THE NEW REGIONALISM IN TRADE POLICY

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in Trade Policy

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Preface

This booklet is meant to disseminate quickly the main themes developed at the conference entitled “New Dimensions in Regional Integration,” sponsored by the World Bank and the Centre for Economic Policy Research, which was held at the World Bank on April 2–3, 1992. The intent of the booklet is to capture the flavor of the conference and of participants’ positions, but the authors are solely responsible for its contents. The papers and discussants’ comments presented at the conference are forthcoming in a volume to be edited by the authors and published by the Cambridge University Press, entitled *New Dimensions in Regional Integration*. The authors thank Maurice Schiff and Vinod Thomas for helpful comments.
Regionalism Is Back—And Here to Stay

Regionalism is once again being viewed as a solution to the major international economic problems of our times. Slow progress of the negotiations at the Uruguay Round of the GATT (General Agreement on Tariffs and Trade) has led some economists to conclude that a division of the world into three trading blocs—Europe, the Americas, and East Asia—is the fastest road to multilateral free trade. They argue that negotiations for free trade are far more likely to succeed when conducted among three parties rather than among 154. And for many countries, the proliferation of nontariff barriers in the industrial world has made regional integration an attractive policy option. Integration with the United States or the European Community (EC) offers them guaranteed access to a large market. Not surprisingly, Mexico, Chile, and other Latin American countries are lining up to join a free trade area (FTA) with the United States. And several countries in Western Europe, Eastern Europe, and North Africa are knocking at the EC’s door. Similarly, perceptions of a “fortress mentality” in Europe and fears of an imminent Western Hemispheric FTA have led some East Asian nations to contemplate a defensive regional bloc of their own. In the former Soviet Union political disintegration has led some to look to regional integration as a means of preserving rapidly declining trade among the republics.

This stampede toward regionalism is not new. Four decades ago, regionalism spread across the world like wildfire, ignited by the creation of the European Community in 1958. The United States, then philosophically opposed to regionalism, saw a united Western Europe as an effective deterrent to the growing Soviet threat and threw its weight behind the EC. This was quickly followed by a proliferation of regional arrangements around the world, especially in the developing countries of Africa and Latin America.

Despite high hopes, this first round of regionalism did not flourish outside Europe. The primary motive behind the movement in the developing world was industrialization through regional import substitution. It was thought that infant industries could first learn to export within a protected regional market—and then face world competition. But for the same reasons that import substitution failed in countries, it also failed in the regions. By the late 1970s, outward-oriented policies had begun to
capture the imagination of policymakers. In the years that followed, unilateral, nondiscriminatory trade liberalization became the order of the day, and regionalism was pushed into the background.

Today regionalism is back with a vengeance. In its current incarnation, regionalism has engulfed all major players in the world economy. Division of the world into three trading blocs—never an issue in the first round—is being debated seriously. Confidence in the GATT process is on the decline, and enthusiasm toward the regional approach on the rise. Most notably, the United States—an ardent defender of the multilateral approach and the most formidable opponent of regionalism in the 1960s—has become an active perpetrator of regionalism. The loudest message from these developments, concludes Jagdish Bhagwati, of Columbia University, is that regionalism this time is here to stay.

Economists Are Divided on the Merits of Regional Integration

In recent years a consensus has evolved on many desirable policies for economic development. Economists are nearly unanimous in their view that openness, primary education, and macroeconomic stability are crucial to economic development. There is also general agreement that production activity is best left to the private sector but that government intervention in the provision of infrastructure and other public goods is critical for development.

It is strange, then, that there are deep divisions among economists and policymakers on the desirability of regional integration, divisions doubly paradoxical since there was near unanimity on the subject four decades ago. Writing in 1950, Jacob Viner opened the key chapter of his celebrated treatise *The Customs Union Issue* as follows:

The literature on customs unions in general, whether written by economists or non-economists, by free-traders or protectionists, is almost universally favorable to them, and only here and there is a skeptical note to be encountered, usually by an economist with free trade tendencies. It is a strange phenomenon which unites free-traders and protectionists in the field of commercial policy, and its strangeness suggests that there is something peculiar in the apparent economics of customs unions.¹

To explain the source of this peculiarity, Viner introduced the seminal concepts of "trade creation" and "trade diversion." These concepts
proved central to the subsequent thinking on regionalism and have been at the heart of the policy debate raging today.

To understand these concepts, suppose that the United States and Mexico, starting from nondiscriminatory tariffs, decide to form an FTA. As a part of the arrangement, the two countries eliminate all trade restrictions between themselves but maintain tariffs on imports from the rest of the world. Assume that unit production costs are constant everywhere and that as a result of the FTA the United States begins importing shoes from Mexico. Is this change for the better? Viner showed that the answer depends on the pattern of production before the FTA. If the United States produces shoes before the formation of the FTA, it must produce shoes at a higher cost than Mexico. This means that the FTA shifts production from a higher-cost source to a lower-cost source. There is trade creation, and welfare improves. If shoes are imported initially from a country elsewhere in the world (such as the Republic of Korea), that country must produce shoes at a lower cost than both the United States and Mexico. In this case, the discriminatory tariff introduced by the FTA shifts production from a lower-cost source to a higher-cost source. There is trade diversion, and welfare declines.

From a global perspective, a trade-creating FTA does not reduce trade between the union and the rest of the world, and it expands trade between partners. This FTA constitutes a movement toward freer world trade. By contrast, a trade-diverting FTA expands trade between partners at the expense of trade between the union and the rest of the world. This change constitutes an extension of protection from the national to the regional level and is a movement away from freer world trade. Purely on economic grounds, those who believe that FTAs are largely trade-creating support regionalism, whereas those who believe the reverse oppose it.

