

7 Regionalisation vs. Globalisation: The Issues

Instinct, common-sense, theory and history all suggest that non-discriminatory free trade across all borders, and not just those divided arbitrarily by nation or region, is clearly the *first best* option from the viewpoint of maximising both global and national welfare. That view, however, rests on traditional concepts rooted in trade theory. In practice, the different and conflicting economic and social objectives of nation states, and the chronic dependency of the fiscus in developing countries on trade taxes, leads to a search for the *least worst* policy options for multilateral economic cooperation, especially when the global economy is still very imperfectly organised and political relationships among nation states are fragmented and in danger of becoming more so.

For these reasons, the resurgence of interest in newer RIAs keeps raising the question of whether an increased tendency towards regionalisation is an optimal or an inferior way of moving towards free trade and investment on a global basis. As one study puts it:

‘... it is questionable whether the prospective proliferation of (regional) arrangements – which involves overlapping country membership, potentially inconsistent rules, and increased scope for conflict – is the most efficient way to move toward free trade on a global basis. Indeed, beyond a certain threshold an undue emphasis on regionalism would undercut the multilateral trade system and render it inoperative. The limits on the liberalisation that regional arrangements can deliver in trade-sensitive sectors where protection is most ingrained raises further doubts about this approach. ... a “fortress mentality” (on the part of regional blocs) that leads to an increase in protection would undermine world welfare. The key element that could reduce this danger is the extent to which the world economy has (already) become integrated through trade and through the globalisation of investment and production. ... The recent trend toward regionalism, however, may be qualitatively different from past efforts and may carry greater risks of becoming a substitute for, rather than a complement to, multilateralism.’ (de la Torre and Kelly, *op. cit.*)

Regionalism as a Mezzanine Step

If one accepts the argument that free trade *within* a region will lead to greater benefits, efficiency and welfare, then the same logic leads to the

conclusion that free trade *across* regions would be even better. The real question is whether it is necessary to go through the RIA route as an unavoidable mezzanine step in order to arrive at global free trade, or whether that intermediate step can be dispensed with since it might delay rather than hasten the world's journey towards its inevitable destination?

In this context, the experience of the Uruguay Round is illustrative. As it turned out, global trade liberalisation was easier to negotiate through regional bloc formations than through negotiations involving individual countries. The answer to the question, of course, lies not in economics but in politics and social organisation – those of nations as well as of global multilateral organisations.

As noted earlier, most existing global institutions seem to be approaching their limits of usefulness. Increasingly, global multilateral organisations appear to have become vested interests in their own right, more concerned about protecting their long-established rights and privileges than about delivering on their obligations to the international community. Moreover, the type of international discourse that occurs through them suggests that nation states themselves have reached an impasse. Present national political and administrative systems are not geared to providing effective and coherent direction to multilateral organisations. They are too internally divided – both within and among nations – and have become disconcertingly captive to the exercise of undue influence by special, single-issue lobbies. As a result, most national systems are more oriented toward short-term insularity than long-term internationalism. That is not surprising for two reasons.

First, few democratic governments have any incentive to employ a perspective of longer than four years. Second, except in very small countries, national governments do not attract votes on the basis of how well they handle international economic issues. They are therefore more attuned to appeasing and pandering than to leading; more adept at resisting change than adapting to it; and more prone to prescribing adjustment for others while resisting domestic adjustment for themselves when, in fact, embracing adjustment would, in the long run, be the least cost option both economically and politically.

In such a world the question becomes one of whether a *regional* approach may, at least for the foreseeable future, be more manageable than a *global* approach for myopic nation states and global organisations to cope with. The example of the European Union, despite its many shortcomings, controversies and distractions, has made a fundamental difference to thinking about whether the relative success of that regional arrangement – in contrast to the perceived daily failures of global endeavours – might not be replicable elsewhere.

When the ideal of globalism fades as a consequence of international

institutional failure and an erosion of national political will – two forces which feed on and reinforce each other negatively – the less ambitious *regional* undertaking begins to look distinctly more attractive if only on the grounds of greater tractability. It may just be that increasingly obsolescent smaller nation states, fighting for their own survival as sovereign entities against a powerful array of global market forces over which they have diminishing control, have subliminally come to the conclusion that they are more able to live with processes and institutions over which they *think* they still have some control (*regional*) than those over which they obviously have none (i.e. *global*).

