Regionalism and the World Trading System

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Increasing economic integration has been one of the major forces driving the world economy's impressive growth over the last forty-five years. Today, however, more than at any time since World War II, the future of the world trading system is in doubt. Ironically, just as the Soviet Union, Eastern Europe, and many developing countries rush to join the General Agreement on Tariffs and Trade (GATT), many in the developed world have become disillusioned with the GATT process. The nearing completion of Europe's 1991 process, the North American Free Trade Agreement (NAFTA) apparently on the way, and even the dissolution of Comecon has forced the question of regional trading blocs increasingly to the fore. It is useful at the outset to consider how the world trading system is now faring. World trade grew 3 percent a year faster than GNP in the 1960s, 2 percent a year faster in the 1970s, and 1 percent a year faster in the 1980s. The good news is that integration has continued; the bad news is that it has increased ever more slowly.

Why did integration increase less rapidly in the 1980s? I think there are two important reasons. First, the technological push toward integration has slowed. Transportation and communication costs fell less quickly in the 1980s than in previous decades. Air transport, for example, is usually thought of as a dynamic industry. Yet the last major innovation was the jumbo jet, introduced nearly a generation ago. Moreover, as the total share of transportation and communication costs declines, incremental reductions have ever smaller effects;

a reduction from $5 a minute to $2.50 a minute will have a greater impact on communication than a fall from 50 cents a minute to 25 cents a minute. Progress in this sense reduces the potential for future progress.

Second, the momentum of trade liberalization has slowed as well. While sixty developing nations significantly reduced barriers to imports over the last decade, twenty of twenty-four Organization for Economic Cooperation and Development (OECD) countries, including the United States, raised such barriers. The United States, which on some measures has trebled the protectionist impact of its policies, has a particularly ignominious record.

In the long run, however, it is those sixty liberalizing developing countries and those that emulate them that are ultimately of greatest importance for the future development of the world trading system. Ninety-five percent of the growth in the world's labor force over the next twenty-five years will occur in what are now developing nations. Even assuming only modest productivity performance, these demographic trends imply that these nations will be the most rapidly growing markets in the world over the next two decades. And this is a moment of historic opportunity in the developing world. There is abundant evidence—most obviously in Eastern Europe, but also in large parts of Latin America, in China, where industrial production has grown at a 30 percent annual rate over the last six years, in India, where a new finance minister has pledged radical change, and even in Africa, where twenty nations are undertaking adjustment programs—that the desirability of market systems has become apparent. Our top priority must be to reinforce these trends.

Trade policy not only needs to proceed on all fronts to lock in the gains that have occurred but also to provide examples that will lead to new trade gains, and even to insure viable investment opportunities for OECD companies—GATT yes, but regional arrangements as well. I therefore assert and will defend the following principle: economists should maintain a strong, but rebuttable, presumption in favor of all lateral reductions in trade barriers, whether they be multi, uni, bi, tri, plurilateral. Global liberalization may be best, but regional liberalization is very likely to be good.

This position is based on four propositions: (1) given the existing structure of trade, plausible regional arrangements are likely to have trade creating effects that exceed their trade diverting effects; (2) there is a very good chance that even trade diverting regional arrangements will increase welfare; (3) apart from their impact on trade, regional trading arrangements are likely to have other beneficial effects; (4) reasonable regional arrangements are as likely to accelerate the general liberalization process as to slow it down.

Are trading blocs likely to divert large amounts of trade? In answering this question, the issue of natural trading blocs is crucial because to the extent that blocs are created between countries that already trade disproportionately, the risk of large amounts of trade diversion is reduced. Table 1 sheds some light on the importance of natural trading blocs. It compares the ratio of observed trade for various entities to the trade one would expect if it were equiproportional to GNP. For example, the number in the upper lefthand comer indicates that the United States and Canada engaged in six times as much trade as they would if U.S. trade with Canada were proportional to Canada's share of world, non-U.S., GDP. Looking at the table, I draw three conclusions:

(1) Existing and many contemplated regional arrangements link nations that are already natural trading partners. Note the disproportionate share of U.S. trade with Canada, of trade within the developing Asian countries, and of trade within industrialized Europe. If I included Mexico in the table it would have a ratio of about 7 with the United States, Korea would have a ratio of nearly 4, and even Israel would have a ratio well in excess of unity.

(2) There is very little sense in which the United States and Canada have a natural affinity with the rest of the Western Hemisphere. American, and to an even greater extent Canadian, trade is disproportionately low, with Europe about equivalent between developing Asia and Latin America. This suggests that America should not be content with an Americas-based approach to trade reduction.

(3) What is striking about the numbers in Table 1 is the isolation of industrial Europe, which trades disproportionately with itself.

This is not an artifact of the fact that Europe is broken up into many countries; this rationalization would fail to explain why it occupies so small a fraction of both Asian and Western Hemisphere trade.

Table 1
Trading Neighbors: Ratio of Share of Trade to Partner's Share of World Output, 1989

Trader	with: U.S.	Canada	Other Americas	Japan	Developing Asia	EC
United States	—	6.06	2.38	0.87	2.34	0.61
Canada	2.63	—	0.66	0.47	0.97	0.39
Other Americas	1.13	0.63	3.16	0.31	0.57	0.67
Japan	0.95	1.15	0.75	—	4.33	0.53
Developing Asia	0.73	0.62	0.43	1.26	4.83	0.54
EC	0.22	0.30	0.42	0.17	0.63	1.75

I conclude from this exercise that most seriously contemplated efforts at regional integration involving industrialized countries cement what are already large and disproportionately strong trading relationships. To this extent they are likely to be trade creating rather than trade diverting. The one idea that looks bad from this perspective is that of a North Atlantic trading bloc which would be building on

Table 2
Trading Neighbors: Ratio of Share of Trade to Partner's Share of World Output, 1975

Trader	with: U.S.	Canada	Other Americas	Japan	Developing Asia	EC
United States	—	6.42	2.68	0.60	1.56	0.51
Canada	2.32	—	0.90	0.37	0.58	0.36
Other Americas	1.19	0.74	2.81	0.55	0.23	0.72
Japan	0.65	1.17	1.12	—	4.70	0.26
Developing Asia	0.71	0.65	0.19	1.53	3.68	0.56
EC	0.18	0.37	0.46	0.09	0.44	1.25

a weak trading relationship. Amongst regional groups of smaller developing countries, even trade disproportionate to GDP may constitute a small fraction of total trade and hence the argument carries less force.