The relative size of trade-creating and trade-diverting effects depends on three key factors. First, the larger the pre-FTA tariff, the more likely that trade-creating effects will dominate. The reason is that a high initial tariff implies that the sources of supply are concentrated in the home economy. If the initial tariff is prohibitive, all supplies come from domestic sources. So, an FTA allows specialization within the union and leads to a replacement of high-cost domestic production by low-cost imports from the partner country. Second, the greater the demand for each country's goods by the partner country, the greater the scope for specialization and hence the greater the potential for trade creation. For rich countries, this complementarity of demand is more likely when the countries are similar. The reason: at high levels of income, differentiated products are in greater demand, and similarity offers gains from intra-industry specialization. For poor countries, the complementarity of
demand is greater the more dissimilar the countries are—because poor countries largely engage in interindustry trade. Third, the lower the external tariffs after the formation of an FTA, the less the trade diversion—because lower external tariffs offer less scope for the displacement of imports from countries outside the union.

Trading Blocs and (Versus?) Multilateralism

In the first round, regionalism was scarcely viewed as a threat to multilateralism. The GATT process was dominated by industrial countries, with the United States as the major economic power. Industrial countries negotiated tariff reductions on products of interest to each other and extended them to other member countries on the most-favored-nation (MFN) basis. So the integration schemes in developing countries posed no threat to the GATT negotiations. And the integration in Europe facilitated rather than hindered the negotiations. The United States could deal with the EC as a single unit because the EC had a common external tariff.

Today there is a distinct possibility that regionalism will divide the industrial world into three trading blocs: Europe, the Americas, and East Asia. This has brought the global aspect of regionalism to the forefront of the policy debate and divided more sharply than ever the defenders of the multilateral process and the devotees of regionalism. At one extreme, trading blocs are viewed as catastrophic to multilateralism. At the other, they are seen as the key to successful conclusion of negotiations aimed at free world trade.

Why Are Trading Blocs Becoming Popular?

The forces of multilateralism have weakened in recent years, and the attraction to regionalism has strengthened. Why? It is important to recognize that thinking about trade policy has a strong mercantilist bias. In choosing its trade policy, each nation operates on the premise that when it liberalizes trade, it alone bears the cost of liberalization—while all those that obtain a freer access to its market share the benefits. So, argues Mancur Olson, of the University of Maryland, even though trade liberalization is beneficial in aggregate, without a coordinated liberalization by all, it is viewed as a losing proposition. Free trade, perceived as a public good, thus suffers from the free-rider problem.

In the decades immediately after World War II, the United States accounted for close to half of global gross domestic product (GDP). It could generate large benefits for the world economy by freeing up its trade. And it could internalize a large part of those benefits. This gave
the United States a reason—and the leverage—to push for freer trade around the world. In the ensuing years, it took on the promotion of the cause of free trade, supplying such international public goods as the Marshall Plan and the various rounds of the GATT negotiations.

Conditions have changed. The United States is no longer the leader it was in the 1950s and 1960s. The EC has grown large and, driven by its farm lobbies and the fortress mentality promoted by progressively deeper economic integration, has become increasingly inward-looking in the view of many observers. Japan and the East Asian newly industrializing economies, hardly significant players in the world economy immediately after World War II, have emerged as major economic forces. The United States is now what Bhagwati calls a "diminished giant," suffering from large current account deficits and a sense that it can no longer dominate the world markets the way it did a few decades ago.

These developments—along with foot-dragging by the EC at the Uruguay Round and a perception that Japanese markets are closed to U.S. suppliers—have fueled the (already existing) anti-multilateralist ethos in the United States and moved it to consider forming a bloc of its own. The results: the Canada-U.S. Free Trade Agreement (CUSTA); the North American Free Trade Agreement (NAFTA) among Canada, Mexico, and the United States; and the Enterprise of Americas Initiative (EAI).

The conversion of the United States to regionalism has encouraged similar thinking in East Asia. The CUSTA and NAFTA negotiations have prompted some countries in East Asia to reassess the possible gains from regional integration. A move is under way to turn the Association of South East Asian Nations (ASEAN) into the ASEAN Free Trade Area. There is also concern that Asia’s future access to the U.S. market will be curtailed substantially if the Western Hemispheric FTA becomes a reality. This concern has encouraged the view that East Asia, too, should form a defensive bloc of its own, centered on Japan. Given its stake in the U.S. market, Japan has resisted the idea so far—but that could change rapidly if the Americas turn into an inward-looking bloc.

Are Trading Blocs Good?

Whether trading blocs are good or bad is the most controversial issue. There is general agreement that complete free trade in the world is the most desirable goal and that today’s trade regime is not the best we can do. But in getting to there from here, many possibilities exist, and the disagreements among economists over these possibilities are pronounced.
To understand the debate over regionalism, we must consider two analytically distinct issues: the static impact question and the dynamic time-path question. The static impact question focuses on whether the immediate effect of regional integration on world welfare will be positive or negative. The dynamic time-path question asks whether, regardless of the impact, regionalism will lead to multilateral free trade by merging regional blocs into a single world bloc.

The questions are illustrated in figure 1, adapted from Bhagwati. The static impact question is whether regional integration today will take the world economy from the current welfare, $U_0$, to a lower welfare, $U_1$, or to a higher welfare, $U_2$. The dynamic time-path question is whether blocs will eventually coagulate to reach the welfare level attainable with complete free trade, $U^*$ (paths I and III), or remain fragmented, leaving world welfare lower, at $U_1$ or $U_2$ (paths II and IV). Moreover, will the multilateral process itself take the world economy to the point of complete free trade (path V) or leave it at a lower level of welfare such as $U_m$ (path VI)? How do the various time paths compare?

*Figure 1. World Welfare under Multilateralism and Regionalism*

A partial answer to the first question, based on trade creation and trade diversion, was provided earlier. This answer was adequate for the first round of regional arrangements that could be reasonably evaluated in isolation, taking the rest of the world as a passive entity. But in the new regionalism, the issue is more complex. Today large blocs are forming almost simultaneously in different parts of the world. So a proper analysis must take into account the interdependence of blocs, including strategic interactions among them.