It may also be that for a variety of reasons which have bred more familiarity, regionalism may be more manageable politically from a domestic point of view. Voters of all social and economic strata are perhaps able to comprehend and react to regional issues more than they can to global issues. Whatever the reasons, regionalism may be here to stay, for economic but mainly non-economic reasons, and therefore may be an unavoidable way-station to globalism. The risk always exists that such a detour might derail globalism. But it cannot do so altogether and for all time if history is a reliable guide. It can only delay the process through temporary setbacks of varying severity.

The questions then are: For how long will regionalism delay globalisation? And at what cost to global welfare? If one accepts that regionalism is here to stay, then the most useful question to answer is: What needs to be done to make it as friendly to the process of global market development as possible? And what should be done to make RIAs contribute to, rather than detract from, global welfare?

Trade Blocs

Clearly the propensity of regional trade blocs to become protectionist in the face of competitive pressures which create domestic political ructions is damaging to global welfare. The various studies which have been done on this subject suggest that the increasing of trade barriers by either the European Union or NAFTA would have large negative effects on global GDP, on most individual countries, and on all regions, including the region which increased protection. Such losses would increase if either bloc retaliated.

For example, in one study, assuming a world comprising the three major trade blocs, it was estimated that if EC-92 was accompanied by an increase in external trade barriers, world GDP (measured in 1988 dollars) would decline by US\$108 billion (US\$52 billion in the European Union, US\$40 billion in

NAFTA, and US\$16 billion in Asia).²⁷ By the same token, more recent estimates suggest that the creation of a North Atlantic free trade area would increase global GDP by about \$250 billion (1994 dollars) and generate almost a million new jobs in the European Union and NAFTA.

One study (Krugman: 1990) explored the implications of trade bloc protectionism in somewhat simplistic terms employing a model of one-product monopolistic competition among a large number of identical countries with each country producing one variety of the product and imposing the optimum tariff on imports from all other countries. Using this model to project different scenarios, the results showed that, as trade blocs emerged, starting from a large number of identical blocs, tariffs become positive and welfare declined. With increasing size of blocs the optimum tariff on extra-bloc trade kept rising, producing both trade-creating and diverting effects. The trade-creation effect dominated trade-diversion only after the number of trade blocs declined to three and was maximised when the world became a single bloc with the optimum tariff diminishing to zero.

Others, arguing that these assumptions precluded inter-industry trade and assumed unrealistic symmetry, have postulated alternative models – with countries differentiated by factor endowments, in which small numbers of trade blocs can maximise welfare.²⁸ The theoretical debate on this issue is not particularly illuminating (de Melo: 1993). The more critical issue is how trade blocs behave vis-à-vis one another once they have been formed. If a dynamic view is taken, it may still be worthwhile for new trade blocs to emerge which generate significant intra-bloc efficiencies, even if their trade-diverting effects diminish global welfare in the short run, provided that such blocs eventually lead to free global trade. That approach could be seen as taking one step backwards or sideways in order to go two steps forward.

RIAs, by their very nature, involve preferential treatment among members and therefore discrimination against countries outside the region. But for RIAs to avoid excessive damage to the long-term interests of global free trade such discrimination must be contained within acceptable bounds.

RIAs among developed countries have limited the damage done by welfare-diminishing discrimination mainly because the focus has been on reducing barriers to trade in manufactures on which most developed countries (in sharp contrast to developing ones) have always maintained generally low levels of intra- and extra-regional protection.

27 Stoeckel, A., Pearce and Banks, *Western Trade Blocs: Game, Set or Match for Asia-Pacific and the World Economy*, Centre for International Economics, Canberra, Australia, 1990.

28 (1) Deardorff, and R. Stern, *Multilateral Trade Negotiations and Preferential Trading Arrangements*, (mimeo), 1991; (2) Srinivasan, T.N., 'Discussion on Regionalism vs. Multilateralism by Krugman', In: de Melo, J. and A. Panagariya, *New Dimensions in Regional Integration*, (op. cit.), 1993.

