

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<sup>34</sup> Panagariya (1994, pp. 828-829).

within the region be removed. In practice, FTAs have tended to comply less than completely with this provision. Examples include the European Economic Community's exclusion of agriculture and, in practice, steel and many other goods.

Second, Anne Krueger (1993, 1995) emphasizes the exploitation of rules of origin. An FTA, unlike a customs union, does not involve the setting of common external tariffs. Rules of origin are a mechanism by which a country can prevent imports coming in from nonmembers, transshipped via the FTA partner, in those sectors where the partner has lower tariffs. Krueger (1993) and Krishna and Krueger (1993) show how individual industries in the FTA negotiation can enhance the extent of protection they receive when their governments use rules of origin to enable them to capture their FTA-partner's market in addition to their own, thus diverting trade from foreign suppliers. Krueger (1995) argues that, customs unions are pareto-superior to FTAs, because they have no rules of origin that can be exploited in this way. Nagaoka (1994) develops a model in which the government is committed to preserve a given "strategic" monopolistic industry, e.g., by manipulating rules of origin. He finds some effects whereby regional integration can reduce the incentive for protection for that industry, and thereby accelerate liberalization vis-a-vis the rest of the world, but

also finds that the formation of a customs union can exacerbate the incentive to protect.

Bhagwati (1993a, 30-31; 1995, 22) and Panagariya (1995, 16-21) point out that large countries like the United States may use their overwhelming bargaining power within regional groupings to obtain from small countries distorting concessions that they might not obtain in more balanced multilateral negotiations. Perroni and Whalley (1994) point out that small countries have been the supplicants in recent regional agreements, and show how large countries have all the bargaining power on their side.

#### **Scarce negotiator resources**

The scarce-negotiator-resources argument points out that negotiations are not costless. If they were, then the world would have achieved free trade by now. If the U.S. Special Trade Representative is spending all his or her time -- and spending all the White House's political capital with Congress -- on a regional agreement (e.g., NAFTA), there is presumably less time or capital left over to spend on multilateral negotiations (e.g., the Uruguay Round). As with the incentive-to-protect argument, regional trading arrangements may set back the process of negotiating worldwide trade liberalization under the GATT.

**\*\* Firms' support for FTAs may be a political dead end**

Regional initiatives might prevent multilateral initiatives when the sequence of decisions matters. The forces in favor of liberalization might win out over protectionists if the only choice is between the status quo and multilateral liberalization, but when offered the option of a regional free trade area, the political process might then take the regional route to the exclusion of the multilateral route. Bhagwati (1993 [p.28-29]) worries that businessmen and bureaucrats, after having achieved regional integration, might then find the effort involved in multilateral negotiation too difficult. "Lobbying support and political energies can readily be diverted to preferential trading arrangements such as FTAs...That deprives the multilateral system of the support it needs to survive, let alone be conducive to further trade liberalization" (Bhagwati, 1993b, p.162).

Krueger (1995, pp.22-24) shares these concerns, and argues that the diversion of political energies is likely to be worse in the case of FTAs than in the case of customs unions. She reasons from two propositions: (1) once trade diversion has taken place as the result of any preferential arrangement, the newly-established firms producing for the partner country's market will oppose moves away from the new status quo toward global free trade; and (2) trade-diversion

is more likely to occur under an FTA than a customs union, due to the arguments explained above regarding rules of origin. It then follows that it will be harder to muster the political support to move from an FTA to multilateral free trade than it would be for a customs union.

A few authors have sought to model issues of sequence. Krishna (1995) assumes that a country will accept proposed changes in trade policy if its firms see a net increase in their profits (in all markets) from the change. She then derives two conclusions: (1) Preferential arrangements that are more trade diverting are more likely to be supported by member countries, because the gains by firms is at the expense of non-members, and (2) preferential arrangements that divert trade will reduce the incentives to seek multilateral liberalization. The end result is that multilateral agreements that otherwise are attainable might be precluded, once countries start down the FTA path. [The argument is similar to Krueger's except that it does not rely of rules of origin.] \*\*

