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Regionalism, Multilateralism, and Deeper Integration: Changing Paradigms for Developing Countries

Robert Z. Lawrence

The proliferation of regional trading arrangements in the 1990s has generated significant debate regarding its implications for the multilateral trading system and for nation-states within it. Robert Lawrence addresses these important issues from the point of view of developing countries. His analysis shows how post–World War II assumptions regarding the global trade system and developing country participation in it have shifted in important ways. At the same time, new forces within the private sector have emerged in favor of deeper forms of regional integration. In the chapter below, Lawrence provides an accessible political economy analysis of the merits of regional, multilateral, and deeper integration from a developing country perspective.

There is a profound tension in our world. Increasingly the economy is global, but the world is organized politically into nation-states. This process of globalization has raised two fundamental questions about how we should be governed. First, to what degree should policies be decided by nations independently, and to what degree should they be subject to international agreement? And second, if international agreement is required, should it be regional or multilateral? This chapter addresses the relevance of these questions to trade policy, adopting the perspective of developing countries. The first part describes the historical shifts in the focus of trade policies in global systems during the period after World War II and then explores specifically how these shifts have given regionalism today its distinctive charac-

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teristics. The second part considers several strategic trade policy questions from the perspective of developing countries. In particular, what are the merits of regional and multilateral agreements in achieving liberalization and to what extent should coverage of these agreements deal with more than border barriers?

The Changing Approaches to International Trade Policy

When barriers at nations' borders were high, as they were in the immediate postwar period, governments and citizens could sharply differentiate international policies from domestic policies. International policies dealt with at the—border barriers, but nations were sovereign over domestic policies without regard to the impact on other nations. In its original form, the General Agreement on Tariffs and Trade (GATT), which was signed in the 1940s, emphasized this approach. Tariffs were to be reduced on a most favored nation basis, and discrimination against foreign goods was to be avoided by according them with national treatment. But the rules of the trading system, by and large, left nations free to pursue domestic policies in other areas such as competition, environment, taxation, intellectual property, and regulatory standards.[1] To the degree that there were international agreements in other policy areas—indeed there were international multilateral agreements on business practices, labor standards, intellectual property, and the environment—these were made outside the GATT, and compliance was typically voluntary. This was the case, for example, when nations signed the conventions on international labor standards of the International Labor Organization (ILO) or the codes of conduct for multinational corporations of the United Nations.

In the 1950s and 1960s there was also a widely held view that in order to develop, developing countries should separate themselves from the world economy. In part this view was a response to the disastrous international environment that had prevailed in the 1930s. In part it reflected a skepticism regarding the potential of market forces and a faith in the capacity of governments to plan development and allocate resources. There was a view that political factors, such as neocolonialism, had created a system biased against developing countries, particularly producers of primary products. As a result, for the most part developing countries adopted import substitution policies and maintained high tariff barriers and restrictive quotas.

For developing countries the GATT approach of reducing tariffs on a most favored nation basis was attractive, particularly when it was amended to provide for special and differential treatment of countries. In principle, developing countries had considerable freedom to pursue whatever policies

they chose. Specifically, developing countries were granted leniency in the use of infant industry protection and trade restrictions for purposes of balancing payments, and they were given special market access under the Generalized System of Preferences (GSP). They were also able to receive most favored nation treatment from other member nations without undertaking much liberalization at home.[2]

In sum, there were three widely accepted principles in the period immediately after World War II that help explain the overall thrust of the policies developed. First, trade agreements should concentrate on lowering border barriers; second, developing countries should try to develop with only limited engagement in the world economy; and third, when they do engage, they should be given special treatment. Over time, however, these principles have been increasingly challenged.

In the first place, starting in relationships among developed countries, pressures began building for deeper international integration—that is, for the harmonization and reconciliation of domestic policies. A host of new issues emerged as part of the international negotiating agenda. These included such issues as services trade, intellectual property, rules for foreign investors, product standards, competition policies, and labor and environmental standards. The increased scope of international trade agreements could be seen in bilateral agreements such as the Structural Impediments Initiative (SII) between Japan and the United States, which emphasized issues such as Japan's spending on infrastructure, its distribution system, and its antitrust policy; in regional arrangements such as the single-market initiative EC92 in Europe, which emphasized increased harmonization and mutual recognition of national standards and social dimensions; and in multilateral agreements such as the Uruguay Round, which resulted in the formation of the World Trade Organization (WTO), the adoption of rules on intellectual property rights, the liberalization of services and agriculture, the adoption of trade-related investment measures, and the development of a more powerful dispute resolution system. The new emphasis is also clear in discussions on the post–Uruguay Round agenda, with some nations calling for agreements to cover issues such as competition policy, labor standards, and the environment.

Why This Shift to Deeper Integration?

