Commentary: The Move Toward Free Trade Zones

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There are three central strands to Paul Krugman's analysis of free trade areas (FTAs):

—that they are considerably better in practice than in theory;

—that this is particularly the case when they are viewed as ***alternatives*** to multilateral trade liberalization because "half a loaf is better than none;"

—which is how they should be viewed because of the demise of the GATT and the poor prospects for the Uruguay Round.

My view is fundamentally different on all three counts:

—that FTAs are considerably less desirable than Krugman suggests, especially in practice;

—that this is ***particularly*** true if they are seen as alternatives to an effective global trading system;

—but that, fortunately, they need ***not*** be seen as alternatives because the Uruguay Round is quite likely to succeed, thereby restoring the credibility and central role of the GATT and making the world safe for FTAs which, as ***complements*** to such a global system, are acceptable and even desirable.

The big picture

Before discussing FTAs in detail, it is essential to place the issue of trade (and currency) zones—the topic of this conference—within the context of the sweeping structural changes that will dominate the world economy in the 1990s and beyond.

The first of these historic transformations is the onset of full economic tripolarity. By sometime in this decade, if not already, the three economic superpowers—uniting Europe, Japan, and the United States—will look much more alike than different.

—In terms of absolute economic size, Europe will be bigger than the United States. Japan, already the largest creditor country and most competitive national economy, will match the GNP of both early in the twenty-first century even on conservative assumptions concerning growth rates and exchange rates.

—In terms of economic openness, defined as the share of exports plus imports of goods and services in GNP, the three are already virtually identical. This ratio has changed very little over the past two decades for Japan and the European Community as a group but has risen sharply for the United States.

Hence, ***there is no longer any economic basis for American hegemony,*** rightly described by Allen Meltzer in his paper as a major element in bringing relative prosperity and stability to the postwar world.

This outcome is reinforced by the second historic transformation: the end of the Cold War. The Cold War provided a "security blanket" over the trans-Atlantic and trans-Pacific relationships for almost half a century, suppressing potential conflicts on economic and other issues in the overriding interest of maintaining firm alliances against the Soviet threat. That security blanket has now been pulled aside: neither Europe nor Japan any longer needs much American protection, and the United States no longer needs to strengthen its allies—who also happen to be its chief economic competitors. Hence, ***there is no longer any security basis for American hegemony either.***[1]

The Gulf War reinforces the conclusion that America's economic dominance is a thing of the past despite its new status as the only military superpower. The United States had to insist that other countries pay for the war—the first admission of such economic dependence by a military leader in modern history. And, despite American efforts to lever its leadership of the Gulf coalition into greater foreign cooperation in the Uruguay Round and G-7 policy coordination, there appears to date to be zero transferability of military power into economic payoff (beyond the payments for the war itself).

The policy choice: globalism or blocs?

Economic (and other issues) are now much more likely to produce conflict among the Big Three because of the onset of equal tripolar economic power and the elimination of the Cold War glue that bound the allies together. Hence, these historic transformations are central to the question of trade and currency zones. In broad strategic terms, the Big Three—who together will clearly dominate the world economy for at least the next few decades—can evolve in only two directions:

—into an informal steering committee (G-3) to revitalize and subsequently maintain a ***globally oriented economic system*** based largely on the existing institutional framework or

—into the poles of ***regional blocs*** where, for the reasons posited by Andrew Crockett in his paper, the dynamics would move from trade arrangements into deeper economic integration and then monetary zones and, as Krugman himself notes, the resulting entities would likely become exclusionary and discriminatory.

Hence, the issue of trade (and currency) zones is far more important than welfare triangles or even dynamic gains from trade. The outcome of the current trade debate will go far to shape the course of the world economy for the coming decades. There will be significant political effects as well--especially if, as Krugman suggests, trade zones were pursued partly to discriminate against a major economic actor (Japan).