Levy (1993) offers what might be called a median-voter dead-end model, in which a bilateral free trade agreement can undermine support for multilateral liberalization because it is a dead end in the political process. As in Grossman and Helpman (1993), it is assumed that trade policy is determined

by the median voter. Trade itself is determined in some sectors by differences in factor endowments, and in others by considerations of imperfect substitutes [which are the rationale behind the gravity model's basic proportionality between trade and country size]. As others have argued, the intra-industry sort of trade that is generated in imperfect substitutes is easier to accept politically than the factor-endowment kind of trade. The reason is that adjustment to import competition requires workers only to move from the assembly line for one product variety to the assembly line for another variety of the same product. Trade based on differences in factor endowments is much more difficult to accept politically, because it requires workers in previously-protected industries to move to different industries (and at lower wages, in the case of capital-intensive industrialized countries).

Levy argues that policy toward trade is thus always a tradeoff between the gains afforded by increased varieties and the losses inflicted by a fall in the relative price of the product that is intensive in the scarce factor (labor, in the case of industrialized countries). If liberalization is not attainable, it is because the losses from factor-endowment trade dominate. If a vote is held first on whether to join a bilateral free-trade area, it is more likely to pass when the

potential partner has similar factor endowments. (It is easier politically to achieve a European Union than a NAFTA or APEC.) The reason is that the gains from increased trade in imperfect substitutes will be large, while the losses from a fall in the relative price of labor-intensive products will be small. But if a vote is then held on multilateral liberalization, it will fail: those key sectors that stand to profit from trade in imperfect substitutes will already have reaped those gains, and there will be fewer political forces to countervail the sectors that lose from the additional factor-endowment trade. In this way regional free trade agreements undermine political support for multilateral liberalization in this model.

In sum, there is no shortage of models and arguments in which regional trading arrangements can undermine multilateral liberalization, or, to use the terminology of Lawrence (1991), in which trade blocs can operate as stumbling blocks rather than building blocks.

#### **4.2 Positive Political Implications for Multilateral Trade Liberalization**

Other arguments go the other way. They offer the hope that the adoption of a regional trading area might undermine

protectionism and reinforce movement toward liberalization more generally. The arguments concern locking in unilateral liberalization, the efficiency of negotiating with larger units, mobilization of regional solidarity, building export constituencies to create domestic political momentum, and competitive liberalization.

#### **Lock-in and mobilizing regional solidarity**

In the late 1980s, Mexican President Salinas reversed a half-century of Mexican protectionism and imposed sweeping unilateral liberalization measures. Future presidents of Mexico might seek to reverse this liberalization. Thus, a good argument for NAFTA was that it locked in the Salinas reforms in a manner that would be difficult to reverse in the future.<sup>35</sup> Panagariya (1995, pp.22-26) and others respond that tariff bindings under the GATT are better devices for locking-in reforms than are regional agreements.

Elsewhere [such as in Andean Pact countries], leaders have used popular support for regional solidarity to achieve liberalization that would be politically impossible if pursued unilaterally. De Melo, Panagariya and Rodrik (1993, Section 3) model the process whereby governments can adopt rules or institutions in a regional grouping to insulate themselves from pressure by private-sector lobbies for intervention on

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<sup>35</sup> E.g., Lawrence (1991).

their behalf.

### **Efficiency of negotiating with larger units**

Within the context of multilateral negotiations, it is awkward to negotiate separately with over 100 small countries.

Some authors have argued that the costs of negotiation go up with the number of countries involved, so that it is easier for a group of countries to negotiate a customs unions first; with a common external trade policy, they can then enter multilateraal negotiations as a group.<sup>36</sup> Others question the practicality of the small numbers claim.<sup>37</sup> This is thought to increase the efficiency of the negotiations, and to make a satisfactory worldwide agreement more likely. The European Union is certainly the most important example of this. Other groupings, such as ASEAN and SAARC, have also been urged to integrate regionally, so as to be able to talk with the larger powers.

### **Building export constituencies to create domestic political momentum**

Wei and Frankel (1994) have made a primitive start at modeling an argument regarding political constituencies. We consider the problem of building export constituencies in a system, like Grossman-Helpman, where a country chooses its

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<sup>36</sup> E.g., Deardorff and Stern (1992), Krugman (1993), and Summers (1991). Kahler (1994; 1995, pp. 125-127) suggests that negotiations among a small number of regional neighbors may allow more efficient treatment of new individual issue areas than do global negotiations.

