Regionalism

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READER'S GUIDE

The number of regional trade agreements has grown rapidly since the World Trade Organization (WTO) came into existence in 1995. More than 40 per cent of world trade is now conducted within these preferential trade arrangements, the most significant exception to the WTO's principle of non-discrimination. Governments have often entered regional economic agreements primarily motivated by political rather than economic considerations. Nonetheless, they may prefer trade liberalization on a regional rather than a global basis for several economic reasons. This chapter reviews the political economy of regionalism: why regional trade agreements are established, which actors are likely to support regional rather than global trade liberalization, the effects that regionalism has had on the trade and welfare of members and non-members, and the relationship between liberalization at the regional and global levels.

Introduction

When the Japanese prime minister, Junichiro Koizumi, and his Singaporean counterpart, Goh Chok Tong, signed a bilateral trade agreement in January 2002, Japan departed from the rapidly depleting ranks of WTO members that were not parties to a discriminatory trade arrangement. By the middle of 2003, only Macau and Mongolia among the WTO's 146 members were not parties to one or more regional trading agreements (RTAs). These take various forms ranging, in scope of cooperation, from free trade areas to economic unions (Box 5.1).

RTAs are the most important exception that the WTO permits to the principle that countries should not discriminate in their treatment of other members. Parties to regional arrangements are obliged to notify the WTO of the details of their agreements; the Committee on Regional Trade Agreements has responsibility for ensuring that the agreements comply with the WTO's provisions. World Trade Organization data reflect the explosion in the number of regional arrangements that has occurred since the early 1990s. Throughout its entire existence from 1948 to 1994, the General Agreement on Tariffs and Trade (GATT) received 124 notifications of regional trade agreements, of which only sixty-five were still in force when it was replaced by the WTO. Between 1995 and the beginning of 2003, the WTO received notification of a further 130 agreements. In addition, the WTO estimated that at the latter date a further seventy RTAs were operational but had yet to be notified to it. This growth in regionalism has led to a marked increase in the share of world trade conducted on a discriminatory basis. Trade within discriminatory regional agreements in 2000 accounted for 43 per cent of total world trade; the WTO expects this share to exceed 50 per cent by 2005 (WTO 2003*c*: 48, Table 1B10).

Three sets of rules in the WTO permit the creation of RTAs:

- Article XXIV of the GATT lays down conditions for the establishment and operation of free trade agreements and customs unions covering trade in goods.
- the 'Enabling Clause', formally the 1979 Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries, permits regional agreements among developing countries on trade in goods.
- Article V of the General Agreement on Trade in Services (GATS) establishes conditions that permit liberalization of trade in services among regional partners.

At the beginning of 2003, of the 179 RTAs in effect, 135 came under the auspices of Article XXIV, twenty-five were under GATS Article V, and nineteen under the Enabling Clause.

Why do governments choose to pursue their foreign economic policy objectives through regionalism rather than through other strategies? What explains the recent growth in regionalism? Which political interests are driving integration at the regional level? What impact do regional agreements have on the economies and on the political systems of participants? And what are the consequences of the growth of regionalism for the global trading system? These are the principal questions that this chapter addresses (our focus is on trade rather than the recent growth in regional collaboration on finance). But first, we turn to matters of definition: what do we mean by regionalism?

Regionalism refers to a formal process of intergovernmental collaboration between two or more states. It should be distinguished from *regionalization*, which refers to the growth of economic interdependence within a given geographical area.

One of the few issues on which writers on regionalism agree is that there is no such thing as a 'natural' region. Regions are social constructions whose members define their boundaries. Consider, for instance, the European Union: in its successive incarnations—European Economic Community, European Community, and, now, the European Union—its membership has risen from its six founders to the current total of twenty-five. And debates over EU membership for Turkey show that no consensus exists on either geographic or cultural criteria that could be used to distinguish the 'European' from the 'non-European'.

Box 5.1 A hierarchy of regional economic arrangements

Regional integration arrangements are usually perceived as a hierarchy that runs from free trade areas through customs unions and common markets to economic unions. The terminology of 'hierarchy' is used because each level incorporates all the provisions of the lower level of integration. This does not imply that particular regional arrangements will necessarily progress from a lower to a higher level of integration. Nor is it the case that regional partnerships inevitably begin at the lowest level and then move to 'deeper' integration: some arrangements, for instance, have been established as customs unions.

A *free trade area* exists when countries remove tariffs and non-tariff barriers to the free movement of goods and services between them. Governments meanwhile are free to choose how they treat goods and services imported from non-regional-partner states. Membership in one free trade area therefore does not prevent a country from establishing or joining other free trade areas: Mexico, for example, is a party to agreements with more than thirty countries. Because free trade areas impose relatively few constraints on national decision-making autonomy, they are the easiest of the regional arrangements to negotiate. More than 90 per cent of regional partnerships take the form of free trade areas. Examples include NAFTA, the Japan–Singapore Economic Partnership Agreement, and the Baltic Free Trade Area.

A *customs union* goes beyond the removal of barriers to trade within the region to adopt a common set of policies towards imports from countries outside the region. This includes agreement on a common level of tariffs (often referred to as a common external tariff) on all extra-regional imports. Such agreements cost governments autonomy in their foreign economic policies (joint institutions are usually required to negotiate and administer the common external trade policies). They will also have distributive effects, depending on the level at which the common external tariff is set for various items. Consequently, customs unions are usually more difficult to negotiate than are free trade areas. The relatively small number of customs unions includes the Andean Community, CARICOM, MERCOSUR, and the Southern African Customs Union. Many have experienced difficulties in negotiating a common external tariff. Even in the European Union individual states maintained different tariffs on some products for more than thirty years after its formation. MERCOSUR's negotiation of a common external tariff took fifteen years longer than anticipated, it applied to only three-quarters of total products, and even then was not accepted by two of its members, Bolivia and Peru.

A *common market* includes a customs union and also allows for free movement of labour and capital within the regional partnership. Such free flows of factors of production inevitably require governments to collaborate in additional policy areas to ensure comparable treatment in all countries within the common market. Few governments historically have been willing to accept the loss of policy-making autonomy that occurs in a common market. The Andean Community, CARICOM, the COMESA (Common Market for Eastern and Southern Africa) grouping, and MERCOSUR have committed themselves to work for the establishment of a common market but it is too early to judge whether their aspirations will be realized.

An *economic union* includes a common market plus the adoption of a common currency and/or the harmonization of monetary, fiscal, and social policies. Only the European Union has reached this level of economic integration.

Many of the free trade agreements signed in recent years also include provisions for 'deeper' integration, the most common of which relate to the removal of restrictions on investment flows. But even though these are elements often found in common markets, these free trade areas do not aspire to the creation of a common external tariff or to the free flow of labour within the regional grouping.

For most of the post-war period, the concept of regional economic integration has usually been associated with an arrangement between three or more geographically contiguous states. Again, the EU provides an excellent example but consider also East African Cooperation (Kenya, Tanzania, and Uganda), and the Andean Pact (Bolivia, Colombia, Ecuador, Peru, Venezuela). In recent years, however, a large number of preferential trade agreements have been signed that involve only two parties (for example,

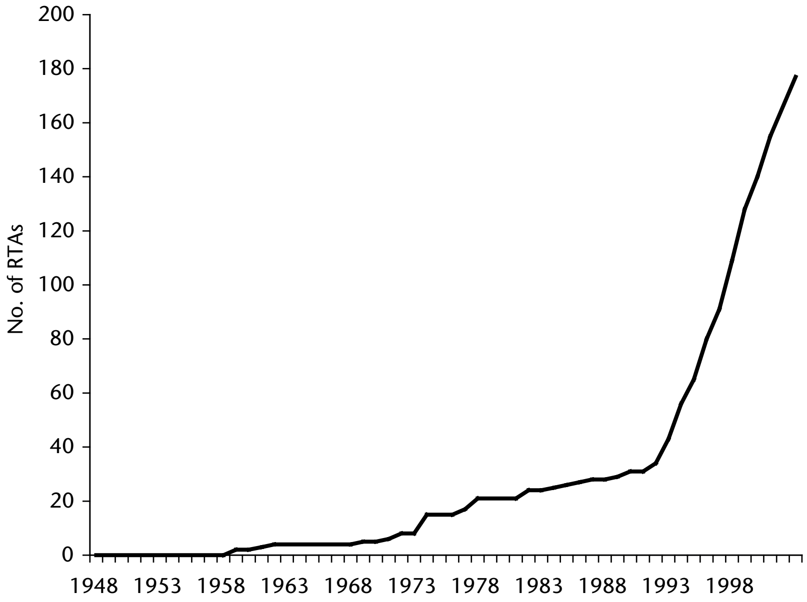

Fig. 5.1 Current RTAs by date of entry into force

Source: www.wto.org/english/tratop_e/region_e/regfac_e.htm

China–Hong Kong), and sometimes these bilateral agreements link parties that are not geographically contiguous (for example, Korea and Chile). Because all these agreements are subject to the scrutiny of the WTO's Committee on Regional Trade Agreements, however, they tend also to be labelled 'regional'. How appropriate is such terminology is questionable. But it is not just the terminology that is problematic: the arguments of the large body of theoretical work on regional integration, which was developed with groupings involving multiple members from the same geographical region in mind, may not be applicable to arrangements that involve only two parties or those that involve states that are not geographical neighbours.

Table 5.1 demonstrates the complexity of the current configuration of 'regional' arrangements—essentially all strategies for trade liberalization that fall between unilateral action at the one extreme and negotiations at the global level in the WTO at the other. Bilateral agreements can occur either between neighbours or between countries that are far removed from one another. Regionalism, as conventionally understood, is a *minilateral* relationship, that is, one that involves more than two countries, on a geographically concentrated basis, for example, the North American Free Trade Agreement (NAFTA) or the ASEAN Free Trade Area (AFTA) (Table 5.5, at the end of the chapter, lists the principal minilateral regional trade groupings). In recent years, however, two other forms of minilateral groupings have emerged among members that are geographically dispersed. *Transregional* groupings link individual countries located in different parts of the world. A good example is the Asia-Pacific Economic Cooperation (APEC) grouping, whose membership comprises twenty-one countries from the Americas, Asia, Oceania, and Europe (Russia). Many of the recently negotiated bilateral RTAs, for instance, USA–Jordan, Singapore–New Zealand, link countries from different geographical areas. *Interregional* arrangements link two established minilateral economic arrangements, as between the European Union and MERCOSUR (the Southern Common Market, comprising Argentina, Brazil, Paraguay, and Uruguay). By the end of 2002, more than twenty-five transregional and interregional agreements were operational.

Table 5.1 Example of the geographical scope of trade liberalization strategies

Unilateral	Bilateral		Minilateral			Global
	Geographically concentrated	Geographically dispersed	Geographically concentrated	Geographically dispersed		
	Bilateral within region	**Bilateral trans-regional**	**Regionalism**	**Trans regionalism**	**Inter regionalism**	
Trade liberalization in SE Asia, Australia, and NZ in 1980s and 1990s	Australia–New Zealand CER	Singapore–USA	NAFTA	APEC[a]	EU–Mercosur CER–AFTA	GATT/WTO

[a] Unlike the other RTAs discussed in this chapter, APEC is not a discriminatory arrangement (its members have pledged to reduce their trade barriers on imports from all sources).

Source: Adapted from Aggarwal (2001: 238).

Why regionalism?

Economists assert that an economy's welfare can be maximized, other than in very exceptional circumstances, if governments lower trade barriers on a non-discriminatory basis (either through unilateral action or through negotiations at the global level that adhere to the WTO's principle of non-discrimination). Regional trade agreements, on the other hand, can reduce global welfare by distorting the allocation of resources, and may even lead to welfare losses for their members (see Box 5.2). Moreover, from the political scientist's perspective, it is usually more efficient to negotiate a single agreement with a large number of states than to undertake a series of negotiations with individual states or with small groupings (because it both economizes on the resources needed for negotiations and also increases the opportunities for trade-offs in reaching a package deal).