The theoretical literature on the economics of trading blocs is still in its infancy. Some innovative models have been developed, but their applicability to the real world is unfortunately limited. Indeed, even the authors of these models hesitate to draw policy implications from them.

At the forefront of the literature is the model of Paul Krugman, of the Massachusetts Institute of Technology, which T. N. Srinivasan, of Yale University, has already declared "theory without relevance." To get some flavor of the model, assume that the world consists of a large number of identical countries and that there is one differentiated product with many potential varieties. Each country specializes in one of these varieties and imports the varieties produced by other nations. Suppose we divide this world into several identical blocs, such that each bloc chooses the tariff on the other blocs optimally. A trivial but important point is that the world welfare is maximized when the number of blocs is either one or very large. In the first case, we have free trade by definition. In the second, the optimal tariff is near zero, so that once again we obtain free trade after the fact. Clearly, as the number of blocs increases beyond one, welfare must first decline, reach a minimum, and then rise.\(^3\) The critical question: at what number of blocs is welfare minimized? For a variety of simulations, Krugman finds that this number is approximately three!

Taken seriously, this result suggests that the static impact of a division of the world into three blocs is negative and will move the world to \(U_1\) in figure 1. But it is easy to construct alternative models that yield different conclusions. In particular, after allowing for asymmetric blocs, there is no clear relationship between the number of blocs and welfare. For instance, depending on how blocs are formed, a given change in the number of blocs may improve or worsen welfare. Srinivasan shows this in a two-good, multicountry Ricardian model.

The implications of theoretical models notwithstanding, Krugman and Lawrence Summers, of the World Bank, have argued separately that since blocs are likely to form among geographically proximate countries that trade intensely among themselves to begin with, trade-creating effects will almost certainly dominate trade-diverting effects. The obvi-
ous example is the NAFTA. Mexico exports more than 80 percent of its
goods to the United States even without a free trade area. So it is unlikely
that NAFTA will be trade-diverting on balance.

Although there is some truth in this, its general applicability is in
doubt. Geographical proximity need not be accompanied by intense
trade: Africa and South Asia export 95 percent of their goods outside
their regions. In the Western Hemisphere, trade of most Latin American
countries is very diversified. Roughly 55 percent of exports from Latin
America (excluding Mexico) go to regions other than the Western Hemi-
sphere. Even East Asia exports more than 65 percent of its goods outside
East Asia.

More important than the static impact question is the dynamic time-
path question. Very little is known about this issue, and Bhagwati
addresses it systematically for the first time. The ultimate question here
is whether, over time, blocs will expand and coagulate in a monotonically
welfare-improving manner. To answer, we must look at the incen-
tives facing the relevant agents—governments and interest groups in
member countries—for further expansion of the union. Bhagwati fears
that governments of member countries will be resistant to further expan-
sion of the union. They are likely to argue, "We are already a large
market, so what do we really stand to gain by going through the hassle
of adding more members?" This Our Market Is Large Enough syndrome is
partly why large countries are more inward looking than small countries.
Interest groups in member countries may also lobby against the expansion
of a customs union. These Are Our Markets syndrome on the part of politically
powerful protectionist interest groups is likely to work against the
inclusion in the union of efficient suppliers from outside the union.

These problems notwithstanding, defenders of regionalism contend
that a division of the world into a few blocs will lead to free world trade
faster—and with greater certainty—than the multilateral process. Un-
fortunately, as with the static impact question, there are two sides to the
issue. A small number of blocs can alleviate the free-rider problem that
afflicts the GATT process and make the approach to a cooperative solu-
tion faster and more certain. But the larger the blocs, the greater the
market power they enjoy, and the greater the temptation to impose
restrictions on trade outside the bloc. There is no clear presumption on
whether blocs will lead to free trade faster and with greater certainty
than the multilateral process.

Experience also gives mixed guidance on this issue. The EC stands in
sharp contrast to other parts of the world. Once the Treaty of Rome was
signed, intra-union barriers to trade came down rapidly and with cer-
tainty. Elsewhere in the world, regionalism has been piecemeal. In Africa
and Latin America, regionalism did not go very far, and there were many reversals. In some cases, regionalism even became a barrier to liberalization. In agriculture, the regional approach was no more successful than the multilateral one. Indeed, the EC's Common Agricultural Policy (CAP) was perhaps a more effective barrier to freeing up trade in agriculture than any other device would have been in the absence of the EC.

**Turning Stumbling Blocs into Building Blocs**

To some extent, the question of whether trading blocs are good or bad is moot. Regionalism is here—and likely to stay. So a more constructive approach is to ask whether mechanisms can be devised to ensure that regionalism complements multilateralism and does not fragment the world into inward-looking blocs. Available evidence suggests that when economic power is centered in hegemons, as during periods of British and American hegemony, and when there is anarchy, the ratio of world trade to GDP is high. By contrast, when there are a few middle powers, as can happen with a few trading blocs, trade-to-GDP ratio is low. To avoid this outcome, we must reform the GATT rules and design regional arrangements in such a way that they serve as building blocs rather than stumbling blocs of a global free trade system.

Three suggestions have been made. First, Article XXIV of GATT could be modified to rule out FTAs and allow only customs unions. A customs union requires a common external tariff and, given GATT bindings on most tariffs, ensures that all tariffs come down to the lowest level prevailing in the union at the time of its formation. This happened when Greece, Portugal, and Spain joined the EC. Because the EC is a customs union, these countries had to substantially liberalize their trade regimes to reach the EC's common external tariff.

In the future trading blocs are likely to form around countries with liberal trade regimes. So a common external tariff can serve the cause of liberalization in countries with inward-looking regimes that want to join a bloc. A common external tariff can also generate some important side benefits. For one thing, it eliminates the need for rules of origin, which often become instruments of protection in the hands of a weak authority. Moreover, to the extent that lobbies are active, their effectiveness may be diluted in a customs union. A union requires unionwide lobbying, while tariffs in an FTA are responsive to lobbying at the national level.