<sup>37</sup> Bhagwati (1993a), Winters (1993) and Panagariya (1994, 830-31).

trade policies by majority vote. Our hypothesis is that, under certain conditions, leaders might not be able to obtain a majority vote in favor of multilateral liberalization, much less unilateral liberalization, and yet might be able to obtain a majority vote in favor of regional liberalization, which, when completed, then shifts the economic incentives so as to produce a majority in favor of wider liberalization.

This model is inspired by Fernandez and Rodrik (1991), who consider a (non-regional) situation where the majority in a country would vote against unilateral liberalization, even though a majority would *ex post* gain from it economically. Divide the population into three groups: those who know they would gain from liberalization because they are confident of their ability to compete on world markets, those who will eventually gain from liberalization because they will turn out to be competitive on world markets but do not know this *ex ante*, and those who will lose from liberalization because of new import competition but do not know this *ex ante*. If the 2/3 of the population who are uncertain have as little as a 49% chance of gaining, all of this group -- a majority of the entire population -- will oppose liberalization *ex ante*, even though a majority of the population gains *ex post* ( $2/3 \times .49$ , plus the 1/3 who are sure gainers). The interesting aspect of the model is that if the leaders are somehow able to push

liberalization through anyway and a new vote is taken after the uncertainty is resolved, a majority will then vote in favor of maintaining the new liberalized status quo. In essence, the act of liberalization itself builds a constituency for liberalization, as those who are good at exporting discover their previously unknown talents. Similar conclusions could be reached in a model where capital and labor moved from previously protected sectors to new trade-oriented sectors, though the status-quo bias in this case would hold for reforms that did not benefit a majority in addition to those that did.

In the Wei-Frankel (1994) version, political leaders may be able to obtain a majority vote in favor of regional liberalization because fewer sectors are adversely affected. More firms then discover their export potential, making it possible to obtain a majority support for previously unattainable MFN liberalization. The story is thus a counter-example to the overly strong claim of Levy (1993) that "bilateral free trade agreements can never increase political support for multilateral free trade."

#### **Competitive liberalization**

In an important analysis of the political economy of regional blocs, Oye (1992) argues that the expected costs of exclusion from groupings change the political dynamics, by

strengthening the anti-protectionist constituencies domestically, so as to draw countries into multilateral negotiations. Whereas many authors might read the recent experience as one in which regionalism helps build support for multilateral liberalization, Oye finds that this was also true of the 1930s experience.

"Competitive liberalization" refers to building political momentum for liberalization among countries, rather than domestically (Bergsten, 1995). An illustration is President Clinton's "Triple Play" of late 1993.<sup>38</sup> By upgrading the Seattle meeting of APEC ministers that had been scheduled for November 1993 into a high-profile Leaders' Meeting, he signaled to the Europeans that if they continued to allow French farmers to hold up the Uruguay Round, other countries might proceed without them. This message carried credibility because of its fortunate timing, coming as it did on the heels of the hard-fought approval of NAFTA in the U.S. Congress. Thus, the NAFTA outcome demonstrated the political will necessary for meaningful agreements, while the APEC meeting demonstrated the possibility that agreements would cover a fraction of the world economy that was sufficiently large and dynamic to give the Europeans cause for worry at the prospect of being left out. German policymakers have reportedly

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<sup>38</sup> Bergsten (1994, pp.18-20) and Kahler (1994, pp.19,25).

confirmed that this was part of their motive for concluding the Uruguay Round in December. In this episode at least, it appears that regional initiatives helped bring about multilateral agreement.