Why, then, has regionalism not only been attractive to governments throughout the post-war period but apparently has become increasingly so in the last two decades? Governments usually have multiple motives in entering an arrangement as complex as a regional partnership: it would be naïve to expect to find a single factor that explains governments' actions across all regional agreements. Moreover, governments often enter regional economic agreements primarily for political rather than economic reasons.

Political motivations for entering regional trade agreements

Economic cooperation and confidence building

Regionalism frequently involves the use of economic means for political ends: the improvement of inter-state relations and/or the enhancement of security within a region. In international relationships that have a history of conflict or where no tradition of partnership exists, cooperation on economic matters can be a core element in a process of confidence building.

The origins of post-war European economic integration provide an excellent example. The European Coal and Steel Community (ECSC), created by the 1951 Treaty of Paris, was the first of the institutions of what eventually was to evolve into the European Union. The ECSC, founded by France, West Germany, Italy, Belgium, the Netherlands, and Luxembourg, pooled the coal and steel resources of its members by providing a unified market for these commodities (perceived as critical to any military capacity); it also created a unified labour market in this sector. The underlying objective was to manage the rebuilding of Germany's economy post-war and to integrate it with those of its neighbours, thereby helping to restore

Box 5.2 **The costs and benefits of preferential trade agreements: trade diversion and trade creation**

Jacod Viner (1950) was the first author to present a systematic assessment of the economic costs and benefits of regional economic integration, and to demonstrate, contrary to the then conventional wisdom, that a selective removal of tariffs might not be welfare enhancing. He argued that increased trade between parties to a regional arrangement can occur through two mechanisms. *Trade creation* occurs when imports from a regional partner displace goods that have been produced domestically at higher cost, which can no longer compete once the tariffs on imports from the regional partner are removed. *Trade diversion* occurs when imports from a regional partner displace those that originated outside the regional arrangement, the displacement occurring because the extra-regional imports are no longer price competitive when the tariffs on trade within the region are removed. Consider, for instance, a hypothetical example of what might happen with the implementation of the North American Free Trade Agreement (Table 5.2 below). Let's assume that Indonesia was the lowest-cost source of imported cotton T-shirts for the United States. Before the implementation of NAFTA, when all countries faced the same level of tariffs on their exports to the US market, its T-shirts were preferred to the higher-cost production of Mexican firms. Assume that the tariff on T-shirts was 10 per cent, the cost of manufacturing and delivering an Indonesian T-shirt to the USA was $5 while that for a Mexican T-shirt was $5.40. Adding the 10 per cent tariff to the costs of manufacturing and delivery, the price paid by the importer before NAFTA would be $5.50 for an Indonesian shirt and $5.94 for a Mexican shirt.

Following the implementation of NAFTA, however, the tariff on imported T-shirts from Mexico is removed. For the importer, the Mexican T-shirt is now the least expensive ($5.40) because it is no longer subject to tariffs, while the Indonesian product will still face a 10 per cent tariff and still costs the importer $5.50. Assuming that the importer chooses the lowest-cost product, imports will be switched after the regional scheme goes into effect from the lowest-cost producer (Indonesia) to Mexico, a relatively expensive producer, which now benefits from zero tariffs in the US market.

Several consequences follow from this trade *diversion*. The consumer in the USA *may* gain because the cost to the importer of purchasing a T-shirt falls from $5.50 to $5.40 (although the producer/wholesaler/retailer may be able to capture some or all of this gain). The US government, however, loses the tariff revenue (50 cents for each imported T-shirt) that it previously derived from taxing Indonesian T-shirt imports (the new imports from Mexico not being subject to tax). For the US economy as whole, therefore, the potential gain to consumers is significantly exceeded by the loss of tariff revenue (which is of course a form of taxation income for the government). Considered again from the perspective of the US economy, real resources are wasted because more money is being spent ($5.40 compared with $5.00) for each imported T-shirt. And, unless exceptional circumstances prevail, the Indonesian economy will also suffer a welfare loss because of the decline in export revenue it experiences (and with the loss of the US market, it may also have to lower the price of its T-shirt exports to compete in other markets).

If trade diversion outweighs trade creation then the net effect of regional scheme on its members' welfare can be negative.

Table 5.2 The potential for trade diversion after the removal of tariffs on intra-regional trade ($)

	Cost of production	Tariff pre-NAFTA	Cost to importer pre-NAFTA	Tariff post-NAFTA	Cost to importer post-NAFTA
Indonesia	5.00	0.50 (10%)	5.50	0.50 (10%)	5.50
Mexico	5.40	0.54 (10%)	5.94	Zero	5.40

confidence amongst countries whose conflicts had embroiled the world in two major wars.

In a similar fashion, the Association of South-East Asian Nations, ASEAN, was founded in 1967 to promote economic cooperation in an attempt to build confidence and avoid conflict in a region that was the site of armed struggles in the Cold War era. Two of its founding members, Indonesia and Malaysia, had engaged in armed conflict in the period 1963–6 as the Indonesian government of President Sukarno attempted to destabilize the newly independent Malaysia. Over the years, ASEAN membership expanded and the organization successfully used cooperation on economic matters to overcome deep-seated inter-state rivalries and suspicions. In 1998, one of the visions of ASEAN's founders was realized when its membership was expanded to include all ten of the countries of South-East Asia (including Vietnam and Cambodia that had in the previous quarter of a century been at war with other ASEAN states and with one another).

In some instances, regional economic integration has been stimulated by a desire to enhance the security of regional partners against threats emanating from *outside* the membership of the regional arrangement. Such concerns played a role in ASEAN's foundation, the desire being to strengthen members against a perceived communist threat. And the Southern African Development Coordination Conference (SADCC) was founded in 1980 in an attempt to reduce members' dependence on South Africa during the apartheid era.

Regional economic cooperation and the 'new security agenda'

Offers by industrialized countries in recent years to extend regional economic cooperation have frequently been encouraged by concerns about 'non-traditional' security threats emanating from less developed partners. Such threats include environmental damage, illegal migration, organized crime, drug smuggling, and international terrorism. Regional cooperation may help address these issues directly, for example, NAFTA's provisions on the environment, or, proponents hope, indirectly by promoting economic development and thereby ameliorating the conditions that were perceived as fostering the security threats. Concerns about new security threats played a part in European enthusiasm for new agreements with Mediterranean states, and in US interest in a free trade agreement with Mexico and its extension to other Western Hemisphere countries.

Regionalism as a bargaining tool

Many of the regional economic agreements that developing countries established in the 1950s through the 1970s were motivated by a desire to enhance their bargaining power with transnational corporations and with trading partners. They were often inspired by the work of the UN's Economic Commission for Latin America, and its principal theorist, Raul Prebisch, whose ideas were subsequently taken up by writers from the dependency school. Prebisch (1963, 1970) had argued that regional integration was essential to provide a sufficiently large market to enable the efficient operation of local industries to produce goods that had previously been imported. Moreover, a regional partnership would enhance bargaining power with external actors if the partners negotiated with one voice. One approach, as in the Andean Pact (founded in 1969 by Bolivia, Chile [which withdrew in 1976], Colombia, Ecuador, Peru) was to adopt a system of region-wide industrial licensing. The intention was to prevent TNCs from gaining concessions by playing off governments of the region against one another, and to use the carrot of access to a larger regional market to extract concessions from potential investors.

Less developed countries have also used regional partnerships as a way of gaining more aid from donor countries and organizations. Over the years, various governments and international organizations have encouraged regional economic integration among developing countries and have set aside some of their aid budgets to promote regional projects. The European Union has been a particularly enthusiastic supporter of regionalism in other parts of the world.

Moreover, a World Bank (2000: 20) study notes that by pooling their diplomatic resources in a regional arrangement, less developed countries are sometimes able to achieve greater prominence in international relations and to negotiate agreements that would not be available if they had acted individually, and to ensure election of their representatives to key positions in international organizations. The best example of successful pursuit of this strategy, the

Bank suggests, is CARICOM, the Caribbean Community and Common Market.

But it is not just developing countries that have perceived regional economic partnerships as a means for enhancing their bargaining power. The Japanese Ministry of Economy, Trade and Industry, for instance, in advocating participation in discriminatory regional arrangements, pointed to the possibility that they could increase Japan's leverage within the WTO (Ministry of Economy 2000). The foundation (in 1989) of APEC was linked to perceptions that it could help to pressure the European Union into trade concessions during GATT's Uruguay Round of trade negotiations (Ravenhill 2001). And some authors have suggested that the negotiation of the Treaty of Rome, which established the European Economic Community in 1957, was at least in part motivated by European countries' desires to increase their leverage against the United States in the upcoming GATT talks (Milward 1984, 1992).

Regionalism as a mechanism for locking-in reforms

Regional trade agreements can enhance the credibility of domestic economic reforms and thereby increase the attractiveness of economies to potential foreign investors (Rodrik 1989). Such considerations have become more important in an increasingly integrated global economy where countries are competing to stake their claims as preferred hosts for foreign direct investment (see Rugman, Chapter 10 this volume).

Commitments made within a regional forum can be more attractive to potential investors than those made in global institutions for several reasons. Countries' compliance with their commitments is likely to be more closely scrutinized within a regional grouping: the numbers of partners to be monitored is smaller than within the WTO with its close to 150 members, and any breaking of commitments is more likely to have a direct impact on regional partners and lead to swift retaliation. Some regional arrangements provide for regional institutions to monitor the implementation of agreements. Moreover, repeated interactions with a small number of partners within regional arrangements may make governments more concerned about their reputations (their credibility as collaborators) than they would be within more diffuse multilateral forums (Fernandez and Portes 1998).

Regional arrangements may be particularly effective in enhancing the credibility of commitments when less developed countries enter partnerships with an industrialized country as, for instance, in Mexico's participation in NAFTA (Haggard 1997). And the possibility that the policy coverage of the RTA may be more comprehensive than agreements at the global level—embracing, for instance, rules on competition policy and on the treatment of foreign investment—further enhances the potential of regional arrangements as a device for signalling to potential foreign investors the seriousness of a government's commitment to reform.

Regionalism to satisfy domestic political constituencies

Often the choice of trade policies faced by governments is not between liberalization at the global level and liberalization at the regional level, but between a regional agreement and unilateral liberalization. In contrast to a unilateral lowering of tariffs, which is usually politically difficult for governments because domestic groups believe that the government is giving something away (tariff protection) and not receiving anything in return from other countries, a regional trade agreement provides a means for a government to ensure that it receives concessions ('reciprocity') from its partners in return for those that it has offered. And, insofar as a regional agreement makes it easier politically for governments to undertake liberalization, and therefore enhances such activities, it may be beneficial not just to regional partners but to the wider international community.

Ease of negotiating and implementing agreements

The larger the number of states, the more likely it is that they will have a greater diversity of interests that will complicate negotiations. Moreover, the larger the number of members, the more difficult it is to monitor behaviour and to enforce sanctions in the event of non-compliance (Oye 1985; Keohane 1984). A regional agreement with a limited number of partners accordingly might be easier to negotiate and implement than one at the global level. This logic is particularly applicable to bilateral trade agreements.

On the other hand, numerous cases exist of large numbers of governments successfully concluding international agreements (within, for instance, the United Nations on issues that range from arms control to the environment to human rights (see, for example, Osherenko and Young 1993: 12). Kahler (1992) has argued persuasively that success in solving the numbers problem depends upon institutional design. Mechanisms for discussing issues and voting procedures can be adapted to counter the problems of numbers and diversity. A larger numbers of participants may bring potential for greater gains and more opportunities for trade-offs among the parties.

In short, the international relations literature is inconclusive on the relationship between the number of participants and the successful negotiation and implementation of agreements. But of greater importance to shaping state action are the perceptions that governments hold on this issue. And there is little doubt that many *believe* that regional agreements are easier to negotiate than those at the global level, given the numbers and diversity of WTO membership. The failure of the WTO ministerial meetings in Seattle in 1999 and in Cancun in 2003 reinforced these beliefs.

Economic motivations for regionalism

Here we can distinguish between two possibilities: (*a*) where governments, for economic reasons, prefer a regional economic agreement to unilateral liberalization or to a non-discriminatory multilateral agreement; and (*b*) where they prefer a regional agreement to the status quo.