Second, Article VI, on antidumping, and Article XIX, on voluntary export restraints (VERs), must be reformed. The liberalization of tariffs by the GATT over the years has been accompanied by the erection of alternative trade barriers in the form of antidumping actions and VERs.
The persistence of these barriers can make regionalism a vehicle for extending national protection to regions. A customs union will intensify competition among partners which can, in turn, increase the pressure for antidumping actions and VERs against countries outside the union. To reduce this possibility, Articles VI and XIX must be strengthened.

Third, countries should be encouraged to adopt liberal rules of entry when designing regional arrangements. In essence, this amounts to extending conditional MFN status, whereby an existing regional arrangement is open to any nation willing to abide by its rules and responsibilities. This is the type of suggestion also made for liberalizing trade in services—and it was tried to some extent in designing the government procurement code in the Tokyo Round. More to the point, the conditional MFN was behind the liberal trade regime that emerged through the bilateral route in the second half of the nineteenth century (see box 1).

Lest this discussion make the problem of turning trading blocs into an instrument of multilateralism appear too simple, it is important to add

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**Box 1. Regional Arrangements in History**

Views about the relative merits of multilateral and bilateral trade policies have been greatly shaped by history. Indeed, the general endorsement for the multilateral approach embodied in the GATT negotiation is much influenced by the relatively free trade during the second part of the nineteenth century, when international trade grew rapidly following a network of treaties containing the most-favored nation (MFN) clause. The lukewarm reception to bilateral agreements is much influenced by the interwar period, when discriminatory trade blocs and protectionist bilateral arrangements sharply contracted world trade.

Irwin notes, however, that it has been overlooked that the efforts to reduce tariffs reciprocally largely failed during the 1830s and 1840s, as they had in the 1780s and 1790s, and that the impetus toward the open trade regime of the nineteenth century came from the bilateral Anglo-French commercial treaty of 1860. Britain adopted the MFN clause so that its tariff reductions benefited all nations while France adopted a two-tier system as other countries faced the “conventional” tariff rates for their exports to France. Other European states quickly sought agreements with France to secure equal treatment for their own goods so that the impetus for the movement toward the liberalization of world trade was the trade diversion that was to accompany the integration of Europe’s two largest nations. By what turned out to be fortuitous circumstances, a single bilateral agree-
a word of caution. Michael Finger, of the World Bank, reminds us emphatically, and painfully, that rule writing in the GATT game is less than half the battle. It is the enforcement of rules that is most difficult. Repeatedly, regional arrangements have violated the articles of the GATT: to date, the GATT has formally declared only four arrangements to be compatible with its articles. Yet it has never censured a single agreement as being incompatible with its standards.

Despite this distressing record on implementation, there is something to be said in favor of why GATT rules on regional arrangements should nevertheless be strengthened. Robert Hudec, of the University of Minnesota, calls attention to the important fact that the GATT rules have had a definite effect on the discussions that preceded the conclusion of various arrangements. So, even though the GATT failed to censure any GATT-incompatible agreements, the presence of rules had an unmistakable influence on regional arrangements concluded.

The new regionalism in trade policy blossomed into dozens of bilateral accords, resulting effectively in a multilateral arrangement (in 1908, Britain had MFN agreements with 46 countries, Germany with 30 countries, and France with 20).

Following the abrupt end of bilateralism with the advent of World War I—in contrast with the nineteenth century, when there were no multilateral conferences—a host of conferences sponsored by the League of Nations during the 1930s expressed concern about maintaining an open trading regime. In the midst of the depression, the effort at restoring unconditional MFN treatment was misplaced, and bilateralism carried the day. This time, trade policy (and bilateralism) was used to palliate a dysfunction of the international monetary system: import quotas, high tariffs, and foreign exchange allocation were used to eliminate bilateral imbalances.

Three lessons emerge. First, long periods of macroeconomic stability with a sound monetary and financial system—as in the latter part of the nineteenth century and after World War II—are conducive to the emergence of multilateral free trade. Second, the trade policy experience of the past 150 years does not provide clear guidance—multilateral cooperation on trade policy is not necessary either for the liberalization of trade or for the adoption of illiberal trade policies. And third, the experience of bilateralism is mixed, as it was a progressive step toward freer trade in the late nineteenth century and the vehicle for squelching trade in the early 1930s. But unlike the relatively open trading blocs of today, the trade blocs of the interwar period raised barriers against nonparticipants.
The Developing-Country Perspective

Quite apart from how regional arrangements affect the world trading system is the issue of what individual developing countries can hope to achieve from them. As with the multilateral dimension of regionalism, the developing country dimension today is different from that in the 1960s.

Two differences are fundamental. First, the initial conditions are different from those prevailing three decades ago. Trade reforms of the 1980s have led to the creation of a liberal trading environment in a large number of Latin American countries and an increasing number of African countries. The additional gains from FTAs through trade creation are thus negligible. So, the attraction of regionalism must lie outside the trade-creation effects.

Second, in the previous round, developing countries attempted integration almost exclusively with other developing countries. In the current round, FTAs are also being proposed between developing and industrial countries. This is clearly a new dimension.

North-South Integration: The Wave of the Future?

A large number of Latin American countries have already liberalized their trade regimes substantially. The conventional efficiency gains from further liberalization, whether unilateral or as a part of a regional arrangement, are thus limited. Why, then, the great rush for regional arrangements?

If regional arrangements are being contemplated with the United States, several sources of potential gains can be identified. First, an FTA with the United States is the most effective instrument for ensuring that hard-fought policy reforms are not reversed by weaker (or more protectionist) future governments. An international treaty with a large and rich neighbor is much harder to repudiate than national legislation. As John Whalley, of the University of Western Ontario, puts it, Mexico wishes to "use a trade agreement to underpin domestic policy reform so as to attract inward foreign investment" and to use "treaties as a way of locking in prior domestic policy reforms." The NAFTA paid off even before it was initialed: U.S.-Mexico trade and foreign investment into Mexico have grown sharply. Foreign investment in Mexico was approximately $15 billion in 1991, up more than 50 percent over 1990.