There is a widespread view around the world, sufficiently powerful that it is rapidly becoming a self-fulfilling prophecy, that we are headed toward the second outcome: regional blocs. The deepening and widening of European economic unity—toward "completion of the single market" in 1992, Economic and Monetary Union (EMU), and the addition of more members and associates (including Eastern Europe)—generate defensive reactions in the Americas and Asia. Initiatives by the United States toward a North American Free Trade Area (NAFTA) and the Enterprise for the Americas Initiative (EAI) produce Asian fears that "the Western Hemisphere is going regional too," both generating proposals for exclusionary regional groupings there (notably Malaysia's East Asian Economic Grouping) and making it harder for Japan and others to resist such calls. The resulting "evidence" of burgeoning Asian regionalism reinforces advocacy of similar steps in the Americas. Some Europeans then cite both to justify the inward-looking focus of their own initiatives. The critical importance of renewing the postwar momentum of trade liberalization on a *global* basis, the only alternative to eventual realization of the prophecy, is shunted aside in the rush toward regionalism. Krugman's paper unfortunately supports this spiral by prematurely writing an obituary for the Uruguay Round, which he rightly suggests is essential to restoring momentum and credibility for the multilateral system.

A revitalized global system managed collectively by the Big Three is far superior to a devolution into regionalism. Within such a system, regional arrangements would still take place but they would complement the global order rather than substitute for it. I believe that it is still eminently possible to forge such a global approach:

—As pointed out by both Allan Meltzer and Jacob Frenkel and Morris Goldstein, the trade patterns of the Americas and Asia are quintessentially multilateral. They have experienced *no* long-run trends toward increased reliance on intraregional trade. Indeed, the trade patterns of both the United States and Japan—the core countries of the supposed blocs—are split into almost equal thirds. These countries have no interest in substituting regional for global arrangements. Europe is now the only bloc but the share of extraregional trade in its GDP is even greater than for the Americas or Asia, so it, too, needs a multilateral world.[2]

—The markets of the three economic superpowers (and much of the rest of the world) are deeply intertwined. There would be enormous economic costs from any significant erosion of global trade and financial openness, and resulting political costs for those who let it happen.

—The Big Three are democracies, have been allies for more than four decades, and have a habit of working closely together on economic issues. Despite the absence of historical precedents for effective cooperative leadership, they should be able to provide it.

—Though the Uruguay Round has clearly faltered, multilateral trade negotiations always resemble "the Perils of Pauline." The prospects for both the Kennedy and Tokyo Rounds looked extremely grim at key points before their eventual successes. The "failure" to conclude the Uruguay Round at Brussels in December 1990 should have come as no surprise because the only real deadline for such talks is the expiration of the negotiating authority extended to the U.S. Administration by the Congress—a deadline set for June 1993 by the Trade Act of 1988 and duly reaffirmed by extension of the 1990 "fast track" authority in May 1991. The Uruguay Round is quite likely to achieve major success, probably greater than either the Kennedy or Tokyo Rounds, if only because the costs of failure would be so high in both economic and political (especially United States-Europe) terms.

Does it matter?

The central issue is whether global or regional trade liberalization is superior and, in particular, whether there need be any conflict between them. Krugman recognizes that trade blocs are decidedly second best because they generate trade diversion and because "they would upset the balance of forces that has allowed the creation of a fairly liberal world trading system." He attacks the "proposals" for "unnatural" (that is, non-neighborly) free trade agreements, such as U.S.-Israel (which has been in place since 1985) and U.S.-Korea. He himself points out that "world welfare is ***minimized*** (my emphasis) for a world of three trading blocs."

But Krugman goes on to endorse blocs, arguing that prospective diversion is modest because they are likely to take place mainly among geographical neighbors and thus the blocs "mostly fall along the lines of 'natural' trading areas." This is an empirical question on which Krugman offers little supportive evidence. There are four reasons why I believe the view is flawed.

First, the impact of geography on trade has declined dramatically in recent decades. Geographical propinquity is no longer central to trading patterns.[3] For example, American trade is much denser with Korea and Taiwan—"unnatural trading partners" in Krugman's view—than with Argentina and Brazil, even adjusting for the different size of the respective economies.