Economic reasons for choosing regionalism over multilateralism

Regionalism enables continued protection of sectors that would not survive in global competition

Even though mainstream economic theory suggests that welfare gains will be maximized when trade liberalization occurs on a non-discriminatory basis, governments may nonetheless prefer a regional (discriminatory) trade agreement. This alternative is attractive, for instance, when they (and interest groups, such as manufacturers' or farmers' associations, which probably will be lobbying the government) believe that domestic producers will be successful in competition with regional partners and will benefit from the larger (protected) market that a regional scheme creates, but that they would not survive a competition with producers located outside the region. Added to this is the possibility (discussed in more detail later in this chapter) that governments will be able to completely exclude 'politically sensitive' non-competitive domestic sectors from the trade liberalization measures negotiated within a regional agreement whereas such exclusion would be more difficult at the global level.

A more benign variant of this argument is that a reform-minded government may seek to enter a regional agreement as a way to gradually expose inefficient domestic producers to international competition, with the expectation that competition from regional partners will generate reforms that will eventually enable the sector to be exposed to full international competition. In this scenario, regionalism is a stepping stone to broader liberalization.

Regionalism provides opportunities for 'deeper integration'

Regionalism may be more attractive than a multilateral treaty to pro-liberalization governments because it enables agreement on issues that would not be possible in the WTO where membership is more diverse. Since the early 1990s, a number of governments, such as those of the United States, Singapore, Chile, and Australia, which have been seeking to raise the tempo of trade liberalization, have turned to regional agreements in an attempt to promote 'deeper integration'. This concept refers to cooperation that goes beyond the traditional liberalization menu of removing tariff and non-tariff barriers. It may include, for instance, agreements on the environment, on the treatment of foreign direct investment, on domestic competition (anti-trust) policies, on intellectual property rights, and on labour standards. The North American Free Trade Agreement was one of the first free trade agreements to incorporate provisions on many of these matters. As trade liberalization within the WTO reduced the significance of border barriers so matters of 'deeper integration' have grown in importance as governments seek to establish a level playing field with their partners.

A regional approach may facilitate reaching agreement on these politically sensitive issues if the partner states share certain characteristics, for example, similar levels of economic development. Moreover, regional agreements, especially bilateral free trade areas, may also enable more powerful states to bring their weight to bear more effectively on weaker parties, for whom the price of gaining security of access to a larger market may be to accept undertakings on issues of 'deeper integration', such as their treatment of foreign investment, etc. (on this issue of unequal bargaining power in regional agreements see Helleiner 1996, and Perroni and Whalley 1994).

Box 5.3 Economies of scale

In modern manufacturing, which often depends on the use of expensive machinery and on very large investments in research and development, large-scale production often enables firms to produce at a lower average cost per unit. These *economies of scale* can result not just from a more efficient use of machinery and of labour but also because specialist managers and workers can be employed, savings can be made in borrowing on financial markets (which generally charge higher rates of interest to smaller borrowers), raw materials can be purchased more cheaply when bought in bulk, and advertising costs are spread across a higher volume of output.

A related concept is *economies of scope*. These occur when firms can spread various costs (including, for instance, research and development, accounting, marketing) across various products, which may, although they will not necessarily, be related (for instance, production of calculators and of LCD screens for laptop computers).

Economic reasons for preferring regionalism to unilateralism or the status quo

Larger markets and increased foreign investment

Governments may not have the option of choosing between a regional agreement and an agreement at the global level: the latter may simply not be available at the time. The choice that governments face is to stick with the status quo, to liberalize on a unilateral basis, or to seek a regional agreement. Besides the political advantages, noted above, that a regional agreement often has over unilateral action, economic advantages may also come into play. Coordinated liberalization on a regional basis broadens the geographical scope of liberalization and may also enable a widening of the product coverage of the agreement, thereby increasing the potential economic gains.

Compared with the status quo, a regional economic agreement can confer two principal economic benefits. First, it provides a larger 'home' market for domestic industries, possibly enabling them to produce more efficiently because of economies of scale. How significant an advantage is gained from regionalism will depend on the number of partner economies and their relative size: a firm in a large economy is unlikely to make significant gains in economies of scale if the regional partnership is with only a couple of much smaller economies.

Secondly, regionalism can increase the attractiveness of an economy to potential investors. Companies that previously supplied the separate national markets through exports from outside the region may now find that the unified regional market is of sufficient size to make local production (and hence foreign investment into the region) attractive. Gains from foreign direct investment may be particularly significant when a less developed country enters into a regional partnership with one or more industrialized economies. Companies may be able to take advantage of the relatively low-cost labour in the less developed country to supply the whole of the regional market from factories established there. The best example here is the dramatic increase that occurred in foreign direct investment into Mexico following the signature of NAFTA in 1994. Inflows of FDI to Mexico, which averaged $8 billion per year in the period 1990–5, rose to $14 billion in 1997 and to $24 billion in 2001 (UNCTAD 2002*c*: 304, Annex Table B.1). Some evidence also exists of similar effects elsewhere, for example, foreign direct investment inflows to ASEAN increased after it negotiated its free trade area (UNCTAD 2003: 47, Box II.5).

A related strategy is for governments to attempt to establish their economies as regional hubs. For a number of activities, companies will wish to establish only one office in a geographical area (it might, for instance, be a central office responsible for procurement, or for providing management services to all of the company's regional subsidiaries). One of the reasons why some governments appear to have chosen to negotiate multiple regional trade agreements is that this strategy enhances the prospects for attracting companies' 'regional' headquarters as the economy becomes a 'hub' for multiple regional 'spokes'. Singapore, an active proponent of regional trade agreements is a good example—it has a larger number of regional corporate headquarters than any other developing economy. Regional hubs may also be attractive to subsidiaries of multinational enterprises seeking to take advantage of the preferential access the RTAs provide to third country markets. For instance, US subsidiaries operating in Singapore enjoy duty-free access to the Japanese market for their production (subject to meeting the rules of origin in Singapore's economic partnership agreement with Japan), something not always available to them if they exported to Japan from their home base in the USA.

Key points

- Governments often enter regional trade agreements for political reasons.
- These include: enhancing security; improving their international bargaining positions; signalling to potential investors the seriousness of their commitment to reforms; to satisfy domestic constituencies' demands for 'reciprocity'; and because they perceive regional agreements are easier to negotiate than those within the WTO.
- Economic motivations for regionalism include access to a larger 'domestic' market; possibilities for attracting additional foreign direct investment; the possibility of engaging in 'deeper integration'; and the opportunity afforded to continue to protect politically sensitive, globally uncompetitive industries.

The rush to regionalism

The rush to regionalism in the 1990s is the second major wave of RTAs since the Second World War: the first occurred in the early 1960s, largely in response to the 1957 establishment of the European Economic Community (regionalism, however, has a much longer history, dating back several centuries: the previous peak in regional activity occurred in the interwar period when industrialized countries responded to the great depression by attempting to form closed trading blocs with less developed countries, in the case of European countries, with their colonies).

Many of the agreements negotiated in the 1960s linked less developed countries. In Africa, the growth of regionalism followed former European colonies gaining their independence in the late 1950s and early 1960s. As in Latin America, the other continent where regionalism took off in this period, the principal objectives of the regional agreements were to promote local industrialization to substitute for imports, and to enhance the bargaining power of participants vis-à-vis external actors (in Asia, few regional economic partnerships, with the exception of ASEAN, emerged, not least because of Cold War conflicts that divided countries in this part of the world). In marked contrast with the most recent wave of regionalism, the agreements among less developed countries in the 1960s aimed to restrict imports from outside the region (in other words, they deliberately sought trade diversion—see Box 5.2—and to control foreign investors).

The landscape of interstate relations in Latin America and particularly in Africa soon became littered with the debris of failed regional arrangements. One reason was that few of the parties to regional arrangements were significant economic partners for one another. This was especially the case in Africa where the economies had been shaped in the colonial era to produce primary commodity exports for the European market. The share of intraregional trade (that is, trade with regional partners) in countries' overall trade was often less than 5 per cent. A consequence was that liberalization of intraregional trade in itself brought the participants few immediate benefits.

Moreover, liberalization of trade within a region often exacerbated existing inequalities among the partner states. Where companies had a choice of a single country location to serve the unified regional market, they usually preferred the city where infrastructure was most developed. Industries therefore tended to cluster around 'growth poles' and shunned the poorer-resourced towns and cities in the least developed parts of the region. The less developed countries in a regional partnership frequently found that they faced significant costs from trade diversion as imports from outside the region were replaced by relatively high-cost production from their partner states. They also lost tariff revenue, on which many less developed economies depend heavily as a source of government funding (both because of the removal of intra-regional tariffs and from the diversion of imports from outside the region to goods sourced from regional partners).

Some regional arrangements (including ASEAN and the Andean Pact) attempted to address the problems caused by this unbalanced growth by pursuing a policy of industrial licensing: the location of new industrial plants would be agreed by governments and allocated across different parts of the region to ensure that the less developed gained a share of the benefits from integration. But such an approach was politically unpopular with the governments of the more developed partners. They perceived the losses in investment forgone and the generally negative responses from foreign partners as exceeding any gains they made from collaboration with their less developed regional partners.

Arguments about the distribution of benefits from regionalism led to the collapse of many of the schemes established in the 1960s, and to a heightening of tensions between regional partners. Contrary to the idea that regionalism might improve inter-state security, disputes over the distribution of benefits from regional partnerships arguably contributed in some instances to the onset of armed conflicts between former regional partners, for example, the 'soccer war' between former Central American Common Market members Honduras and El Salvador in 1969, and hostilities between former East African Community members Uganda and Tanzania in 1979.

The new regionalism

The failure of many regional trade agreements among less developed countries in the 1970s (Figure 5.1 shows how few schemes from the 1960s and 1970s are still in force today) occurred at a time when there was a considerable degree of pessimism about the prospects for the European Community. There, integration had proceeded more slowly than many had anticipated, and progress had been punctuated by increasingly acrimonious disputes among the member governments. By the middle of the 1970s, when worldwide economic conditions were more turbulent than at any time since 1945 because of the Organization of Petroleum Exporting Countries-induced oil price rises and subsequent recession, regional integration no longer appeared to be a viable solution to the problems of interdependence that governments faced. To political leaders and academics alike, regional integration appeared increasingly obsolescent—the terminology the intellectual father of European integration studies, Ernst B. Haas (1975), applied at the time to theories of integration.

Two factors were to change the global context to make it far more favourable to regionalism in the 1990s. The first was the end of the Cold War. Regional economic agreements, like other aspects of international economic relations, are, in Aggarwal's (1985) terminology, 'nested' within the overall security context. A dramatic change in the security context opened up new possibilities for partnerships among countries that had previously been on opposite sides of the Cold War divide. In Europe, the disintegration of the former Soviet Union and the 1991 break-up of COMECON, the Council of Mutual Economic Assistance (founded in 1949 by the Soviet Union as an alternative to the assistance that the USA was providing Western Europe through the Marshall Plan, its membership expanded to include Czechoslovakia, East Germany, Poland, Hungary, Romania, Bulgaria, Mongolia, and Albania), opened the way for East European countries to enter into economic agreements with the European Union, and required new arrangements to be established amongst their former members if economic cooperation was to be sustained. Georgia, for instance, signed six free trade agreements with other former Soviet republics in the 1990s.

The concentration of new regional agreements in Europe in the 1990s underlines the importance of the East European fragmentation for the growth in the number of regional trade agreements. In Asia also, the end of the Cold War broke down the barriers that had previously prevented regional economic integration. In 1991, China joined the APEC grouping, which included its former Cold War foes Japan, the USA, and South Korea. In 2001, demonstrating the enormous improvement of relations that had occurred in East Asia over the previous decade, China began to negotiate a free trade agreement with ASEAN.