It is sometimes suggested that whatever may have been true in the past, today's market is worldwide and regional arrangements are therefore more likely to be damaging than would once have been the case. Table 2 provides a fragment of evidence on this issue by redoing the exercise reported in Table 1 for 1975. It is striking how similar the pattern of trade is. Perhaps this should not be too surprising; it is well known that intra-European trade has risen much faster than Europe's external trade.

Let me come now to my second point: trade diverting regional arrangements may be desirable despite their trade diverting effects. I find it surprising that this issue is taken so seriously—in most other situations, economists laugh off second best considerations and focus on direct impacts. Further, it is a consequential error to think that just because a regional trading agreement's trade diverting effects exceed trade creating effects it is undesirable. Suppose that Korea and Taiwan were identical—a free trade area between the United States and Korea would divert Taiwanese trade to Korea but would have no welfare costs. Only where trade diversion involves replacing efficient producers with inefficient producers is it a problem.

I think this point has considerable force. We too often forget that more than half of U.S. imports are either from U.S. firms operating abroad or to foreign firms operating within the United States. And the fraction is rising rapidly. Under these circumstances, trade and investment decisions are inseparable. With many similar sites for investment by U.S. firms producing for the U.S. market, it is far from clear that trade diversion would have important welfare impacts.

While trade diversion is unlikely to involve large efficiency costs, trade creation is much more likely to involve real efficiency gains. First, it will help realize economies of scale which can be gained through creation, but are unlikely to be lost due to trade diversion. Second, especially where agreements link developed and developing countries, or developing countries that are heavily specialized, the trade they create is likely to be substantially welfare enhancing.

My third reason for eclectically favoring integration schemes is a reading of where the real benefits are. To the chagrin of economists, the real gains from trade policies of any kind cannot, with the possible exception of agriculture, lie in the triangles and welfare measures we are so good at calculating. Instead, they can be found in the salutary effects of competition and openness on domestic policy more generally. Pedro Aspe in his speech yesterday clearly thought more of NAFTA as a device for locking in good domestic policies and attracting investment than as a mechanism for gaining market access. To the extent that the benefits of trade integration lie in these areas, it may not be important how geographically general it is, or whether it is trade diverting. Take the case of Enterprise for the Americas. If the rest of Latin America desires to follow in Mexico's footsteps, a standstill on future U.S. protection for reassurance, and the political and symbolic benefit that it can bring in promoting domestic reform, it seems almost absurd to resist them on the grounds that some trade might be diverted from some part of Asia that would produce a little more efficiently.

It is instructive to consider the breadth of the European Community (EC) 1992 and GATT agendas. No small part of what is good about 1992 is the downward pressure on regulation created by mutual recognition policies. Similarly, competition for investment within the EC will have salutary effects on tax and regulatory policies. But there are diminishing returns to increasing numbers of policy competitors. A significant part of the benefits of trade liberalization in improving domestic policy may be realizable within small groups of countries.

The fourth and final part of the case for supporting regional arrangements is their impact on the multilateral system. I do not share the view held by some that GATT is to trade policy what the League of Nations became to security policy. I believe that a successful completion of the Uruguay Round and its successors would be highly beneficial to the world economy and that the developed nations especially must work to bring one about.

But I am far from persuaded that over time regional arrangements make multilateral trade reduction impossible. The essential reason for concern is that large blocs will have more monopoly power than small ones—and will then use it. The argument is that the resulting reduced cross bloc trade would do more harm than increased within bloc trade would do good. This is a legitimate concern. But it is also true that three parties with a lot to gain from a successful negotiation are more likely to complete it than are seventy-one parties, each with only a small amount to gain. It may be well that a smaller number of trade blocs are more likely to be able to reach agreement than a larger number of separate countries.

This is not just a theoretical proposition. I doubt that the existence of the EC has complicated the process of reaching multilateral trade agreements. Instead, I suspect that the ability of Europe to speak with a more common voice would have helped, not hurt, over time.

Furthermore, there is the beneficial effect of successful arrangements in attracting imitation and in providing a vehicle for keeping up the momentum of liberalization. Those concerned that the U.S.-Mexico or possible follow-on agreements will divert attention from the Uruguay Round ought to consider whether they will also divert Congress' attention from the Super 301 process, or that of the business community from negotiating further import restrictions.

Even strong presumptions remain rebuttable. Obviously some past and current proposals for regional integration would fail to satisfy the conditions. Agreements within groups of small, highly distorted, and protectionist countries that diminish momentum for greater overall liberality are clear candidates for welfare worsening regional agreements.

But the crux of the argument is this: regional arrangements will necessarily speed up the GATT, and moving the GATT along is important if it is possible. But, holding the degree of multilateral progress constant, the world will be better off with more regional liberalization. And the case that regional integration will slow multilateral progress is highly speculative at best. The Uruguay Round may well be the best hope for the world trading system, but it is surely not the last best hope.