Second, partly as a result (and as already noted), there are no major "natural trading areas" anyway except for Europe and possibly NAFTA. United States and Japanese trade is split into almost equal thirds. The Americas and Asia as a whole are highly diversified. The concept of "natural trading areas" rationalizes the EC and NAFTA but provides no guidance beyond.

Third, it must be candidly recognized that trade diversion is a ***goal*** of many contemporary proposals for trade blocs. Canada sought primarily to achieve preferential treatment (that is, exceptions) under any new protectionist steps by the United States. Mexico is driven importantly by a similar motive. As already noted, and stressed by Krugman, anti-Japanese sentiment lies near the surface of many FTA initiatives. Such a desire for discrimination suggests that it could very well occur.

Fourth, Krugman's supposition that neighboring countries would be the primary beneficiaries of trade liberalization anyway—so why not proceed on a regional basis?—does not stand up in practice, at least in the case of the Western Hemisphere. The hypothesis can be tested by assuming U.S. liberalization on an MFN basis and asking which countries would "naturally" get the business. Tariffs are already so low that their elimination would not make much difference. Hence, the outcome would be determined primarily by the new trade patterns generated by liberalization of the seven large U.S. import quota regimes:[4]

(1) Textiles and apparel: East Asian, South Asian and some other developing countries are far more competitive than Latin America.

(2) Steel: Brazil and Mexico could take some advantage but the major increases would accrue to Europe and Japan.

(3) Automobiles: Mexico and perhaps Brazil could expand sales of parts but the overwhelming increases would come from Japan, Korea and possibly Europe.

(4) Machine tools: virtually all new imports would come from Europe, Japan and Taiwan.

(5) Dairy products: the bulk of the increased trade would emanate from Australia, New Zealand and Europe.

(6) Sugar: several Latin American countries could compete effectively if U.S. quotas were lifted, but Australia and several others outside the Hemisphere would also be major beneficiaries.

(7) Meat: several Latin American countries could gain markets but the bulk of the increased imports would derive from Australia and New Zealand.[5]

The lesson is that trade liberalization by the United States on a regional basis would almost certainly generate much more trade with uncompetitive countries than with efficient suppliers. Economic welfare would be reduced to the extent that current (efficiently produced) imports were supplanted by less efficiently produced imports. For example, the United States has already unilaterally increased Mexico's share of its textile quotas while deducting a like amount from the quotas of Hong Kong and other Asian suppliers. Since the latter are considerably more efficient, the shift has further increased the welfare costs of the textile quotas to the American economy.[6]

Beyond this central point, there are a number of additional reasons why Krugman's advocacy of trade zones does not stand up in practice:

—His conceptual case for free trade arrangements, akin to the optimal tariff argument, is that they can strengthen the region's terms of trade by increasing its weight in the global economy and permitting it to extract better prices from its trading partners., This would, however, by definition hurt other countries. Moreover, it has very little to do with the contemporary world: "EC 1992" and EMU emphasize deepening rather than broadening of Europe's economic zone, and the creation of NAFTA would add less than 15 percent to the weight already exercised by the United States in the world economy.

—He is simply wrong to argue that regional trade deals produce bigger results than global deals. The United States-Canada FTA, contrary to his assertion, was a mouse in terms of liberalization: on the biggest issues, like agriculture and subsidies, the countries explicitly deferred to the Uruguay Round because there was not enough benefit on other issues in the bilateral context to justify taking on the domestic opponents.[7] Is it conceivable that America's textile quotas could be liberalized more meaningfully in NAFTA than in GATT, where the offsetting "gains" (in GATT-think terms) would at least give the effort a fighting chance?

—He notes that, to an economist, unilateral liberalism is best but fails to observe that countries all over the world are practicing it: Australia and New Zealand, Eastern Europe and many in both Asia and Latin America. A successful Uruguay Round can induce these countries to bind their new regimes and thus obviate the risk of reversal. On the other hand, a withering of GATT would make it much easier for them to reverse gears—and could even compel them to try to strike defensive deals with one or another bloc instead that would include the erection of new barriers against outsiders.