The second contextual factor was the growth in global interdependence, and the ascendancy of neo-liberal ideas in Western governments and in the international financial institutions. The growing integration of markets—for goods, services, and finance—placed increasing pressure on governments to pursue market-friendly policies. Potential foreign investors quickly voted with their feet when faced by governments that attempted to impose conditions on them: indeed, from the early 1980s onwards, the balance of bargaining power between investors and governments shifted dramatically so that investors were increasingly able to demand concessions from host governments on issues such as taxation, rather than accepting restrictions on their activities. Similarly, financial markets were quick to punish governments that were perceived to be inward-looking or inclined towards interventionist measures.

In this new context, the regional arrangements that developed were often designed to enhance states' participation in the global economy, to signal their openness to foreign investment, and to seek access to the markets of industrialized countries. Unlike the arrangements from the 1960s and 1970s, the new regionalism frequently involved partnerships between industrialized and less developed economies, that is, they were often North–South rather than South–South in orientation. The North American Free Trade Agreement is the obvious example; meanwhile, many less developed economies sought free trade agreements with the European Union, and by the early years of the new millennium, Japan had begun to negotiate free trade agreements with less developed economies in South-East Asia and Latin America.

It was not just less developed countries that responded to the increased market integration through seeking regional economic partnerships. The decision by European member states to deepen integration and to complete the implementation of a single internal market (brought into being by the Single European Act, signed in 1986), has been widely interpreted as an attempt to strengthen the capacity of European companies to compete in the new global market place (Sandholtz and Zysman 1989; Schirm 2002).

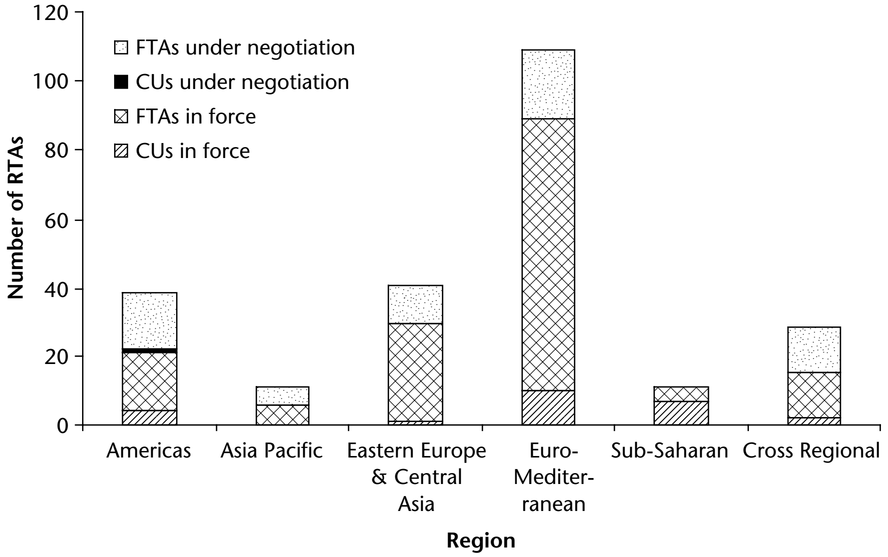

Fig. 5.2 Geographical distribution of RTAs, both in force and under negotiation
Source: WTO (2000*b*)

Table 5.3 Notified RTAs in goods by the date of entry into force and type of partners (as of January 2003)

	Developed-Developed	Developed-Developing	Developed-Transition	Developing-Developing	Developing-Transition	Transition-Transition	Total
1958–1964	2	0	0	1	0	0	3
1965–1969	0	0	0	0	1	0	1
1970–1974	5	3	0	2	0	0	10
1975–1979	0	5	0	1	0	0	6
1980–1984	2	1	0	1	0	0	4
1985–1989	1	1	0	2	0	0	4
1990–1994	3	3	12	5	0	6	29
1995–1999	3	7	10	4	12	28	64
2000–2002	0	11	4	5	4	6	30
TOTAL	**16**	**31**	**26**	**21**	**17**	**40**	**151**

Note: Developed countries include Canada, the United States, EU, EFTA, Japan, Australia, and New Zealand; transition countries include the former Soviet Union, Eastern and Central Europe, the Baltic States, and the Balkans; the remaining countries are classified as developing.

Source: WTO (2003*c*: Table 1B.9).

Table 5.3 illustrates a number of the factors contributing to the explosive growth in regionalism in the 1990s. Transition economies (the former Soviet bloc countries) were involved in more than one half of all RTAs signed in the 1990s (including forty RTAs that only involved other transition economies). Reflecting the desire of Southern countries to seek alliances with Northern partners, there was also a dramatic jump in the number of RTAs linking developed with developing countries in the 1990s. In contrast, only six of the more than 120 agreements initiated between 1990 and 2002 linked two or more developed economies.

A variety of other factors also contributed to the growth of regionalism in the 1990s.

Frustration with the difficulties of negotiating global agreements

The GATT began as a relatively small international institution dominated by Western industrial countries (see Winham, Chapter 4 in this volume). As more countries joined the GATT, so the difficulties of reaching agreement among an increasingly diverse group on an agenda that was becoming more complex were intensified. The consequence was that it took much longer to bring successive rounds of GATT talks to a conclusion.

When the Uruguay Round of GATT negotiations stalled over issues relating to trade in agricultural products, governments turned to regional agreements both as a substitute for a global agreement and as a means of increasing pressure on other countries to attempt to persuade them to make concessions in global talks. Similar considerations applied a decade later when the WTO prepared to launch a new round of global trade negotiations: membership of the WTO was approaching 150 economies and the agenda was yet more complex. The 'debacle in Seattle', the failure of the WTO's ministerial meeting in December 1999, convinced many governments (including that of Japan, see Ministry of Economy 2000), that negotiation of a new global agreement would not bring early results and that they should therefore look to RTAs if they wished to advance their trade agendas. The failure of the Cancun WTO ministerial meeting in September 2003 reinforced these beliefs.

Bandwagoning and balancing: 'contagion' effects

The fact that post-war regional integration has come in two waves points both to the likelihood that common responses have occurred across various parts of the globe to the same stimuli (especially, as noted above, to increased economic interdependence), and to the possibility that regionalism in one part of the world triggers regionalism elsewhere through 'demonstration', 'emulation', or 'contagion' effects.

The establishment of the European Common Market in 1957, with its apparently positive impacts both on inter-state relations and on the economies of its members, inspired a wave of imitations among less developed countries. Similarly, the completion of the single internal market in the EU in 1992 and the establishment of NAFTA in 1994 led governments elsewhere to take a keener interest in becoming participants in regional agreements. The Japanese government report cited above, for instance, presented a detailed review of academic studies of existing regional arrangements, concluding that they generally had a positive effect on the welfare of member states. For many governments, therefore, the new interest in regionalism was primarily a defensive response to developments elsewhere. And some governments that were already party to regional arrangements sought new ones in an attempt to reduce their dependence on existing regional partners. Mexico, for instance, began negotiations for free trade arrangements with the European Union and Japan as a means of reducing its heavy reliance on its NAFTA partners.

It was not just governments, however, that were prompted into action by regionalism elsewhere. The essence of preferential trade agreements is that they are discriminatory: non-members do not share the benefits they provide. Companies located in non-members therefore find that RTAs place them at a competitive disadvantage. They have an incentive to lobby their governments either to bandwagon by joining existing regional arrangements where such possibilities exist, or to negotiate a treaty that provides them with equivalent access to markets. For instance, following the implementation of NAFTA and the signature of the Mexico–EU Free Trade Agreement, Japanese manufacturers found themselves at a disadvantage in competing in the Mexican market. Whereas their American and European counterparts enjoyed duty-free access to Mexico, Japanese companies faced tariffs that averaged 16 per cent. The main business grouping, the Japan Federation of Economic Organizations, *Keidanren*, lobbied the government to sign a free trade agreement with Mexico that would give Japanese companies equivalent access to that enjoyed by their competitors (Ravenhill 2003).

The proliferation of preferential trade agreements across the globe, with the potential competitive disadvantages they bring for non-participants, increases the incentives for governments to either join existing agreements or to seek similar arrangements for their own exporters (Baldwin 1997; Oye 1992).

The change in the US attitude towards preferential agreements

The United States government was the strongest supporter of a non-discriminatory multilateral approach to trade in the negotiations that led to the creation of GATT at the end of the Second World War. Not only had it been a victim of the discriminatory colonial trading blocs that the European powers had created in the inter-war period, but it believed that their closing off international trade had made a significant contribution to the global recession of the 1930s. It was largely at US insistence that non-discrimination was enshrined as the cornerstone of the post-war global trade regime.

Washington was, however, willing to tolerate regional trading groupings that discriminated against its exports where it believed that these helped to achieve its political objectives through, for example, facilitating reconciliation between former enemies and strengthening the economies of the participants so that they would be less susceptible to the perceived communist threat. Security concerns trumped economic principles. The primary example was the European Economic Community (EEC). Washington had encouraged European recipients of Marshall Plan assistance (Box 5.4), to coordinate their plans (which led to the formation of the Organization for European Economic Cooperation, the forerunner to the OECD, the Organization for Economic Cooperation and Development). It put pressure on France to accommodate the rebuilding of Germany's industry and to devise a mechanism that would allay French concerns (which ultimately became the Schuman Plan for the European Coal and Steel Community). The US government supported the formation of the EEC in 1957 even though it was obvious that the new Community, like the ECSC, would not be fully compatible with GATT requirements for regional agreements, and would discriminate against US exports. At the same time it exerted pressure on the Europeans not to introduce any provisions that would increase discrimination against US economic interests. Its support for European integration was also accompanied by

Box 5.4 The Marshall Plan

Under the Marshall Plan, the US government provided $11.8 billion in grants and a further $1.5 billion in loans to assist in the rebuilding of European economies (and, in some instances, those of their colonies) in the years 1948–52. The United Kingdom received the largest volume of grants ($2.8 billion) followed by France ($2.5 billion), Italy ($1.4 billion), and West Germany ($1.2 billion). The Plan was an outgrowth of Washington's concerns about the perceived growth of Soviet influence in Europe. Funds were used for purposes such as purchasing new machinery for factories, providing technical assistance to enable Europeans to become familiar with new technologies, and the rebuilding of roads, railways, and ports. The bilateral assistance provided to Europe under the Marshall Plan far exceeded the funds available from the International Bank for Reconstruction and Development (World Bank). The Organization for European Economic Cooperation (which subsequently evolved into the Organization for Economic Cooperation and Development (OECD)) was created to manage the Marshall Plan aid.

American initiatives in the GATT for new rounds of global negotiations with the objective of reducing overall tariff levels and thus the discrimination its exporters would face in the European market (the 'Kennedy Round', 1963–7, was the response to the EEC's creation, and the 'Tokyo Round', 1973–9, the response to the first enlargement of the Community when it admitted Denmark, Ireland, and the United Kingdom in 1973).

Washington's attitude towards regional economic agreements among less developed countries was more ambivalent. Although it appreciated the possibility that regionalism might improve the security of the participants, its enthusiasm was tempered because of the anti-import and pro-interventionist frameworks that figured prominently in many of the regional schemes among less developing countries in the 1960s. Its support for regional economic integration among Latin American countries therefore was at best lukewarm. And, in other parts of the world, especially Asia, Washington opposed any movement towards a regional agreement from which it would be excluded.

The US attitude towards regional economic agreements changed in the early 1980s as it despaired of the slow progress in global trade liberalization and bristled at the growing trade distortions generated by the European Community's Common Agricultural Policy. United States Trade Representative William Brock announced in 1982 that Washington was willing to enter into regional trade agreements. Negotiation of a free trade agreement with Israel followed quickly. The USA also launched the Caribbean Basin Initiative, a programme of trade preferences for the island states of the region. Far more significant, however, was Washington's positive response to a Canadian proposal for negotiation of a free trade agreement. In one sense this was not a dramatic departure in American trade policy. Washington had offered such an agreement to Canada on several occasions over the previous century only to be rebuffed by a Canadian government concerned about maintaining its economic independence. Nonetheless, the signature of the Canada–US Free Trade Agreement in 1988 sent a dramatic signal to other members of the international community. This was reinforced in the following years when the first Bush administration indicated its willingness to construct a 'hub and spokes' framework that would link the USA in a series of free trade agreements with partners in Central and Latin America, Oceania, and East Asia.