Second, in an age when nontariff barriers are on the rise and the EC is becoming increasingly inaccessible to those outside it, an FTA with the United States offers Latin American countries guaranteed access to a
large market. Whalley notes that a primary motive behind NAFTA from Mexico's viewpoint is to secure future access to the U.S. market. With trading blocs and quantitative trade barriers, the simple small-country assumption underlying the proposition that unilateral free trade is optimal may simply not be valid. Even if the countries were to trade entirely freely, they may not be able to export and import as much without an FTA as with it.

Third, when trade policy is endogenous and subject to interest group politics, an FTA can help influence it in the right direction. As the authors, with Dani Rodrik, of Columbia University, show, if the level of protection is determined by lobbying activity, an FTA can lower the level of lobbying by making the benefits of lobbying more diffuse and the free-rider problem more acute. Similarly, liberalization through an FTA may be easier to sell to the electorate than unilateral liberalization. With an unmistakable mercantilist bias in the politics of trade policy, an FTA that has the appearance of opening the partner country's market may be more acceptable to the electorate than unilateral liberalization.

Fourth, an FTA can allow a developing country to import a growth-stimulating environment and institutions of its industrial country partner. The developing country might thus be able to enforce a more stable macroeconomic environment. It might also be able to reform its labor, investment, and industrial policies as a part of the overall agreement. Often reforms of these policies are politically difficult to carry out unilaterally.

Alan Winters, of Birmingham University, tells us that expectations of these gains significantly influenced the decisions of Greece, Portugal, and Spain to join the EC. They saw accession to the EC as a means of obtaining a guaranteed access for their labor-intensive and agricultural exports to the EC market. For instance, they will be able to expand considerably their exports of footwear to other EC members. Their accession to the EC also introduced an external authority and helped take some of the heat off their unpopular policy reforms. The adoption of the EC's common external tariff also liberalized their trade regimes substantially—liberalization that otherwise would have been much harder to carry out unilaterally and that would, in any case, have taken longer. As the economic integration in Europe deepens, they will find it politically easier to reform their regulatory and competition policies.

As always, optimism must be accompanied by caution. Economists broadly agree that—from the developing countries' viewpoint—North-South integration schemes are beneficial overall. But some possible negative effects of these schemes must be minimized. Specifically, it is possible for some inefficient, growth-retarding policies of industrial
countries to spread to developing countries as a result of North-South integration—as happened with antidumping mechanisms and VERs. Bhagwati provides an interesting example. Suppose that as a result of the NAFTA, the United States begins to outcompete an inefficient Mexican industry. Suppose that Korea is more efficient than the United States and is the other competitor in the Mexican market. As the Mexican industry suffers, it is likely Mexico will initiate antidumping actions against Korean exports. In the end, the U.S. exports will divert Korean exports because antidumping actions raise the discrimination against third-country imports.

An equally serious problem may arise for VER-type restrictions. If the regional arrangement is an FTA, complex rules of origin often accompany it. These rules will likely interfere with the efficient functioning of the FTA. If the regional arrangement is a customs union with a common external tariff, rules of origin are not required, but restrictive policies of the industrial country must be adopted by its union partner as well. To take an obvious example, a VER on auto imports in the United States cannot be effective if the United States forms a customs union with Mexico and if Mexico allows unlimited auto imports at the common external tariff.

Winters discusses several instances in which individual member countries' policies eventually became the European Community's policies. The EC restrictions on imports of Japanese videocassette recorders in 1983 resulted from the need to "communitarize" unilateral French action against Japan. Similarly, in 1990 the French and Italian national quantitative restrictions on footwear against Korea and Taiwan (China) were converted into EC-wide restrictions. A similar phenomenon has been witnessed for vehicle imports. Moreover, the efficiency costs of the Common Agricultural Policy are well known. The communitarization of agricultural policy made it immune to reform.

South-South Integration in Africa and Latin America: A Mistake Not Worth Repeating

The gains just described are not available to a developing country integrating with another developing country. All developing country markets are small relative to those of the United States or the EC. So the argument that integration improves market access is not particularly applicable. Nor is the argument that an FTA can lend credibility to past reforms. Potential penalties for breaking an agreement with a small developing country are small relative to breaking an agreement with a large industrial country. The effects of interest group politics on
efficiency are almost certain to get worse if an FTA is concluded with another developing country. Industries will group themselves to extend protection regionwide rather than be exposed to competition from an industrial country. And it is unlikely that integration with another developing country will bring a growth-stimulating environment and institutions.

Indeed, experience with regional integration between two or more developing countries leaves little doubt that these countries cannot expect big gains by integrating themselves. Integration schemes among developing countries, benign at best, have in many cases been positively harmful. In the benign cases, the potential for trade expansion among the countries simply was not there. In the harmful ones, the arrangements themselves became instruments of protection.

In Africa and Latin America, only five of more than a dozen regional groupings pass the test of a share of intraregional exports in total exports above 4 percent for one or more of the reported years (table 1). In the industrial world, all groupings qualify for inclusion. If the test is 15 percent or more of the region’s exports, not a single developing country arrangement qualifies, but in the industrial world, three of four arrangements do. In Africa, none of the regional arrangements accounts for even 10 percent of total exports. The only arrangement between Sub-Saharan Africa and Latin America that had an undisputable effect on intraregional trade is the Central American Common Market (CACM). Between 1960 and 1970, intraregional exports in the CACM expanded from a low of 7 percent to a high of 26 percent. But even this trend was subsequently reversed, and by 1990 the share of intraregional exports had dropped to 15 percent. By contrast, the share of intraregional exports in the EC—perhaps the only example of a successful regional scheme—has been extremely high, rising from 35 percent in 1960 to 51 percent in 1970, 54 percent in 1980, and 60 percent in 1990, alongside the rapid expansion of extraregional exports.