Of course, the game need not always come out so well. The trouble with making credible threats is that sometimes they must be carried out. The process that is traditionally feared is *competitive regionalization*, where the formation of one regional grouping puts pressure on other countries to form a bloc of their own, rather than to liberalize unilaterally or multilaterally. The worst situation for a country is to be one of the few that do not belong to any bloc, because the terms of trade then turn against it. For this reason, there is a danger that the world will become stuck in an Nash noncooperative equilibrium of several continental FTAs: each continent forms an FTA because, given that the next continent is doing so, it will be hurt if it does not respond in kind. In the resulting equilibrium, all are worse off than they were under the status quo of MFN. (Hence the argument for discouraging FTAs in the GATT in the first place, as under Article XXIV.) Furthermore, even if continents are allowed to choose the level of intra-bloc preference to maximize their individual welfares, rather than being constrained to go all the way to FTAs, in equilibrium they will still choose a level

of preference that is so high as to leave everyone worse off.

This is the "incentive to protect" argument we have already seen. These points are shown in a model with inter-continental transport costs by Stein (1994, p.83-93).<sup>39</sup>

On the other hand, since the ultimate goal is worldwide free trade, it is not clear that the ultimate political economy dynamic is bad. Worldwide economic welfare is so reduced by a non-cooperative equilibrium of four continental FTAs, that it may then become politically possible for them to agree multilaterally to remove the barriers that remain between them and go to worldwide free trade. This would seem to follow if the obstacle to a move from MFN to worldwide free trade is a moderate fixed resource cost to negotiations (say 1 per cent of GDP, to buy off producers that stand to lose). The leap to free trade would be all the more likely to follow if the resource cost to negotiation increases with the number of distinct entities involved.

What happens if the first bloc allows other countries to join? (This is one possible interpretation of the phrase "open regionalism.") A number of authors have shown that non-member countries will, one-by-one find it in their interest to join a

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<sup>39</sup> In a simulation, the status quo of MFN features worldwide welfare that falls short of free trade by only about 0.5 per cent of GNP [which may not be enough to overcome negotiating costs]. Each continent in sequence has an incentive to form an FTA, raising its welfare but lowering that of all the other continents, until all four have done so. In that non-cooperative equilibrium, the loss relative to global free trade is about 2.5 per cent.

given FTA.<sup>40</sup> As the bloc expands, its members gain progressively, as the terms of trade are shifted further and further in their favor. Those that continue to be left out lose progressively. In the model of Deardorff and Stern (1992), the bloc continues to grow until it encompasses the whole world, the happy outcome of global free trade. Their model, however, assumes that the bloc at each stage places prohibitive tariffs on outsiders, a rather extreme assumption.

Saxonhouse (1993) and Stein (1994) consider the same problem, while allowing trade with non-members. They find that when the bloc reaches a certain size (20 out of 30 members in Saxonhouse, and 16 out of 30 in Stein), it will choose not to accept any new members, because its own welfare starts to decline after that. What makes this story especially alarming from the viewpoint of ultimate multilateral liberalization is that the single bloc is truly a dead-end: welfare of the bloc members is higher than it would be under world-wide free trade, so that they have an incentive to reject multilateral liberalization that they did not have when the alternative was MFN. (At this unhappy dead-end point, worldwide welfare is close to its minimum, the very low welfare of the non-members outweighing the high welfare of the

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<sup>40</sup> Bond and Syropoulos (1994), Deardorff and Stern (1992), Saxonhouse (1993) and Stein (1994), each with somewhat different specifications of the model.

members.)

At some point, the non-members will presumably wise up and form a bloc of their own. But given two competing blocs, the incentive for individual countries will be to join the larger of the two to share in its monopoly power. A world of two equal-sized blocs is unstable (Bond and Syropoulos, 1994).

A simulation in Stein (1994, p.99-102) shows that the stable equilibrium has 26 out of 30 countries in one large bloc, and 4 in the other. Again, the large bloc has no incentive to take mercy on those excluded.

Stein (1994, 103-105) has a proposed solution to this difficulty: that Article XXIV be amended to state that preferences within a bloc cannot go beyond a specified low level (22 per cent is the magic limit, in his simulation). We have already seen [in Frankel, Stein and Wei, 1994] that such a restriction -- the opposite of the current Article XXIV requirement for 100 per cent preferences -- would be welfare-improving in a world of equal-sized continental blocs. The same is true when there are no inter-continental transport costs and there is a temptation for countries to join the larger of two blocs. The equilibrium still features one large bloc (24 countries) and one small (6 countries). But with the limit on the margin of preferences in place, the large bloc has nothing to lose by moving to worldwide free trade, so that

the happy outcome is still ultimately attainable. Of course the members of the large bloc would vote against such a rule in the GATT. However, if the issue is decided before any single incipient grouping is large enough to know that it will be the dominant bloc, then everything will work out for free trade.