The new approach to trade policy in the early 1990s was stated succinctly by Lawrence Summers, who became Under-Secretary of the Treasury for International Affairs in the first Clinton administration: that there should be a 'presumption in favor of all the lateral reductions in trade barriers, whether they be multi, uni, tri, plurilateral' (quoted in Frankel 1997: 5). In other words, the policy was one of 'anything goes' in trade policy as long as it contributed to trade liberalization, there no longer being a presumption that discriminatory regional agreements would be barriers to liberalization at the global level.

With the United States itself in the second half of the 1990s actively pursuing regionalism through NAFTA and advocating its extension into a Free Trade Area of the Americas, it would have been difficult for Washington to maintain its opposition to regionalism in other parts of the world. The change in attitude was particularly important in facilitating the development of preferential trade arrangements in East Asia. Whereas Washington had vigorously opposed a proposal from Malaysian Prime Minister Mahathir Mohamad in the early 1990s for the creation of an East Asian Economic Group, which would have excluded the countries of North America and Oceania that were members of the rival APEC grouping, by the late 1990s it acquiesced in the creation of an equivalent grouping (ASEAN Plus Three, the ten ASEAN members plus China, Japan, and South Korea), and in numerous East Asian moves to negotiate bilateral free trade arrangements.

Making existing preferential trade arrangements compatible with WTO requirements

Some of the new free trade areas came into being because industrialized countries perceived that they needed to make their trade agreements with less developed countries compatible with the WTO's regulations. Here the European Union has again been the most important actor.

The European Union had previously constructed a network of preferential trade arrangements with the countries of the southern Mediterranean and with the ACP grouping, which comprises over seventy countries in Africa, the Caribbean, and the Pacific, many of which had formerly been European colonies. These agreements had been negotiated in contexts entirely different from that prevailing in the second half of the 1990s. The arrangements with the ACP grouping were codified in the Lomé Conventions, the first of which had come into effect in 1975 at the height of the demands from less developed economies for the creation of a New International Economic Order. Reflecting a context in which industrialized countries were responsive to the demands from less developed economies for special treatment, the Conventions offered duty-free access to the European market for most ACP exports, without obliging the ACP countries to provide similar preferential treatment to European exports: in other words, they were non-reciprocal arrangements. (Treaties with southern Mediterranean countries, signed in 1975–7, offered similar duty-free access to the European market: the Mediterranean countries committed themselves to lower their tariffs on imports from the European Community but the timetable for this process was not specified).

Besides the general trade provisions, the Lomé Conventions also included special arrangements for specific products, including bananas, beef, rum, and sugar, on which some countries' export earnings were heavily dependent, often enabling their sale in European markets at prices much higher than those prevailing elsewhere. In some instances, they rested on a segmentation of the European market, with, for instance, exports of ACP bananas being subject to different treatment in the United Kingdom and in France than they received in Germany and the Netherlands. The European Union, in fact, operated three different tariff regimes for bananas even though, as a common market, it had supposedly adopted a common external tariff. The new commitment to realizing a single internal market in the EU in 1992 made it impossible to maintain this arrangement for ACP bananas.

In an attempt to preserve the special position of ACP bananas, the European Union introduced an interventionist system of import licensing that discriminated against bananas coming from non-ACP countries (primarily Central and Latin America). Several of these producing countries challenged the new EU banana regime in the GATT; they were supported by the US government, which had been lobbied by the two giant US agribusiness firms, Dole and Chiquita, that handled most of the trade in Central and Latin American bananas. The outcome of the lengthy and convoluted dispute, which spanned the time period during which the WTO took over from the GATT, and which at one stage threatened to trigger a 'trade war' between the United States and the European Union, was that a WTO Dispute Settlement Panel found that the European provisions on bananas contravened several of its articles. The Europeans eventually backed down, committing themselves to introduce arrangements that were compatible with their WTO obligations.

The dispute illustrated how the WTO makes it possible for less developed countries to initiate a successful challenge against an aspect of the trade policies of an economic superpower, the EU. It also demonstrated the significance of the changed arrangements for dispute settlement with the transition from the GATT to the WTO: unlike the situation under the

GATT, when countries simply ignored dispute settlement judgements that they did not like, the EU had no viable alternative but to conform to the WTO's requirements. More important than the specifics of the banana dispute itself are the implications of the WTO's judgement for rules governing the relations between industrialized and less developed economies.

In finding that the EU's banana regime contravened several of its provisions, the WTO rejected European arguments that the trade arrangements with the ACP were legitimized by WTO rules on RTAs and on special treatment for less developed economies. The WTO found that the Lomé Convention did not conform to its rules for regional trade arrangements because the ACP countries were not required to remove their tariffs on European imports (under the requirements of Article XXIV, all parties to a regional economic agreement must liberalize 'substantially all trade' between them). Moreover, the Convention did not conform to the rules on preferences for less developed economies because it gave special treatment to one group (the ACP) but not to other economies at similar levels of development. These rulings left the EU with only one other avenue for seeking WTO legitimacy for the Convention: to apply under Article IX of the WTO for a special waiver from the most-favoured-nation rule. But the requirements for such a waiver are more stringent under the WTO than they were in the GATT, the waiver is only for a fixed term and would not prevent WTO members from subsequently challenging specific elements of the arrangements. In other words, a waiver would have provided little assurance to the ACP states that the provisions would not be disrupted in the future.

Faced with this dilemma, the EU decided that the only means through which it could provide long-term trade security for the ACP would be to abandon its previous approach and to negotiate arrangements that were compatible with WTO rules on regional trade agreements (Article XXIV). It proposed to do this through concluding a series of economic partnership agreements with groupings of ACP countries. A similar decision had been made earlier regarding the trade agreements with the countries of the southern Mediterranean: in its Barcelona Declaration of 1995, the EU stated its intention to negotiate WTO-compatible free trade agreements with these countries. These have subsequently been concluded with Tunisia (1995), Israel (1995), Morocco (1996), Jordan (1997), Egypt (1999), Algeria (2001), and Lebanon (2002).

Key points

- The regional trade agreements of the 1960s and 1970s aimed to promote regional industrialization behind tariff walls.
- They often broke down because of disagreements over the distribution of benefits and costs from regional cooperation.
- The new regionalism differs from this previous wave in seeking countries' increased integration into the world economy.
- Its origins lie in the end of the Cold War, the perceived success of RTAs elsewhere; frustrations with the pace of trade liberalization at the global level; a desire to make existing preferential trade relations compatible with WTO rules; and a change in US attitudes towards regionalism.

The political economy of regionalism

Private sector interests

Previous sections of this chapter have identified several reasons why governments and private sector actors might wish to pursue regional economic integration. It is straightforward, for instance, to suggest that when companies face high tariffs in markets where their competitors' products enter duty free because of the existence of free trade arrangements, they will lobby their governments to obtain similar arrangements. But other than for these defensive reasons, when might companies support the establishment of a regional free trade area rather than prefer either continued protectionism or non-discriminatory liberalization?

To address this question requires a starting point that is far removed from the assumptions of trade theory as developed in neoclassical economics (which assumes constant returns to scale and immobile factors of production, that is, unit costs of production are the same regardless of the size of the production run, and factors of production, for example capital, will not move across national boundaries). In particular, it rests on the possibility that companies will be able to produce more efficiently for a regional rather than a domestic market because they are able to capture economies of scale, on the increasing mobility of capital, and on observations regarding the geographical distribution of subsidiaries of transnational corporations.

The economies of scale argument assumes that regional integration is able to provide firms with the minimum market size required for them to capture scale economies whereas the domestic market alone is too small for this to happen. But why would firms not prefer multilateral liberalization so as to gain access to even larger global markets? The reason is that a regional agreement will provide an opportunity to retain tariff and other barriers against competitors from outside the region. The logic is that of strategic trade theory, one component of which asserts that it is possible for governments to provide an advantage to their domestic companies if they offer a protected domestic market that enables them to realize economies of scale (Krugman 1990; for an application of the argument to the regional level see Milner 1997*b*; and Chase 2003).

The other departure from conventional trade theory rests on an acknowledgement that contemporary manufacturing often involves conducting various stages of production in different geographical locations to take advantage of local characteristics such as relatively low-cost labour or a concentration of product- or industry-specific skills. From the 1980s onwards, United States and European firms, facing intense competition in their domestic market from imports from East Asia, established subsidiaries in relatively low-labour-cost neighbouring countries, from which they sourced components. The establishment of regional free trade areas facilitates this corporate strategy (and here it is appropriate to remember the North–South architecture of many of the new regional arrangements of the 1990s, for example, trade agreements between the European Union and Eastern European and Mediterranean countries, NAFTA, and the Caribbean Basin Initiative). Moreover, the rules of origin, in NAFTA for instance, that allow components sourced from US companies to be counted towards requirements that goods must meet if they are to be deemed to have been manufactured in Mexico, serve as a protectionist device that provides further advantage to US-based corporations (for further discussion see Cox 2000).

As Alan Rugman demonstrates in Chapter 10, even though multinational enterprises disperse their activities to capitalize on local characteristics, their production and sales are frequently concentrated within one geographical region. This geographical concentration of activities is likely to cause many MNEs to put their efforts into lobbying for regional trading agreements rather than for liberalization at the global level because their principal interest is in removing barriers to trade between those countries in which their manufacturing plants are located. This concentration on the regional level is encouraged by the better prospects there, compared with the global level of pursuing the 'deeper integration' that MNEs need for efficient integration of their production networks, for example, agreements on the treatment that foreign investment will receive, protection of intellectual property rights, and facilitation of the movement of skilled workers and management.

Economies of scale and regionalization of production may both incline companies towards lobbying for regional trade agreements but their impact on the attitudes of labour is likely to be more ambiguous. On the one hand, the possibility of gaining larger market share, longer production runs, and higher profits through the realization of economies of scale offers the prospect to labour of additional employment, higher wages, etc. On the other, the opportunity that the negotiation of a free trade area provides companies to regionalize their production will be likely to worry labour unions in relatively high-wage countries who will fear that labour-intensive stages of production will be moved to those parts of the region with lower labour costs. It was not surprising, therefore, that companies with regionalized production

Box 5.5 **Rules of origin**

Countries that enter into a free trade agreement inevitably are concerned that non-members should not exploit the benefits they provide to their partners. In particular, they fear that because free trade areas do not have a common external tariff, non-members will send goods into the free trade area through the country with the lowest tariff, and then use the free trade provisions of the grouping to access other members' markets. This *trade deflection* will lead to a loss of tariff revenue for the economies with higher tariffs and possibly to greater competition for their domestic producers.

Consider, for instance, the following hypothetical example. Assume that Mexico has a 5 per cent tariff on cameras whereas Canada and the United States both have a 12 per cent tariff. If they were able to take advantage of the introduction of free trade under NAFTA, Japanese camera manufacturers would export their cameras to Mexico and supply Canada and the United States from these exports. Both the Canadian and US governments would lose tariff revenue that they would otherwise collect on imports of Japanese cameras. And Japanese cameras (now subject to a lower tariff) would become more competitive than they otherwise would have been with cameras produced in Canada and the United States.

To prevent free trade areas from causing trade deflection of this type, their members typically adopt what are called rules of origin. These are intended to ensure that goods will only benefit from the provisions of the free trade agreement if they can be considered to have 'originated', that is, to have been produced, in the partner country. Goods that are merely passing through the partner or, for instance, have been re-stamped as 'Made in Mexico', will not qualify for duty-free access to other members' markets. Determining where a product has originated has become increasingly difficult in an integrated global economy with goods often being assembled from components manufactured in various countries.

Rules of origin typically take one or more of the following forms:

(*a*) A value-added criterion. This specifies that a particular percentage of the value of the export must have been generated within the partner country. For instance, to qualify as a local product for the purposes of NAFTA, 62.5 per cent of the value of an automobile must have been generated locally.

(*b*) A change of tariff heading criterion. The World Customs Organization has developed a 'Harmonized System Nomenclature' of tariff headings that classifies all products according to their degree of processing, ranging from raw materials through semi-processed products to finished manufactures. Under this criterion, a good is considered to have been produced domestically if a change in tariff heading results from the local processing/manufacture.