In some cases extra-regional barriers were reduced as RIAs were implemented. In others trade barriers were already low when these arrangements were agreed. Such outcomes have done little to damage global welfare. But even in such cases, large negative effects may still be felt by *non-regional* countries whose production and exports are concentrated in products and industries where discrimination applied by large global trading blocs such as the European Union and NAFTA – because of the proportion of world trade which they account for – have been increased or remain high. For example, in the European Union products discriminated against are in agriculture, coal, steel, shipbuilding, textiles and apparel. These products have enjoyed excessively high protection for several decades. The European Union has raised average effective protection for these products above those which would have prevailed in several member countries in the absence of the common market.²⁹

RIAs (like those of the European Union in the automobile and electronics industries) which force defensive foreign direct investment by firms from non-member countries also damage global welfare. Defensive foreign investment is FDI which is diverted to a particular region by foreign firms anxious to establish production capacity within that region and avert the risk of losing market share should that region increase its trade barriers later. It represents a diminution of global welfare if it reflects a pattern of foreign investment which is different from what would occur in the absence of regional trade barriers and guided by undistorted market signals.

GATT Rules

RIAs, by definition, go against the *raison d'être* of GATT, which is founded on the principle of non-discrimination in trade across all of its signatories (Article 1). Yet GATT permits RIAs under Article 24 as long as: (a) other GATT members are notified of their details; (b) they do not raise trade barriers against other GATT members; (c) such arrangements embrace substantially all trade between the regional members; and (d) RIA partners

²⁹ The absurdity of the EU's Common Agricultural Policy (CAP) has been a glaring example of regional and global welfare reducing protectionism for a long time. The CAP has introduced substantial discrimination against non-regional producers (mainly Eastern European and developing countries) in virtually the entire range of agricultural tradeables. CAP sets intra-EU prices so far above world prices that it encourages over-production and structural oversupply with very heavy (and costly) stockpiling and even more heavily subsidised dumping in export markets which depresses world prices even further and drives efficient farmers in other parts of the world out of business. CAP involves an egregious expense for foreign producers as well as to EU consumers. It also results in major losses of production efficiency within the EU because of the amount of resources it compels to be misallocated.

are committed to reducing barriers to intra-regional trade along a specified schedule within a reasonable time span.

Article 24 was included in GATT mainly because those who framed the Agreement felt that RIAs could provide a complementary, practical and possibly, in some areas, faster route to global trade liberalisation. But the clauses in Article 24 were inserted to minimise the adverse effects of RIA-induced trade diversion on members of such arrangements as well as on non-members. There was also concern that the number of RIAs within the GATT system should be limited to those where the intensity of the political commitment to RIAs was commensurate with the liberalisation and structural adjustment effort required for such arrangements to succeed (Bhagwati: 1993).³⁰

GATT's main concern was that the world trading system should not again fragment into the myriad discriminatory or sectoral, bilateral, and plurilateral arrangements that characterised the 1930s. It also recognised that, if RIAs led to regional blocs assuming nation-state characteristics as far as their trading and other economic arrangements were concerned, they might actually facilitate rather than debilitate eventual global integration by reducing the complexity involved in global negotiations. It would not be unreasonable to argue that global integration might actually be easier to achieve through negotiations among a few large players (e.g. regional blocs which were fully internally integrated) than through negotiations involving 200 individual players of vastly differing weight, size and capacity. Moreover, trade liberalisation via RIAs could be a useful first step towards global liberalisation under future WTO negotiations.

RIA negotiations are less affected than GATT rounds by *free riders* (i.e. members who benefit from most-favoured nation (MFN) treatment while escaping the reciprocal obligations that MFN requires), *foot dragging* (when advantage is taken of rules requiring consensus to block movement) and the *convoy effect* (moving at the pace of the slowest).

In 1979, an enabling clause was inserted into GATT which weakened Article 24 by allowing RIAs involving only developing countries to ignore Article 24 altogether unless they involved the selective lowering of non-tariff barriers, in which event approval was required by all GATT members. Though the intent and spirit (if not the letter) of Article 24 have been violated extensively by several RIAs, not least by the European Union, it would be difficult to make the case that such side-stepping of its provisions has impeded movement towards gradual globalisation of freer trade – as the

30 Bhagwati, J., 'Regionalism and Multilateralism: An Overview', In: de Melo, J. and A. Panagariya, *New Dimensions in Regional Integration*, (op. cit.), 1993.

completion of the Uruguay Round would suggest is happening. Despite the proliferation of RIAs, most of them (especially EU and NAFTA) maintain relatively low external trade barriers except in the egregious cases of certain protected industries and sectors mentioned earlier (especially agriculture).