—This would clearly include "unnatural" alignments of the type that Krugman himself denounces. In particular, few Asian countries want to join a bloc led by Japan. The United States is unlikely to "settle for" Latin America, both because such insulation from the most dynamic world markets would erode its own competitiveness over time (as Britain's preferences within the Empire and, later, Commonwealth, undermined its economic strength) and because all the other countries in the Hemisphere are also debtors and cannot help the United States improve its trade balance. Moreover, the United States could hardly push for a Western Hemisphere bloc and oppose Japan's pushing for an Asian bloc—as it clearly would—without offering the Asians a place in its own "regional" arrangement. Hence there would almost certainly be an "unnatural" trans-Pacific dimension to a world of trading areas.

—The increasingly central global role of multinational enterprises adds to the potential for a negative dynamic if a world of blocs were ever to get seriously under way: once positioned within each bloc to hedge themselves, the companies would enjoy relative gains from the erosion of interbloc trading freedom and would, at a minimum, no longer espouse global liberalization. Other constituencies within member countries of a bloc also acquire a distaste for global liberalization and thus add to the exclusionary dynamic.

—Krugman strangely ignores the historical absence of any successful free trade agreements between industrial and developing countries, despite the centrality of this issue to any meaningful construction of blocs in Asia and the Americas. The difficulties in combining Japan and China, or even the United States and Mexico, loom considerably larger than meshing Greece and Portugal with the EC—and even that arrangement includes transfers of public capital equal to 5 percent of the GNP of the LDC partners.

—Indeed, as Krugman notes, the biggest losers from a world of regional blocs would be those left outside—which, in practice, would be primarily the poorest developing countries which could least afford it.

—One can only cringe when Krugman argues that "the great advantage of regional pacts is that they can exclude Japan." Many Americans and Europeans certainly do "deeply distrust the Japanese," as he asserts. It does not take much knowledge either of history or of contemporary thinking in Japan, however, to conclude that steps to institutionalize, rather than combat, that distrust would run enormous risks. History teaches that failure to accommodate rising powers in the systemic structure is a sure recipe for serious conflict.

—On the political economy plane, both the United States and Japan have sufficient national power to be world leaders without forming blocs around them. No individual European country does; hence bloc creation was essential to restore that area as a global player but such considerations hold nowhere else.

—It would be particularly tragic if the countries that created and nurtured the global trading system and the GATT, notably the United States and to a degree the EC, were to turn their backs on it now when (a) virtually all of the countries which have heretofore rejected that regime are now clamoring to get in (the USSR, China, East Europe, and most of Latin America) and (b) the developing countries have, in the Uruguay Round, for the first time become active participants in it.

Would FTAs undermine globalism?

Regional trading arrangements are clearly going to happen: further deepening and eventually broadening in Europe, NAFTA, and perhaps the Enterprise for the Americas Initiative in this hemisphere, Australia-New Zealand, and even conceivably an East Asian Economic Grouping per the current Malaysian proposal. Another possibility is a Pacific Basin construct, growing out of the recent Asia-Pacific Economic Cooperation initiative.

The crucial question is whether these arrangements take place within the context of an effective and credible ***global*** system. If so, they will be—and will be viewed as—supplements to that system between countries that choose to liberalize further together, perhaps providing a constructive challenge for emulation at the global level.

Indeed, it is the existence of tariff bindings under GATT (along with the proscriptions of Article XXIV itself) that prevent bloc members from raising barriers toward the outside world to exploit the potential gains described by Krugman. Even more importantly, it was the major liberalizing negotiations under the GATT—the Kennedy Round in response to the creation of the Common Market itself and the Tokyo Round in response to its broadening to include the United Kingdom and others—that achieved the reductions in the common external tariff of the EC that, as he correctly notes, were essential to convert the European Community from a beggar-thy-neighbor arrangement into a positive force for the world economy.[8] At a minimum, a strong GATT system is essential to avoid the costs that Krugman acknowledges are quite likely to result from FTAs.

If there is no effective GATT system, FTAs would almost certainly come to be viewed as alternatives to globalism. In that case, they would almost certainly evolve over time—as Krugman suggests—in an exclusionary and eventually discriminatory direction. The economic costs would be significant and growing. The political effects would, at a minimum, be worrisome.