(*c*) A specific processing criterion. This stipulates that particular stages in the production of the export must have been undertaken locally. For instance, cloth may only be considered a local product if weaving has been undertaken locally.

(*d*) A specific components criterion. This establishes that particular parts of the finished good must have been manufactured locally for it to qualify for duty-free treatment. In NAFTA, colour television sets are considered to be local products only if their picture tubes have been manufactured locally. Usually, rules of origin allow for 'cumulation' so that components sourced from partner countries are counted as if they have been produced domestically (so that, for instance, a colour TV manufactured in Mexico which contains a picture tube manufactured in the USA would be classed as a local product for NAFTA rules of origin purposes).

As is evident from these examples, rules of origin are usually product-specific and can be very complex. Specification of the rules of origin often constitutes the bulk of the agreements that establish free trade areas. Those for NAFTA, for instance, run to close to 200 pages of small print. They require detailed, complex negotiations. The complexity of rules of origin is often viewed as a barrier to developing economies' participation in international trade, especially when they have to cope with multiple sets of rules that govern trade with different partners.

The negotiation of rules of origin, moreover, whose product-specific provisions often appear to be arbitrary, offers an opportunity for domestic interests to attempt to seek protection against the effects of regional trade liberalization. Setting a high value-added criterion may make it impossible for rival producers in partner countries to qualify for duty-free access to the domestic market. And the requirement that a specific component be produced locally may increase the discrimination against non-members and exclude them from the enlarged regional market. For instance, Schiff and Winters (2003: 80) cite the example of tomato ketchup. Under the 1988 Canada–US Free Trade Agreement (CUSFTA), ketchup produced from imported tomato paste qualified as a local product and received duty-free treatment. When the CUSFTA was converted into NAFTA, however, the new rules of origin stated that ketchup would be considered a local product only if it contained tomato paste manufactured within NAFTA. The result was *trade diversion* from Chile to Mexico: whereas Chile accounted for more than 80 per cent of US imports of tomato paste before NAFTA, after the introduction of the NAFTA rules of origin Chile's share dropped to 5 per cent whereas that of Mexico rose to 75 per cent.

networks lobbied in favour of NAFTA whereas labour unions (together with American firms that produced solely within the USA for the domestic market) expressed their concern that the agreement would generate, in the words of H. Ross Perot, a 'giant sucking sound' as US jobs were lost to Mexico (Chase 2003).

What drives regionalism forward?

As indicated in Box 5.1, governments that enter regional agreements that involve more than the creation of a free trade area inevitably have to agree to establish institutions that 'pool their sovereignty' on policies that have to be determined at the regional level, for instance, the determination of common external tariffs and other common foreign economic policies in customs unions. The deeper the integration, that is the broader the scope of policy issues on which members agree to cooperate, the greater will be the number of policy areas on which regional institutions will have to be given competence (unless members agree to a policy of mutual recognition whereby they accept policies/standards in other members as if they were their own).

Political scientists have long been fascinated by the question of whether, once a regional arrangement is established, it generates its own momentum towards not only closer economic but also closer political integration. The vast majority of regional economic agreements take the form of free trade areas, which, because they do not require setting a common external tariff, provide little stimulus for the establishment of a regional institution to coordinate policies. Most free trade areas do provide a process for the resolution of disputes between the parties over the interpretation and/or implementation of the free trade area's rules, but this is usually managed by secretariats within the governments of the member countries. For instance, although there is a NAFTA secretariat, which administers the dispute resolution procedures created by the agreement, this is a 'virtual' secretariat comprised of three sections located within the respective national governments. Very limited scope is available to such national agencies to act to promote deeper regional integration: indeed, the very lack of the creation of any alternative source of authority at the regional level is one of the attractions of free trade areas to many national governments. Even in those free trade areas where member governments have agreed to create a central secretariat, as in ASEAN, they often deliberately keep such institutions weak so that they do not develop as challengers to national governments.

With deeper integration, the scope for regional institutions to act autonomously may increase. The best example is the European Union, the only regional agreement that has fully implemented a common market and moved beyond this to form an economic union. It has by far the most complex of governance arrangements of any regional grouping. As Helen Wallace (2000: 44) suggests, 'much of what makes the EU so interesting . . . is the density of institutions and the evidence of institutional creativity. EU institutions provide both opportunities and constraints, and they serve to channel and to structure the behaviour of political actors from the participating countries.'

The principal political organs at the regional level are a supranational secretariat, the European Commission ('supranational' because it is autonomous from the governments of the member states and its officials have the responsibility of promoting the interests of the EU as a whole rather than those of specific members), an institution comprised of ministers from the national governments (the Council of Ministers), the European Parliament (directly elected since 1979 by voters in the member states), and the European Court of Justice (which is charged with interpreting the various EU treaties that member states have signed). The EU treaties now extend far beyond the liberalization of internal trade and the establishment of common foreign economic policies to include competition policies, environmental policies, common foreign and security policies, justice and home affairs, and regional development. The European Union and its member states now constitute a complex web of multilevel governance, with authority for making and implementing policies on various issues being split between institutions at the regional level, at the national level and, in some instances, at the subnational level (for further discussion see Bomberg and Stubb 2003; and Wallace and Wallace 2000).

Most of the theorizing in international relations on regionalism has concentrated on the European experience. The early experience of European integration inspired the development of *neo-functionalist* analysis (Haas 1958; Lindberg 1963). This approach suggested how a regional grouping could generate a momentum of its own that would lead to a deepening of cooperation. The logic was that cooperation in one area of economic activity would produce pressures for cooperation in other areas as the costs of pursuing uncoordinated policies became increasingly evident to member states, a process that the neo-functionalist theorists termed 'spillover'. Entrepreneurial leadership by regional institutions could intensify the pressures for further cooperation.

In the European Union, the European Commission has the power to take initiatives in the various areas where the members have agreed that the EU has competence; it thus has the capacity to shape agendas and to push for further cooperation at the European level. The European Court of Justice's responsibility for interpreting the treaties and for adjudicating disputes between member states affords it an opportunity that extends into the realm of policy making; over the last quarter of the twentieth century some of its judgements significantly extended the scope of European competence.

One element of neo-functional theorizing was to emphasize the significance of the unintended consequences of previous actions and decisions. For instance, member states did not anticipate the important role that the Court of Justice would come to play in extending the scope of integration when they created a body that was intended to arbitrate disputes on the implementation of treaties. For scholars in the neo-functionalist tradition, the logic of spillover and the creative leadership provided by regional institutions can provide the integration process with a dynamic of its own (Sandholtz and Stone Sweet 1998 provide a recent example of theorizing from this perspective).

The neo-functionalist approach has consistently been challenged by scholars who assert that national states have primacy in the integration process. Stanley Hoffmann (1966) pioneered this challenge; the economic historian Alan Milward (1992) subsequently developed the theme that integration in Europe is best interpreted as a strategy pursued by national states to strengthen their own positions. Andrew Moravcsik (1998) presents the most theoretically sophisticated articulation of this 'liberal intergovernmental' argument, suggesting that the major steps forward in European integration were driven not by the European Commission or the Court of Justice but by member governments that were responding in a rational way to domestic economic interests. Key decisions on integration reflect bargains struck among member states; the most significant European institution therefore is not the supranational Commission but the intergovernmental Council of Ministers. For writers in this tradition, to the extent that member states delegate authority to community institutions, such moves are 'calculated, rational, and circumscribed' (Bomberg and Stubb 2003: 11).

In this hotly contested debate, as is often the case in international relations theorizing, authors writing from one perspective have been reluctant to acknowledge that the arguments of the competing school have any legitimacy. Because the EU embraces such a wide array of activities, and the competencies of its various actors and the balance of power between them have evolved over time, it is possible for both sides to this debate to find compelling examples that support their case. Rather than perceiving this issue as a dichotomy of government preferences versus the actions of supranational institutions, it would be more helpful to focus on the interaction between these two. Sandholtz (1993) has argued persuasively that state preferences themselves are not formed in a vacuum: membership in the EU itself has become an important influence on how governments define their interests.

To date, the failure of those other regional schemes that aspire to become common markets to realize their aspirations inevitably limits to the European context debates about the role that supranational institutions can play in driving integration forwards. Meanwhile, it is too early to tell whether the neo-functional logic of spillover will apply to some of the more significant free trade areas, most notably NAFTA, that were established in the 1990s.

Key points

- Corporations may prefer regionalism to global trade liberalization if it enables them to capture economies of scale while avoiding exposure to global competition.
- Regionalism may be particularly attractive to companies that seek 'deeper integration' to facilitate the operation of regional production networks.
- Unskilled labour in industrialized economies is likely to oppose regional integration if this includes less developed economies with significantly lower labour costs.
- Because most RTAs are free trade areas, they requiring little pooling of sovereignty and afford little scope for the emergence of sources of power at the regional level that rival national governments.
- In the EU, evidence from different sectors at different periods of time supports arguments from both the intergovernmental and the neo-functionalist perspectives.

The economic consequences of regional integration

The discussion of trade diversion in Box 5.2 reminds us that no assumption can be made that regional trade agreements will necessarily enhance the welfare of their participants. It is not straightforward to estimate the effect that RTAs have had on members' trade and their welfare more generally because the impact of many other variables has to be taken into consideration.

Regional agreements and members' trade

That the share of world trade conducted within RTAs has risen, as noted at the beginning of this chapter, reflects both an increase in the number of RTAs and an increase in the share of their total trade that members of RTAs conduct with one another. Table 5.4 shows for the major minilateral RTAs how the share of intra-regional trade in members' total trade evolved in the last quarter of the twentieth century.

The share of intraregional trade in the total trade of members of some regional agreements rose dramatically: most notable here were NAFTA, the Central American Common Market, CARICOM, and MERCOSUR. In contrast, ASEAN states were no more important as trading partners for one another in 2001 than they had been a quarter of a century before, despite implementing a free trade agreement in the interim. The record of many African RTAs was mixed: SADC was notably successful in increasing intra-regional trade, a reflection of the reintegration of the post-apartheid South Africa into the regional economy.

Simple statistics of this type, however, do not tell us whether the RTA itself has been a significant influence on trade among the member economies. Multiple factors other than the existence of a regional trade agreement can influence the volume of trade between any two countries. Among the most important of these are the size of the two economies, the levels of per capita income, the geographical distance

Table 5.4 Changes in the share of intra-regional trade in selected RTAs, 1970–2001

	1970	1980	1985	1990	1995	2000	2001
EU (1957)	59.5	60.8	59.2	65.9	62.4	62.1	61.2
NAFTA (1994)	36.0	33.6	43.9	41.4	46.2	55.7	54.8
CACM (1961)	26.0	24.4	14.4	15.4	21.7	13.7	15.0
Andean Group (1988)	1.8	3.8	3.2	4.2	12.2	8.8	11.2
CARICOM (1973)	4.2	5.3	6.3	8.1	12.1	14.6	13.4
MERCOSUR (1991)	9.4	11.6	5.5	8.9	20.3	20.7	20.8
ECOWAS (1975)	2.9	9.6	5.1	8.0	9.0	9.6	9.8
SADC (1992)	4.2	0.4	1.4	3.1	10.6	11.9	10.9
ASEAN/AFTA (1992)	22.4	17.4	18.6	19	24.6	23	22.4
GCC (1981)	4.6	3.0	4.9	8.0	6.8	5.0	5.1

Note: Figures in parentheses refer to year in which the RTA came into force.
Source: WTO (2003*c*: Table 1B.11).

between the two countries (and hence the transportation costs in trading), whether or not they share a common boundary, and whether or not their populations speak the same language. Such factors have to be built into any model that attempts to isolate the impact of the regional agreement itself on trade. Jeffrey Frankel (1997) has undertaken the most comprehensive modelling of this type. He finds that after allowing for the various factors identified above, regional trade agreements have had a (statistically significant) positive impact on the trade between their members. This positive effect is particularly pronounced for agreements among less developed economies, including ASEAN and MERCOSUR, but trade among EU member states was also 65 per cent above the level that would otherwise have been expected in the absence of a regional trade agreement. These results echo those in several other studies. The evidence points strongly to preferential trade agreements having caused changes in patterns of international trade.