The share of the EC’s exports in total world exports, about 25 percent in 1960, rose steadily to 60 percent in 1990. By comparison, the share did not rise beyond 1.7 percent for any regional grouping in Africa or beyond 6 percent in Latin America. This evidence indicates that markets within regional groupings in Africa and Latin America were small in relation to the world market—and not particularly dynamic. For each of the five regional arrangements, the share of exports in world exports declined from 1960 to 1990. This decline, and the low share of intraregional exports, suggests that the arrangements’ potential for improving efficiency through competition or technological diffusion within the arrangements was limited or nonexistent.
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— Not available.

a. Intraregional exports as percentage of the region's total exports.
b. Region's exports as percentage of total world exports.

Source: International Monetary Fund, Direction of Trade Statistics (Washington, D.C.).
In a more systematic analysis of regional arrangements in Sub-Saharan Africa, Faiezeh Foroutan, of the World Bank, observes (in accord with the evidence in table 1) that—despite the proliferation of regional institutions, treaties, protocols, and resolutions—the groupings have achieved only limited integration. The reasons for this are twofold. First, because of low per capita income and the dominance of primary (resource-based) commodities in output and exports, the potential for intraregional trade was limited. Second, the success in removing intraregional barriers to trade was at best partial.

The reasons that intra-union barriers proved difficult to remove lie in the political economy of regional integration in Africa. All African economies set goals for industrialization during the 1960s and 1970s. As Harry Johnson taught us many years ago, an essential condition for a cohesive and lasting integration under such circumstances is that the member countries be “at a similar stage of economic development.” If this condition is satisfied, each member can expand some industrial activity following intraregional liberalization. If not, industries in the less advanced members are likely to migrate to their more advanced counterparts. This possibility is bound to restrain the less advanced members from liberalizing, even regionally, unless there is a well-functioning compensatory mechanism to cushion their required adjustment.

Evidence suggests that this factor was indeed important in Sub-Saharan Africa. Compared with regional groupings elsewhere in the world, those in Sub-Saharan Africa exhibit a very divergent pattern of industrialization—indirectly manifested in a highly asymmetric pattern of intraregional trade. For example, in 1990 Cameroon accounted for 90 percent of intra-UDEAC (Union des Etats d’Afrique Centrale) exports but for only 4 percent of imports. Similarly, in the same year, Côte d’Ivoire accounted for 75 percent of intra-CEAO (Communauté des Etats de l’Afrique de l’Ouest) exports but for only 13 percent of imports.

This asymmetry, in addition to explaining why integration in Africa was limited, accounts for very skewed distributional effects of whatever integration took place. Although necessary, the compensation schemes for transfers from gainers to losers have themselves been distortionary. Some groupings have created special funds to promote industrialization in the poorest members. Contributions to these funds are based on highly complicated formulas that take into account the total and per capita GDP of member countries and their share in intraregional exports and imports.

The CEAO and UDEAC have gone a step further by providing preferential customs duties tailored to the “protection needs” of the least devel-
oped partners. Under the elaborate system devised by the Treaty of CEAO and the revised Treaty of UDEAC, manufacturing goods originating in member countries are charged duties distinguished by enterprise, product, country of origin, and country of destination. Broadly speaking, duties on products originating in the least advanced countries are low, whereas duties on products entering these countries are high. A dramatic example of the distortionary effect of this system is chewing gum, produced by eight enterprises in the CEAO. It is taxed at 10 percent in Côte d'Ivoire, independent of the source, and at 46 percent in Mali if imported from Côte d'Ivoire but only 8 percent if imported from Burkina Faso. In other countries, the duty varies from 7 to 21 percent, depending on the source and destination.

Julio Nogués and Rosalinda Quintanilla, both of the World Bank, describe similar experiences in Latin America for the Andean Pact and the CACM. Parties to the Andean Pact pursued an aggressive strategy of import substitution at the regional level. They divided industries among one another with the supposed intention of exploiting economies of scale. To complement this process, it was decided that members would liberalize differentially, cutting tariffs on a product by a larger amount for the member assigned to produce it than for others. Although trade within the region grew after the founding of the pact, it never became very large. For instance, intratrade was 0.5 percent of GDP during 1964–68 and 1.6 percent during 1974–78.

As already noted, the experience of the CACM was more favorable because the signals were more transparent. Within the union, rules were nondiscriminatory. For instance, each country gave the investment from all other member countries the national treatment (that is, it subjected investment from other member countries to the same policies, including taxes, that applied to domestic investment). The same was true for the implementation of quality control. Most important, tariff reductions were across the board, not based on the source or destination. For most products, a common external tariff was also established. As a result of these measures, intraregional exports expanded rapidly between 1960 and 1970, with the ratio of intratrade to GDP rising from 1.8 percent during 1957–60 to 10 percent during 1966–70. Remarkably, this was accompanied by a stable ratio of trade outside the region to GDP. But as in Africa and elsewhere in Latin America, members' differences on equitable sharing of benefits (such as the location of new manufacturing plants) led to frictions and to the CACM's eventual end.

Where do we stand, and where do we go from here? Despite the common experience in Africa and Latin America, the answers differ for the two regions—largely because of the differences in external circum-
stances, partly because of the differences in their internal economic environments.

Despite past failures, the enthusiasm for regional integration in Africa is high and rising, in part because the policy reforms in the 1980s did not produce dramatic results. The success of the EC and increasing fascination with regional integration in other parts of the world, particularly in the Western Hemisphere, have also contributed to this phenomenon. And at some level, African unity has always been a goal of African leaders.