The present stalemate in the Uruguay Round has sharply raised the prospect of the regional path. If the Uruguay Round were to fail, the trend toward regionalism almost certainly would accelerate. And it will be much harder to avoid "failure" of this multilateral negotiation than in the past because a modest agreement that tries to paper over the major problems would be denounced as such by the growing corps of proponents of regionalism as well as others; world leaders and trade officials can no longer " declare victory and go home."

The United States usually plays the pivotal role on international trade issues. It will do so even more in this case. Europe is already a bloc and Asia is clearly not, so the United States will tip the balance. It is thus imperative for the United States to continue to make clear that its priority is a successful outcome to the Uruguay Round.

The United States was motivated to negotiate the FTA with Canada, in the wake of the failed GATT Ministerial of late 1982, primarily to spur the launch of what became the Uruguay Round.[9] It fully intended to complete the Uruguay Round before negotiating NAFTA, reaffirming the primacy of the global system. It has held back on any substantive negotiations with Latin American countries, other than Mexico, despite the eagerness of Chile and others to commence such talks.

The "failure" at Brussels in December 1990, however, means that NAFTA may now be concluded before--or simultaneously with—the Uruguay Round. Hence the United States will be characterized as "joining the rush toward regionalism." This will reinforce the self-fulfilling prophecy, as noted above, making it harder for Japan and others in Asia to resist blandishments such as Malaysia's to pursue defensive arrangements of their own.

As important as continued American fealty to a successful Uruguay Round is full support for such an outcome from Europe and Japan. Europe bears a special responsibility in this context. As the only trade bloc, it has done much to stimulate similar developments in other parts of the world. Its current inward orientation, while unlikely to produce a "Fortress Europe," has raised anxieties elsewhere and intensified the risk of realization of the self-fulfilling prophecy. The EC has been the key partner of the United States in achieving successful outcomes of the last two global trade negotiations; it has both a major interest in, and major responsibility for, doing so again.

The stakes are even higher than the future of the international trading system, however. As noted at the outset, the overarching issue for world economic policy in the decade or more ahead is whether the Big Three can effectively co-manage a reinvigorated global order. The Uruguay Round is one of the first test cases. If the Big Three cannot deal with a few farmers and other recalcitrant interest groups, they will hardly be able to provide global leadership on the wide array of issues—including money, macroeconomic cooperation, energy, and the environment as well as trade and the GATT—where it will be needed.

The monetary dimension

Finally, it is necessary to note that the one monetary bloc now extant and potentially expanding in the near future—again, in Europe--could also raise significant problems for the global system.

A successful move to EMU will convert Europe from a series of small and medium-sized open economies into one large and much less open economy. This change alone will have several effects:

—It will tend to increase the extent of currency fluctuations among Europe, America, and Japan—generating greater international financial instability and potentially misalignments that would distort trade and add further to the tendencies toward trade protection outlined above.

—It will tempt Europe to practice "benign neglect" from time to time, as the other large and relatively closed economy has done, or at least to try to force the costs of adjustment onto others as the United States has also done.

—If it fails to achieve a unified fiscal policy to go with its unified monetary policy, there will be a strong possibility of a Europe-wide repetition of Reaganomics from the early 1980s and the German policy mix of the early 1990s: large fiscal stimulus, very tight money, a sharp appreciation of the currency, big trade deficits, and resultant protectionism.

—Without a political master, the European Central Bank will be particularly likely to foster such an outcome. This will be especially true in its early years, as it seeks to prove its fealty to the goal of price stability and to discipline recalcitrant governments into fiscal rectitude.