These results in themselves, however, do not distinguish between trade creation and trade diversion effects, and thus tell us little about the welfare effects of the regional trade agreements. Again, isolating the causes of the increased trade is no easy task. The new preferences created for regional partners have to be viewed in the context of other changes in the participants' trade policies including, for instance, any reduction of their tariffs towards nonmembers of the regional agreement (as occurred in the 1980s and 1990s both through unilateral liberalization and through implementation of GATT/WTO agreements).

A major study by the World Bank (2000) finds that although the ratio of intra-regional trade to Gross Domestic Product (GDP) increased in all regional groupings reviewed, so too did the ratio of trade with extra-regional partners to GDP. In other words, not only did trade with regional partners grow in economic importance but so too did trade with countries outside the region. Consequently, the Bank concluded, while studies suggest that some trade diversion occurred in the EU, European Free Trade Association, and NAFTA, 'the picture is sufficiently mixed that it is not possible to conclude that trade diversion has been a major problem' (World Bank 2000: 48), a finding consistent with Frankel's (1997) comprehensive study (see also Krueger 1999).

That RTAs may distort members' trade patterns to only a limited extent is consistent with the lowering of MFN tariffs (and thus the preferential margins enjoyed by partner countries) that has occurred in the last two decades. In Canada, half of all MFN tariff lines are duty free; in the United States, the figure is 35 per cent. As noted in the previous chapter, the average tariff level in industrialized countries on imports of manufactured goods is less than 5 per cent.

A similar trend towards tariff reduction is also evident in most less developed countries, with an inevitable consequence for the preferential margins that RTAs create. In ASEAN, for instance, in roughly two-thirds of the tariff lines, MFN and preferential tariffs are identical. For many of the others, the preferential margin is so small in the most developed economies (Singapore and Malaysia) that few companies have found it worthwhile to meet the rules of origin requirements and file the necessary paperwork: less than 5 per cent of all intra-ASEAN trade takes advantage of preferential tariffs. Not only do many RTAs create few advantages for partners for many exports, they also seldom help in the most heavily protected areas: when 'sensitive' sectors are protected by high MFN tariffs, governments frequently also exempt them altogether from the regional agreement or minimize the liberalization provided.

Scale economies and competition effects

Regional trade agreements affect the welfare of their participants through impacts beyond those on trade itself. One argument made in support of RTAs is that they will lead to increased investment flows for participants. As noted earlier, inflows of foreign direct investment into Mexico increased substantially after the signature of NAFTA. Similarly, the establishment of the European Community and the subsequent deepening of European integration through the completion of the single internal market led to substantial increases in foreign direct investment in the EU, both intra-regionally, that is from one member state to another, and from external countries (Motta and Norman 1996).

The other area in which RTAs are often assumed to improve the welfare of participating countries is by increasing the size of the 'home' market. As noted earlier, this can be particularly important for firms dependent upon access to a market larger than that available within one country to achieve economies of scale. Moreover, regionalism may generate increased competition for domestic companies, thereby forcing them to become more efficient. Again, estimating these effects requires complex economic modelling with often 'heroic' assumptions. Although the computer simulations reach dramatically different conclusions depending on the assumptions they use, the most frequent finding is that regional integration produces only a very limited positive aggregate effect on the economies of participants (on the Asia-Pacific region, for instance, see Scollay and Gilbert 2001). Critics suggest that these findings reflect the inability of the models to capture the 'dynamic' effects of regional integration, those that develop over time as companies benefit from scale economies and other efficiencies. Others, however, argue that the majority of benefits from regionalism come from increased competition rather than from realizing economies of scale, and that these competitive benefits can be achieved more effectively through non-discriminatory liberalization that exposes domestic companies to worldwide competition (Schiff and Winters 2003: 51–2).

In short, the verdict on the economic effects of regional trade arrangements is mixed and frequently inconclusive. Economic models suggest that there is little evidence that RTAs have generated significant trade diversion. They do appear to have been associated with increased inflows of foreign direct investment. Yet their overall effects on the economic welfare of participants, if positive, have been of limited magnitude. And in the most sophisticated of regional schemes, the European Union, any welfare benefits arising from improved competitiveness in manufacturing have been at least partially offset by the welfare losses caused by the EU's Common Agricultural Policy.

Key points

- Although considerable complexity is involved in attempting to isolate the economic effects of RTAs, evidence suggests that they have led to more trade among members than would otherwise be the case.
- RTAs do appear to have encouraged increased investment in member states.
- Economic simulations suggest that RTAs have had little aggregate effect on members' economic welfare.
- Little evidence exists that RTAs have produced significant trade diversion.

Regionalism and the WTO: stepping stone or stumbling block?

The advent of the new regionalism has been accompanied by a lively debate about its relationship to trade liberalization at the global level. Will regional trade agreements facilitate or obstruct global trade liberalization or, in Bhagwati's (1991) terminology, are regional agreements stepping stones or stumbling blocks?

Several arguments suggest how regional agreements might facilitate global negotiations:

1 Global negotiations involving regional groupings reduce the number of actors involved;
2 Reaching agreement on issues of deeper integration will be easier within regional groupings; these agreements can serve as models for global treaties;
3 Regional agreements can enhance the competitiveness of domestic industries, paving the way for full liberalization;
4 Regional agreements improve the financial position of export-oriented interests, thereby providing them with the means and incentive to lobby governments for broader liberalization.

The intuitively attractive argument that regional groupings simplify global negotiations by reducing the number of parties is counteracted by the difficulties that regional groupings often have in reaching a common position (witness the European Union on agricultural issues in global negotiations). Moreover, once a regional grouping has reached internal agreement on its own position, it may have little flexibility in bargaining with other actors. And there is no assurance that the common position adopted by a regional grouping will not be more restrictive than that held by a majority of its member states: in other words, the regional grouping can end up throwing its combined weight behind policies that might not have been supported by a majority of its members had they acted individually in the global negotiations. The recent proliferation of regional trade arrangements, many of which have overlapping memberships, suggests further complications should negotiations occur between 'regions' rather than between individual countries.

Until recently, little evidence existed to support arguments that agreement on contentious issues or on matters of 'deeper' integration could be reached more easily at the regional level. The European Union, for instance, has found it very difficult to liberalize the most politically sensitive areas of trade, especially in agriculture. In the OECD's words, 'regionalism has often failed to crack the hardest nuts' (2002: 20). And few regional agreements had moved beyond the basics of removing tariffs. Nonetheless, the recent wave of regionalism has provided greater encouragement for the argument that deeper integration on issues such as investment and the environment is more easily accomplished through regional negotiations (for further discussion see OECD 2002). Developments at the regional level on these issues, however, have yet to be translated into global agreements, so the idea of the regional positively influencing the global has yet to be substantiated.

The argument that regional agreements will enable industries to become internationally competitive and therefore that an RTA will ease the path towards non-discriminatory liberalization assumes that the level of competition at the regional level will be similar to that in the global market place to which firms will then be able to graduate. An alternative proposition is also intuitively plausible: that the regional market will be of sufficient size to enable firms to realize economies of scale, and that they will prefer to operate with the comfort provided by the external tariff of the regional grouping rather than be exposed to enhanced competition. Companies content with operating in the regional market may be financially strengthened through regional integration, and therefore may have an incentive to lobby against extending trade liberalization beyond the region.

Critics who see regional agreements as stumbling blocks in the path of global liberalization assert that:

1 They magnify the influence of power disparities in international trade relations, enabling larger economies to impose their will on smaller partners, gaining them advantages through rules of origin

that would not be achieved if liberalization occurred on a global basis, and thereby enhancing popular resentment in smaller, less developed economies against trade liberalization.

2 They lead to a diversion of scarce bureaucratic resources and political leadership away from global trade negotiations towards those at the regional level.

3 They give rise to what Bhagwati (1995) has termed a 'spaghetti bowl' effect of numerous, criss-crossing preferential arrangements with a multiplicity of tariff rates and different rules of origin. The complexity of regulations provides opportunities for special pleading by interest groups and generally increases the costs of engaging in international trade. With countries being members of several RTAs, each with its own set of rules, companies face difficult decisions on where to establish subsidiaries and where to source their inputs (OECD 2002: 18).

4 They provide exporters with the access to markets that they desire thereby removing their incentive to lobby the government for more complete domestic liberalization.

5 They enable governments to exempt sensitive political sectors from liberalization, thereby energizing protectionist forces and strengthening political resistance against liberalization at the global level.

The last two of these arguments rest on the possibility that regional arrangements will not be comprehensive in their product coverage because members are able to exploit the ambiguity of the WTO's rules on RTAs (Box 5.6 summarizes these rules). For the WTO to regard regional trade agreements as legitimate, average duties at the regional level must not be higher than those imposed by individual members before the agreement, and the arrangements must cover 'substantially all the trade' between the parties. The first of these obligations is ambiguous because it takes no account of rules of origin and non-tariff barriers; moreover, a substantial gap often exists between the tariff levels that countries have committed to in the WTO (so-called 'bound' rates) and the actual tariffs (usually lower) they have applied. In entering a regional agreement, countries, therefore, can keep the regional tariffs below their bound levels while actually imposing higher rates than they previously applied to non-members.

The ambiguities of the second obligation—the requirement that RTAs should cover substantially all trade—are of even greater import because they have enabled countries to exclude politically sensitive sectors from regional agreements. The European Union, for instance, did not include most of Mexico's and South Africa's agricultural exports in the free trade agreements it signed with these countries. Similarly, the Japanese government excluded the few agricultural products that Singapore exported to it from its free trade agreement with the island state.

The political significance is that free trade agreements that provide partial liberalization can provide exporters with what they want (access to foreign markets) while enabling governments to avoid tackling the problem of inefficient domestic industries. The result is a process of 'liberalization without political pain'. The continued protection that uncompetitive domestic industries enjoy by being exempted from regional liberalization may encourage them to lobby against any liberalization, whether at the regional or the global level. Meanwhile, the wider the network of preferential trade agreements, the less incentive will domestic exporters have for lobbying for liberalization at the global level. Take Mexico as the current extreme example. It has more than thirty preferential trade agreements with partners on all continents that collectively account for more than 60 per cent of global GDP and more than 97 per cent of its exports (the vast majority of course going to the United States). The signature of RTAs has substantially reduced the incentive for Mexican exporters to expend resources in lobbying for global liberalization.

The evidence

The sometimes contradictory arguments on the relationship between regional trade agreements and global trade liberalization rest on intuitively plausible hypotheses, but ones that are not easy to test. Moreover, the relatively brief period for which many of the new regional agreements have been operating makes it difficult to reach conclusions about their effects (and generalization is hazardous when the agreements themselves differ so markedly in their scope and content).

Box 5.6 **The World Trade Organization and preferential trade agreements**

Article XXIV of the GATT lays down the criteria that regional arrangements must meet to be regarded as legitimate by the WTO. Members' customs duties under the new agreement must not be higher or more restrictive than those previously imposed by the individual countries. The preferential agreement, according to Article XXIV.8, must also eliminate duties and other restrictions on 'substantially all the trade' between participants.

These provisions have generated enormous controversy over the years. In particular, members have failed to reach agreement on defining and applying the phrase 'substantially all the trade'. The WTO notes 'there exists neither an agreed definition of the percentage of trade to be covered by a WTO-consistent agreement nor common criteria against which the exclusion of a particular sector from the agreement could be assessed'. The European Union, a pioneer in negotiating preferential trade agreements, has argued that the Article XXIV.8 requirement has both a quantitative and a qualitative element, with at least 90 per cent of the trade between parties being covered and no major sector excluded. But other members have contested this interpretation, which raises its own problems of definition: How is the 90 per cent of trade to be measured (does it refer only to existing trade or to that which might take place should restrictions be removed)? And how does one define a 'major' sector? An agreed interpretation of Article XXIV.8 is one of the items on the agenda in the current Doha Round of multilateral negotiations.