Clearly, it will be best for Sub-Saharan African countries to integrate with the EC and reap all the possible benefits. This, however, is a distant goal. The EC is simply not ready to grant entry to even North African countries, let alone Sub-Saharan African countries, despite the trading preferences accorded through the Lomé convention and the convertibility gained by members of the Communauté Française Africaine (CFA) zone. So, the possibilities for integration appear for the time being to be limited to those available within Africa. In view of experience, these possibilities should be resisted. Despite a greater acceptance of outward-oriented policies today, the temptation to use regionalism as a vehicle for import-substituting industrialization will be high. African markets remain small, and efforts at regional integration will only divert attention from efforts to integrate Sub-Saharan Africa with the world economy.

The role of regionalism in Africa should therefore be limited to cooperation on matters that have an obvious regional dimension. Roads and other transportation networks are obvious examples: they may not be profitable for two nations individually, but they may become profitable if financed jointly. Other examples are educational institutions, information-sharing, and regional environmental problems.

The circumstances in Latin America are different. Countries there can look to future integration with the United States more credibly than African countries can to integration with the EC. The United States is already negotiating the NAFTA with Mexico and has signaled its readiness to negotiate a similar arrangement with Chile. For other countries in the region, the United States has sent a strong signal—through the Enterprise of Americas Initiative—that it prefers to enter free trade areas with groups of countries organized to remove trade barriers among themselves. Taken at its face value, this means that an individual Latin American country can improve its chances of an FTA with the United States if it first enters an outward-oriented FTA with other countries in the region. Is this desirable?

Before answering, it may be noted that vigorous new efforts at regional integration within Latin America are already under way. These
include reviving the CACM and Andean Pact and establishing MERCOSUR, intended to create a common market by 1995 among Argentina, Brazil, Paraguay, and Uruguay.

It is difficult to imagine that these schemes, if implemented, will by themselves produce big positive gains for the participating countries. One can only derive comfort in the fact that most Latin American countries are more industrialized than Sub-Saharan African countries and that they have more liberal trade regimes. Because Latin American countries depend on tariffs for revenue much less than African countries do, and because the intellectual climate there was far more sympathetic to liberalization, they were able to go much further toward liberal trade regimes—and with greater credibility—than were their African counterparts. This means that the discriminatory impact of regional integration in this region will be less than in Africa, and that the risk of turning integration schemes into vehicles for import-substituting industrialization is lower. But this is not enough to make a case for more South-South regional integration. The issue is whether such integration will make it easier for member countries to join in an integration scheme with the United States, which it may well do.

**Regionalism in the Middle East, Eastern Europe, and Asia, Too?**

For reasons entirely different, the advisability of regional integration is also being debated for the Middle East, Eastern Europe (including the former Soviet Union), and Asia. In the Middle East, a primary issue is whether factor mobility—especially labor mobility—can promote integration among the countries in the region. In Eastern Europe, the main issue is whether regional integration among all economies in the region—or a subset—can ease the transition. In Asia, regionalism is being viewed as a defensive, strategic weapon.

Stanley Fischer, of the Massachusetts Institute of Technology, notes that the Middle East's intraregional flows are dominated heavily by labor flows, not goods flows. In 1983, the last year for which figures are available, intraregional trade was only 6.2 percent of the region's total trade. But as much as 18 percent of the labor force of labor-exporting countries in the region worked in the Gulf countries. Even more surprising is that more than half the labor force of labor-importing countries came from outside the region, especially Asia.

Fischer sees “no realistic prospects of Middle East–wide regional integration on either the NAFTA or EC models in the near future.” Nor is this desirable. Fischer does, however, envisage more limited moves toward economic cooperation in functional areas such as water manage-
ment, agreements on regional infrastructure that will facilitate trade within the region, and regional institutions such as a Middle Eastern Bank for Reconstruction and Development.

Josef Brada, of Arizona State University, shows that regionalism played a peculiar role in Eastern Europe and the former Soviet Union. For political and ideological reasons, there was a strong bias against trade with the Western world. Regional integration—although never called that—was a natural outcome. The principal vehicle for the promotion of integration among the economies of the region was the Council for Mutual Economic Assistance (CMEA), founded in 1949. The CMEA had two parts. The first facilitated trade among a group of state trading companies. Trade was conducted on the basis of bilateral agreements cleared bilaterally at first but later multilaterally. The second promoted specialization in production among CMEA members, implemented by promoting broad agreements on investment. Members were often granted a monopoly in specific products through specialization agreements.

The CMEA countries clearly viewed regional integration in Johnsonian terms and used it to promote industrialization. At first this was successful, but by the late 1950s and 1960s, signs of low productivity growth became evident. In the end, the regionalism proved costly in both static and dynamic efficiency, and it has been estimated that intra-CMEA trade levels have been up to 60 percent higher than those suggested by their geographical position and resource endowments. Resources were misallocated by a central, command-based process that was captured by political forces. Moreover, the potential productivity gains from competing in the world markets were never internalized.

Today the CMEA has disintegrated, and the former Soviet Union has been replaced by fifteen new nations. From the long-run viewpoint, this is a good thing economically. The investment diversion and the accompanying trade diversion that was a part of the CMEA system can be corrected. But the political breakdown has also been accompanied by a very substantial breakdown of trade among the CMEA countries and the republics of the former Soviet Union. This in turn has led to an abrupt and large decline in economic activity in all CMEA countries.

There is general agreement on the direction of these economies in the long run, but not on the transition. The major regional integration issue is whether some form of regional arrangement is desirable as a transition measure. Brada argues that this is unwarranted. In his view, any regional arrangement within the region will simply resurrect the CMEA trade and payments mechanisms, and this is undesirable. Alan Gelb, of the World Bank, by contrast, argues that at least in the republics, there are good
reasons for considering mechanisms to temporarily cushion a sharp fall in intraregional trade. In his view, there are definite constraints on the speed of economic restructuring. The experience of Eastern Europe suggests that these constraints have to be taken seriously. Gelb also feels that measures to sustain trade within the Commonwealth of Independent States (CIS) need not imply a return to the old system of planning. "For example, if full convertibility is not immediately possible, then a currency-union type arrangement ... would indeed create some preference for intra-CIS trade. But is this such a bad thing relative to the possible alternatives? Certainly, it is far from central planning."