#### **4.3 Which Effects are Likely to Dominate?**

In short, there are a variety of possible channels of political causation running from regionalism to multilateralism, some positive and some negative. How can one get an idea as to which effects dominate in practice? The gravity framework presented above offers a way of shedding some light on the net effect of political interactions like the ones we have described, as they have actually played themselves out over the last 25 years. For each grouping that is believed to have undertaken regionalization, we add a dummy variable for "openness." This dummy variable indicates when at least one country of the pair is a member of the grouping in question, not necessarily both countries.

If tariffs and other barriers against imports from nonmembers remain unchanged when a given regional grouping is formed, then the coefficient on the openness variable should be negative, indicating trade diversion. Trade creation is

indicated by a positive coefficient on the standard bloc variable (the dummy variable indicating when both countries in the pair are members of the grouping in question). If trade diversion is large enough relative to trade creation, then the FTA may reduce economic welfare. If trade diversion is small, the FTA is likely to improve welfare. A third possibility is that adoption of a regional FTA is associated with political momentum in favor of more widespread liberalization, for any of the reasons enumerated in the preceding sub-section. In this case, the best outcome from the standpoint of economic welfare, the coefficient on the openness variable would be positive rather than negative.

Table 2 supplements Table 1 by adding to the gravity equation variables to test the openness of six groups. East Asian and Western Europe both show highly significant openness with respect to the rest of the world. When East Asia is divided into ASEAN countries and others, both show highly significant openness (as reported in Table 2). These results are similar to those of Dhar and Panagariya (1995), who use the gravity model to find that East Asian countries are open with respect to outside countries, contrary to the usual view. (They also find that North America and the EU are characterized by greater intra-regional trade bias than East Asia.) When Western Europe is divided into the European

Community countries and others (the old EFTA), it is the EC that shows positive openness.<sup>41</sup> The Western Hemisphere shows no significant openness effect in Table 2.<sup>42</sup>

The openness coefficient is insignificant for Asia as a whole: the openness of the East Asian countries has already been captured by the East Asia variables. Finally, South Asia is the one grouping that shows up with a significant negative openness coefficient: India and Pakistan are relatively closed to trade with the rest of the world. This is not an example of a trade-diverting bloc. India and Pakistan are a sort of "anti-bloc." Because they also have an unusually low level of trade with each other, their low level of trade with the rest of the world is perfectly consistent with the general pattern evident in the table. That pattern is that when groups of countries integrate their economies with each other, they also tend to reduce their barriers to outsiders. The liberalization vis-a-vis outsiders is not as great as the liberalization within the bloc, but it is not necessary that it be so.

In other words, our results suggest that the third

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<sup>41</sup> EFTA members show up with a negative openness coefficient, indicating that the grouping is actually trade-diverting. [It doesn't show a significant bloc effect. These results are reported in Frankel, Wei, and Stein (1994).]

<sup>42</sup> This result, which pools data from 1970-1992, masks a pattern of some significant negative openness coefficients in 1965-1975, followed by significant positive coefficients in 1985 and 1990, as Latin America entered its era of benign FTAs. [Estimates on sub-regional FTAs show this pattern for Mercosur in particular. Frankel, Wei, and Stein (1994).]

possibility enumerated above is the relevant one. These countries have tended to open up with respect to all trading partners at the same time that they have opened up with respect to other members of their own grouping. This conclusion matches that of a recent report from the WTO Secretariat (1995), to the effect that the recent regional arrangements among its members have not been fortresses, but to the contrary have sometimes helped to promote freer trade worldwide.

Thus, the tentative verdict seems to be that the net political effect of the removal of regional barriers has tended to support liberalization with respect to nonmembers as well and that the effect of further liberalization has been more than enough to offset any trade diversion resulting directly from the original regional arrangements themselves. From the economists' viewpoint, this verdict is an encouraging one.

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