The lack of agreement on Article XXIV.8 has stymied the work of the WTO's Committee on Regional Trade Agreements, created in February 1996 to examine preferential trade agreements and their implications for the multilateral trading system. Members have simply failed to determine whether or not any of the large number of PTAs notified to the Committee since 1996 is fully compatible with the relevant rules. Lack of consensus has prevented the Committee from finalizing any of its reports. The WTO's record on this matter is similar to that of the GATT, which was able to agree on the compatibility with Article XXIV of only four of the more than fifty RTAs submitted to it for consideration. Political considerations have dominated decision making on this issue. Nowhere was this more evident than when a GATT Working Party considered whether the Treaty of Rome, which established the EEC in 1957, met the requirements for RTAs. Faced with a threat by the Europeans to quit GATT should their integration arrangements be found incompatible with the full requirements of Article XXIV (which they clearly were), the GATT Working Party failed to reach consensus in its deliberations. Ultimately, contracting parties' desire (as much for security as for economic reasons) for integration in Europe to proceed outweighed their concerns about the legality of the agreements. Subsequently, GATT and the WTO have simply failed to pass judgement on the vast majority of RTAs they have examined including CUSTA and NAFTA (one of the rare exceptions was GATT's approval in 1994 of the customs union between the Czech and Slovak Republics).

The rules relating to the establishment of preferential trading arrangements among less developed economies under the 'Enabling Clause' are even less restrictive than those under Article XXIV. They make no reference to coverage of trade, the complete elimination of duties or to a timetable for implementation. They require only that the regional agreement not constitute a barrier to most-favoured-nation trade reductions or cause 'undue difficulties' for other members. RTAs notified to the GATT/WTO under the Enabling Clause include AFTA and MERCOSUR.

Two pieces of evidence support those who believe that regional trading agreements have not been barriers to liberalization at the global level. The first is the successful conclusion of the Uruguay Round of GATT negotiations which, as documented in the previous chapter, produced major steps forward in liberalization at the global level (although most of the Uruguay Round's negotiations took place *before* many of the agreements that are part of the new wave of regionalism came into being). The second is that members of many of the regional trade agreements, particularly those in Latin America, have lowered their barriers to non-member states more rapidly than did countries that were not members of regional agreements (Foroutan 1998). Although it is impossible to demonstrate a causal relationship here, the logic is straightforward: lowering barriers to non-members at the same time as entering a preferential trade

Table 5.5 Membership of Minilateral Regional Trading Agreements

AFTA	ASEAN Free Trade Area **www.asean.or.id**	Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam
APEC	Asia-Pacific Economic Cooperation **www.apecsec.org.sg**	Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Taiwan, Thailand, United States, Vietnam
BAFTA	Baltic Free-Trade Area	Estonia, Latvia, Lithuania
BANGKOK	Bangkok Agreement	Bangladesh, China, India, Republic of Korea, Laos, Sri Lanka
CAN	Andean Community **www.comunidadandina.org**	Bolivia, Colombia, Ecuador, Peru, Venezuela
CARICOM	Caribbean Community and Common Market **www.caricom.org**	Antigua & Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Monserrat, Trinidad & Tobago, St Kitts & Nevis, St Lucia, St Vincent & the Grenadines, Surinam
CACM	Central American Common Market **www.sice.oas.org/trade/camertoc.asp**	Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua
CEFTA	Central European Free Trade Agreement **www.ijs.si/cefta/**	Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovak Republic, Slovenia
CEMAC	Economic and Monetary Community of Central Africa **www.izf.net/izf/Institutions/Integration/Default.htm**	Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon
CER	Closer Economic Relations Trade Agreement **www.dfat.gov.au/geo/new_zealand/anz_cer/anz_cer.html** **www.mft.govt.nz/foreign/regions/australia/tradeeconomic/cerbackground.html**	Australia, New Zealand
CIS	Commonwealth of Independent States **www.cis.minsk.by**	Azerbaijan, Armenia, Belarus, Georgia, Moldova, Kazakhstan, Russian Federation, Ukraine, Uzbekistan, Tajikistan, Kyrgyz Republic
COMESA	Common Market for Eastern and Southern Africa **www.comesa.int**	Angola, Burundi, Comoros, Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, Zimbabwe
EAC	East African Cooperation **www.eachq.org/**	Kenya, Tanzania, Uganda
EAEC	Eurasian Economic Community	Belarus, Kazakhstan, Kyrgyz Republic, Russian Federation, Tajikistan
ECO	Economic Cooperation Organization **www.ecosecretariat.org/**	Afghanistan, Azerbaijan, Iran, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan
EEA	European Economic Area	EC, Iceland, Liechtenstein, Norway
EFTA	European Free Trade Association **www.cefta.org**	Iceland, Liechtenstein, Norway, Switzerland

EU	European Union europa.eu.int	Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom
GCC	Gulf Cooperation Council **www.gcc-sg.org/**	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates
GSTP	General System of Trade Preferences among Developing Countries **www.g77.org/gstp/**	Algeria, Argentina, Bangladesh, Benin, Bolivia, Brazil, Cameroon, Chile, Colombia, Cuba, Democratic People's Republic of Korea, Ecuador, Egypt, Ghana, Guinea, Guyana, India, Indonesia, Islamic Republic of Iran, Iraq, Libya, Malaysia, Mexico, Morocco, Mozambique, Myanmar, Nicaragua, Nigeria, Pakistan, Peru, Philippines, Republic of Korea, Romania, Singapore, Sri Lanka, Sudan, Thailand, Trinidad and Tobago, Tunisia, United Republic of Tanzania, Venezuela, Vietnam, Yugoslavia, Zimbabwe
LAIA	Latin American Integration Association **www.aladi.org/**	Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay, Venezuela
MERCOSUR	Southern Common Market **www.mercosur.org.uy/**	Argentina, Brazil, Paraguay, Uruguay
MSG	Melanesian Spearhead Group	Fiji, Papua, New Guinea, Solomon Islands, Vanuatu
NAFTA	North American Free Trade Agreement **www.nafta-sec-alena.org**	Canada, Mexico, United States
PTN	Protocol relating to Trade Negotiations among Developing Countries	Bangladesh, Brazil, Chile, Egypt, Israel, Mexico, Pakistan, Paraguay, Peru, Philippines, Republic of Korea, Romania, Tunisia, Turkey, Uruguay, Yugoslavia
SAPTA	South Asian Preferential Trade Arrangement **www.south-asia.com/saarc/sapta.htm**	Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka
SPARTECA	South Pacific Regional Trade and Economic Cooperation Agreement **www.forumsec.org.fj/docs/SPARTECA/foreword.htm**	Australia, New Zealand, Cook Islands, Fiji, Kiribati, Marshall Islands, Micronesia, Nauru, Niue, Papua New Guinea, Solomon Islands, Tonga, Tuvalu, Vanuatu, Western Samoa
TRIPARTITE	Tripartite Agreement	Egypt, India, Yugoslavia
UEMOA/WAEMU	West African Economic and Monetary Union **www.uemoa.int/**	Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal, Togo

arrangement reduces the risk of welfare loss through trade diversion. Critics of the new regionalism, however, point to evidence that after joining regional arrangements, Israel, Mexico, and MERCOSUR members when encountering economic difficulties all raised their tariffs against non-members.

Like so many other issues relating to the new regionalism, the link between RTAs and global liberalization remains inconclusive. Whether or not the current Doha Round of global trade negotiations is brought to a successful conclusion within a reasonable time frame will be a significant pointer to the validity of the contending arguments about the relationship between regionalism and the broader trade regime.

Key points

- A lively debate amongst writers on RTAs has produced several plausible arguments suggesting that regionalism can facilitate or hinder trade liberalization at the global level.
- The new regionalism is of such recent origin that the evidence on its effects remains inconclusive.

- The success of the Uruguay Round refuted the popular arguments in the late 1980s that the world economy was about to fragment into three rival trading blocs. But the results of the Doha Round will be a more significant indicator of the effects of the new regionalism on liberalization at the global level.

QUESTIONS

1. How does the 'new regionalism' differ from that of the 1960s and 1970s?
2. For what economic reasons might governments prefer trade liberalization at the regional rather than the global level?
3. What political benefits might membership of a regional agreement bring?
4. What are the likely sources of domestic political opposition to regionalism?
5. What is 'deeper' integration?
6. What were the sources of the failure of many of the regional trade agreements of the 1960s and 1970s?
7. Why did the United States government change its mind on the desirability of regional trade agreements?
8. How does trade creation differ from trade diversion?
9. Why are rules of origin regarded as a protectionist device?
10. What evidence is there that regional integration has had a positive impact on the economies of participating economies? And what has been its impact on non-members?
11. For what reasons might regionalism assist or impede trade liberalization at the global level?

FURTHER READING

General

Bhagwati, J., and Panagariya, A. (eds.) (1996), *The Economics of Preferential Trade Agreements* (Washington, DC: AEI Press). An accessible overview of arguments by economists against regionalism.

Fawcett, L., and Hurrell, A. (eds.) (1995), *Regionalism in World Politics: Regional Organization and International Order* (Oxford: Oxford University Press). An initial exploration of the new regionalism with overviews and case studies.

Frankel, J. A. (1997), *Regional Trading Blocs in the World Economic System* (Washington DC: Institute for International Economics). The most comprehensive examination of the effects of regional trade agreements.

Haas, E. B. (1975), *The Obsolescence of Regional Integration Theory* (Berkeley, Calif.: Institute of International Studies, University of California). A reconsideration of the relevance of early integration theory.

Mansfield, E. D., and Milner, H. V. (eds.) (1997), *The Political Economy of Regionalism* (New York, NY: Columbia University Press). A recent collection of articles from a political economy

perspective on regionalism in general; it includes case studies of the principal geographical regions.

Moravcsik, A. (1998), *The Choice for Europe: Social Purpose and State Power from Messina to Maastricht* (Ithaca, NY: Cornell University Press). The most sophisticated statement of the liberal intergovernmental approach to regionalism.

World Bank (2000), *Trade Blocs* (New York, NY: Oxford University Press). A review of the evidence on the economic and political effects of regionalism and their relevance to less developed economies.

Africa

Bach, D. (ed.) (1999), *Regionalisation in Africa: Integration & Disintegration* (Bloomington: Indiana University Press). A collection that examines the relationship between regionalism, regionalization, and state disintegration in Africa.

The Americas

Cameron, M. A., and Tomlin, B. W. (2000), *The Making of NAFTA: How the Deal was Done* (Ithaca, NY: Cornell University Press). Analyses the negotiating process leading up to the signature of the NAFTA treaty.

Hufbauer, G. C., and Schott, J. J. (1993), *NAFTA: An Assessment* (Washington DC: Institute for International Economics). An early review of the terms of the NAFTA treaty.

Roett, R. (ed.) (1999), *Mercosur: Regional Integration, World Markets* (Boulder, Colo.: Lynne Rienner). A collection of articles on integration among MERCOSUR members and their relations with the global economy.

Asia-Pacific

Aggarwal, V. K., and Morrison, C. E. (eds.) (1998), *Asia-Pacific Crossroads: Regime Creation and the Future of APEC* (New York: St Martin's Press). A collection of articles on the foundation of APEC, the objectives of its founders, and its early impact.

Ravenhill, J. (2001), *APEC and the Construction of Asia-Pacific Regionalism* (Cambridge: Cambridge University Press). Applies the theoretical literature on regionalism to APEC's foundation and operating principles.

Europe

Bomberg, E. E., and Stubb, A. C. G. (2003), *The European Union: How Does It Work?* (Oxford: Oxford University Press). An up-to-date introductory text on the EU.

Milward, A. S. (1992), *The European Rescue of the Nation-State* (London: Routledge). A historical review of European integration from an intergovernmental perspective.

Wallace, H., and Wallace, W. (eds.) (2000), *Policy-Making in the European Union*, 4th edn. (Oxford: Oxford University Press). The most comprehensive and theoretically sophisticated overview of the various dimensions of EU integration.

WEB LINKS

Table 5.5 lists addresses for the websites maintained by most regional trade agreements.

www.wto.org/english/tratop_e/region_e/region_e.htm The WTO website's gateway to the Organization's material on regional trade agreements.