Also, the unilateral trade liberalisation undertaken by countries which are members of RIAs has helped to mitigate the potentially negative effects of trade diversion. It is generally accepted that RIAs are not responsible for the various non-tariff barriers that have crept in since 1980 such as voluntary export restraints, countervailing duties, anti-dumping measures, orderly marketing arrangements and legislation like Super 301 in the United States. Such measures reflect the resistance of most developed economies to undertaking the necessary structural adjustments required by changes in dynamic comparative advantage.

Theoretical Objections and Practical Benefits

For RIAs to contribute to the globalisation of free trade, the multilateral system must be receptive to commensurate change in order to be able to subsume effectively and gradually the liberalisation occurring under regional integration arrangements. As de la Torre and Kelly argue:

‘The multilateralisation of liberalisation gains under regional arrangements presupposes, of course, that a credible and well-functioning multilateral system is in place. Thus, steady progress with multilateral liberalisation is essential to: subsume preferential trading arrangements into a broader and more open trading system; to hold in check – and indeed to erode – the inherent discrimination of such arrangements; to convert their regionally circumscribed liberalisation into building blocks for freer trade on a global basis; and to prevent regionalism from fragmenting the world trade system.’ (de la Torre and Kelly, *op. cit.*, p. 44)

Whether RIAs are consistent with, or antithetical to, the strengthening of the multilateral system is, in the final analysis, more a matter of judgement than of fact. Assessing whether RIAs (either particular ones or in general) will help or hinder the cause of globalisation is more a matter of *ex-post* empirical than of *ex-ante* theoretical analysis. Global trade authorities who are also confirmed multilateralists, like Bhagwati and Schott,³¹ remain sceptical about the revival of regionalism while acknowledging its popular and political appeal. Others take the opposite view in being somewhat overenthusiastic

31 Schott, J., ‘More Free Trade Areas?’, In: Schott, J. (ed), *Free Trade Areas and U.S. Policy*, Institute for International Economics, Washington DC, 1989.

about the benefits of regionalism versus the intractability of achieving much at the global level.

Taking the view that RIAs would be less harmful if they were more open to new (and non-regional) members – because they might then realise the potential of being building rather than stumbling blocks towards globalisation – the sceptics see the following issues as limiting the extent to which RIAs can aid the cause of global trade liberalisation:

- When negotiations for RIAs and multilateral trade rounds occur simultaneously, as in the Uruguay Round, RIA negotiations divert more capable and scarce human resources and skills available in participant governments away from the GATT negotiations. Such diversion occurred even in cases where members were more committed to the cause of multilateralism but felt the need to take a defensive posture in the face of moves towards RIAs by major trading partners.
- The cumulative trade-diverting effects of RIAs across several different regions increase the risk of trade frictions and political pressures for retaliation, thus risking damaging chain reactions and setting back the cause of global free trade.
- Proliferation of RIAs would trigger a number of technical problems such as mismatching in the phasing of tariff reductions under different overlapping agreements, inconsistent rulings under different dispute settlement mechanisms, and confusion in interpreting and enforcing different rules of origin.
- Smaller countries would be hurt more by RIAs than by globalisation of trade liberalisation, particularly if they were undertaking structural adjustment programmes at the same time.

The interested observer might be forgiven for concluding that some of these reservations, manufactured in the heat of debate, when it appeared that the Uruguay Round was in mortal danger, seem to be more contrived than real. The Uruguay Round has now been satisfactorily concluded, despite a few loose ends. It has succeeded in striking a crude bargain between developed and developing countries, with the former conceding the need for further liberalisation in agriculture and textiles and the latter agreeing to consider opening their markets in areas not formerly covered by GATT, i.e. services, investment and intellectual property. Now that the distemper of negotiation has faded, some of the more imaginative arguments against RIAs have moderated with an acknowledgement that regionalism is here to stay and that it may, on balance, be a beneficial development.

It is now more widely accepted that RIAs may bring collateral benefits to trade liberalisation, especially by: (i) cementing economic cooperation in non-trade areas such as sectoral investment coordination, macroeconomic policy coordination, financial sector integration and in achieving efficiencies

in externalities; and (ii) bringing about closer political cooperation and perhaps even providing a framework (*à la* ASEAN) for the more effective settlement of disputes on a regional neighbourhood watch basis than the multilateral security system presently provides.

In the last aspect, of course, the UN security apparatus needs to develop much more effective linkages with regional political organisations (such as Organisation of African Unity and Organisation of American States) than it has done so far with the world community devolving more responsibility to these regional organisations for resolving conflict and maintaining stability in their regions.