Moreover, achievement of EMU--even without the final step of a single currency, but especially with it—will propel the ECU to a central role in a new multiple reserve currency system. This will both reflect and produce a substantial portfolio adjustment from (mainly) dollars into ECU, reinforcing the likely appreciation of European currencies with attendant trade balance and protectionist problems. This effect would be further accelerated if the EMU pooled Europe's monetary reserves and attempted to dispose of some of the "excess," identified by the EC Commission as on the order of $200 billion.[10]

The policy implication is that the 'united States and Japan should engage Europe in negotiations on the global monetary system while the latter works out its regional arrangements—particularly as both of the basic blueprints for EMU, the report of the Delors Commission[11] and Karl Otto Pöhl's design for a Eurofed,[12] totally ignored the external dimension thereof. American strategy in the trade area has been to engage Europe in a global negotiation at each key milestone in its evolution: the Kennedy Round when the Common Market was created, the Tokyo Round when it expanded to bring in the United Kingdom and others, the Uruguay Round as it moved toward "1992." A similar approach is needed in the monetary area to avoid the risk that EMU will destabilize global arrangements and that, once its details have been put in place, it will be too late. This should be feasible now that the G-7, by successfully placing a floor under the dollar in February 1991 and (so far) effectively capping the dollar in July 1991, seems to .be returning at least de facto to reference ranges among the major currencies à la Louvre.

Epilogue

There is still time to restore the effectiveness and credibility of the global approach to world economic policy and its existing institutional framework. Contrary to Krugman's assertions, the Uruguay Round is still alive—and, if not totally well at this juncture, with reasonable prospects for meaningful success. EMU can still be channeled in directions that are fully compatible with global monetary stability.

The Big Three must seize leadership on both issues (and several others) and make a conscious effort to restore a global focus, however, or the regional drift will continue and perhaps accelerate. The costs of permitting such an outcome could be extremely high in both economic and political terms. Reversing it is the first major test the Big Three face in the tripolar, post-Cold War world economy of the 1990s and beyond.

Endnotes

[1]A detailed analysis of these historic transformations on the world economy can be found in C. Fred Bergsten, "The World Economy After the Cold War," ***Foreign Affairs,*** Summer **1990,** pp. **96-112.**

[2]Robert Z. Lawrence, "Emerging Regional Arrangements: Building Blocks or Stumbling Blocks?' June **1991, mimeo.**

[3]The downsizing of economic activity accelerates that trend. See Alan Greenspan, "Remarks at the Annual Dinner of the Japan Society," New York, May 22, **1989.**

[4]See the discussion of the impact of FTAs on nontariff barriers in Paul Wonnacott and Mark Lutz, "Is There a Case for Free Trade Areas?" in Jeffrey J. Schott, ed., ***Free Trade Areas and U.S. Trade Policy.*** Washington: Institute for International Economics, **1989,** p. 64.

[5]These U.S. quota regimes are largely implemented through "voluntary" restraints administered by the exporting countries which are enormously costly to the United States because they transfer most of the quota rents to the exporting countries and firms. See C. Fred Bergsten, Kimberly Ann Elliott. Jeffrey J. Schott, and Wendy E. Takacs, ***Auction Quotas and United States Trade Policy.*** Washington: Institute for International Economics, September **1987.**

[6]These costs are estimated in William R. Cline, ***The Future of World Trade in Textiles and Apparel.*** Washington: Institute for International Economics, Revised **1990.**

[7]See Jeffrey J. Schott and Murray G. Smith, eds., ***The Canada-United States Free Trade Agreement: The Global Impact.*** Washington: Institute for International Economics, **1988.**

[8]Excluding, of course, its agricultural component which, however, resulted from the EC's decision to create a customs union rather than a free trade area and where liberalization was severely hampered by the United States' decision to take agriculture out of the GATT in **1955** to protect its own farmers.

[9]The difference between that situation, when a regional initiative by the United States clearly promoted global liberalization, and that of today is emphasized in Jeffrey J. Schon, ***More Free Trade Areas?*** Washington: Institute for International Economics, **1989.**

[10] See ***One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union.*** Brussels: Commission of the European Communities, European Economy, No. 44, October **1990,** Chapter 7.

[11]***Report on Economic and Monetary Union in the European Community,*** prepared by the Committee for the Study of Economic and Monetary Union, April **1989.**

[12]"Basic Features of a European Monetary Order," a lecture by Karl Otto Pohl, president of the Deutsche Bundesbank, organized by *LeMonde,* Paris, January **16, 1990.**