Gary Saxonhouse, of the University of Michigan, takes up the case of East Asia, a region that clearly has benefited far more from an open global trading system than it could have from a world divided into blocs. He provides a formal model in which forming a bloc can benefit its members but hurt the outside world. As the bloc is enlarged, the world GDP declines but the terms of trade of the bloc improve. Initially, the second effect dominates so that the bloc members benefit from enlargement. But after a point, the negative effect on the GDP begins to dominate. The bloc will want to be exclusionary when this point is reached.

This scenario captures the fears of East Asia. As the NAFTA and the EC continue to enlarge, countries in East Asia may be hurt through a terms-of-trade deterioration and a loss of markets. Therefore, the options for them may be to either join the NAFTA or form a bloc of their own to counter the terms-of-trade deterioration.

There are other ways in which NAFTA could lead to harmful effects on East Asian economies. To the extent that interest groups are powerful in North America, increased imports from other members of the union will be accompanied by tighter controls in the form of VERs and antidumping duties on East Asian (and other) competitors. Equally important is the possibility of investment diversion. Some of the investment that would have gone to East Asia may now go to Mexico to take advantage of tariff-free access to the large U.S. market. This is likely to be harmful for East Asia and perhaps the world economy.

Hugh Patrick, of Columbia University, notes that the scenario of defensive regional integration being played out currently in East Asia had also been played out in response to the formation of the EC. Japan informally proposed a Pacific free trade area with the United States, Canada, Australia, and New Zealand. But it was quickly rejected by American economists at the first PAFTAD (Pacific Association for Trade and Development) conference in Tokyo in 1968. The United States saw itself as the champion of a freer global trading system and was not willing to entertain any regional arrangements beyond the EC.
Today, with the United States itself looking to the regional route, should East Asia consider a bloc of its own more seriously? This again is a difficult question. Vinod Thomas, of the World Bank, points out that East Asia’s trade expansion has been across the board. During the 1980s, East Asian trade expanded at a rate of 12 percent a year—with the United States, with the EC, and within itself. Considering that growth in trade is a key factor in the region’s economic growth, the opposite could be true of an East Asian bloc: the countries in the region should keep pushing the process of liberalization to ensure that the damage from the expanding bloc to the global trading system is minimal!

Thomas also suggests, however, that once we take into account the socialist and other transitions in East and South Asia, the issue gets further complicated and the role of regionalism may look a little more compelling. The largest countries in the world, China and India, still have highly protected trade regimes. “In these countries . . . the question of what arrangements are most likely to generate the political support for trade liberalization cannot be minimized. Thus, it is quite conceivable that an argument that trading blocs are not desirable for East Asia is qualified once these cases are considered.”

Where Do We Go from Here?

The experience with South-South integration has been discouraging, and any temptation to promote such schemes in the future should be resisted. Max Corden, of the School of Advanced International Studies, reminds us:

The plain fact is that such free trade areas (or preferential areas) would not make a great deal of difference, and have not in the past. . . . It is far better for Argentina to go for the world market—i.e., to liberalize unilaterally and in a nondiscriminatory fashion, as she has been doing—than just to go for the Brazilian market. Brazil has the largest economy in the Third World, and yet it is smaller than Canada’s (as measured by the dollar value of GDP). And this applies even more to Brazil.

As for North-North integration, despite the reservations by Winters, it has been widely successful in Europe. Intraregional trade expanded greatly, but not at the expense of trade with nonpartners, which also grew rapidly. And European integration has greatly diminished, if not eliminated, the possibility of future internal conflicts.
Looking to the future, North-South integration holds much promise for developing countries. Regional arrangements of this type can solidify past reforms, guarantee future access to a large market, and stimulate growth via increased direct foreign investment, more intense competition, and faster technological diffusion. On the Mexico-U.S. FTA, Richard Cooper, of Harvard University, writes:

As I understand it, Mexico has two principal reasons for wanting a free trade area. The first is to foster and to lock in through international commitment a set of liberal trade policies. . . . The second is to lock the United States into a set of procedures that are more predictable for Mexican exporters with respect to the whole range of "safeguards"—antidumping and anti-subsidy procedures in particular.

The implications of regionalism for the global trading system nevertheless remain contentious. Rudiger Dornbusch, of the Massachusetts Institute of Technology, argues that regional and multilateral approaches are complementary. He applauds GATT: "GATT is wonderful—has been, is, and will be." To those who declare that GATT is dead, his response is: "GATT is not dying—it is resting." While GATT rests, he feels we need the regional approach to complement it. Bhagwati is skeptical: "'We are only walking on two legs' is the popular argument. That we may wind up walking on all four is ignored."

In the end, the ambiguity of the economics of regionalism and trading blocs divides economists on this issue. The dilemma in the economists' thinking on the issue is captured well by Thomas:

One can make an argument, depending on initial conditions, either that regional blocs may be a bad idea in principle, but good in practice, something Professor Krugman seems to argue; or that even if it is a good idea in principle, it is likely to be bad in practice, as Professor Bhagwati seems to conclude.

Notes


2. The post-Vinerian literature has emphasized that trade diversion need not lead to a decline in welfare and trade creation may not improve welfare. Nevertheless, the concepts have remained extremely influential in debates on trade policy, with trade creation equated to welfare improvement and trade diversion to welfare decline. Because of convenience and widespread use of these terms, we have chosen to stick to this tradition despite some loss in precision.
3. Starting from one bloc, if we divided the world into two blocs, there is trade diversion due to a positive tariff on extrabloc imports; welfare declines necessarily. If we now divide the world into three blocs, the optimum tariff declines but each bloc becomes smaller. The former effect is trade creation while the latter is trade diversion. So the net effect is ambiguous.

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