There are both political and functional forces driving this trend. When nations were separated by high border barriers and had little trade with each other, they could overlook each other's domestic affairs. As the barriers have come down, however, the impact of different domestic policies has become apparent. Improvements in communications and increased travel have made countries increasingly aware of foreign practices. In addition, as

international competition has intensified, firms, workers, and citizens have become increasingly aware that different national policies have international effects. Increasingly, therefore, the call is for a level playing field.

The major political actors in society are business, labor, and environmentalists. When these groups see national rules affecting trade that are different from those of their countries, they are moved to cry foul. Pejorative terms are used to describe abhorrent foreign practices. For business the problem is dumping; for labor it is "social dumping"; and for environmentalists it is "ecodumping." All three groups are therefore seeking to achieve their goals, either by directly changing the trading rules or by using trade as a weapon to enforce agreements achieved elsewhere. In some cases groups put forward these arguments as a pretext for protectionism. Their real goals are not an integrated international system based on rules, but a world economy fragmented on the pretext that national differences preclude fair competition. In other cases, however, there are more widely held social concerns about the impact of unfair competition, low labor standards, and lax environmental standards. One argument is that once markets and competition are global there is a strong case for the rules defining fair competition to be global. Similarly, as the world becomes increasingly aware of shared environmental problems such as global warming and the depletion of the ozone layer, the case for international coordination of environmental policies becomes stronger. Likewise, as labor markets become linked through immigration and trade and international humanitarian concerns are raised because of improved publicity and communications—the CNN effect—the call for basic standards becomes stronger.

In addition to these political forces, there are even more powerful functional reasons behind the trend toward deeper integration. Foreign trade and foreign investment have become increasingly complementary. Access to foreign markets has become vital for competitive success not only for products, but also for foreign investment. To sell sophisticated products requires a significant domestic presence to provide marketing, sales, and service. The ability to follow market trends, respond to customer needs, and acquire innovative small foreign firms in all major markets has become vital for competitive success. These factors all lead companies to pay increasing attention not only to trade barriers, but also to foreign domestic practices that hinder their operation. This, in turn, leads to frictions resulting from different systems of corporate governance and rules of operation. Even absent trade barriers, other factors—for example, the weak enforcement of antitrust policies—can lead to collusion by domestic firms that limits new firms' entry into the market. International investment in services industries stimulated in part by deregulation, privatization, and liberalization has contributed to these trends. Once foreign firms operate in regulated sectors, they become increasingly interested in the rules that govern their behavior.

From Closed to Open Domestic Markets

The second basic premise of the early postwar system—that developing countries should develop behind high trade barriers—has also been questioned. In the 1980s developing nations responded both to success and to failure by moving toward liberalization and outward orientation. In Asia success led to external pressures on Taiwan and Korea to liberalize; elsewhere shifts toward an outward orientation were induced by debt problems, the Asian example, the encouragement of the International Monetary Fund (IMF) and the World Bank, and the need to attract new capital in new forms. The collapse of communism brought a large new group of nations into the international marketplace. China, the world's largest developing country and also its most rapidly growing, is only the most visible of these nations. Although complete removal of border barriers has not been achieved, the leaders of most nations can agree in principle that free trade is desirable, and many are prepared to commit their countries to achieving it in the foreseeable future. In late 1994, for example, thirty-four nations in the Western Hemisphere and eighteen members of the Asia Pacific Economic Cooperation (APEC) Forum committed themselves to eventual full regional free trade and investment.

From Special to Reciprocal Treatment

As developing countries have sought to liberalize and attract foreign investment, the pressures driving deeper integration have led to erosion of another part of the postwar consensus about how developing countries should be treated. In particular, there has been a turn away from the idea of preferential treatment. This is the logical implication of the shift toward deeper integration. It is straightforward to provide special treatment when an agreement relates to barriers at the border. The developed countries simply adopt lower tariffs than developing countries. But often when the agreement relates to adherence to a common rule—whether the rule is adopted or it is not—it is more difficult to have an agreement that does not involve reciprocal obligations. In addition, developing countries have increasingly seen the adoption of such commitments to be in their interest, as their efforts have been directed toward internal reforms that can be reinforced by international agreements.

Again, this development is evident in both multilateral and regional arrangements. In the Uruguay Round, although developing countries were given longer periods of time in which to adopt new disciplines such as those related to intellectual property, they were generally not exempted to anywhere near the same degree as they had been earlier. Likewise, in traditional regional arrangements such as the Lomé Convention between the European Union (EU) and developing nations in Africa and the Caribbean,

manufactured goods from developing countries were granted duty-free access, but these countries were not expected to reciprocate. By contrast, the more recent agreements signed by the EU with eastern European nations and those from the Middle East and North Africa are markedly different. These agreements envisage much more complete reciprocity. Similarly, in the North American Free Trade Agreement (NAFTA), after the transition period the obligations assumed by Mexico and the more developed NAFTA partners are reciprocal. Likewise, in the APEC agreements, although developing countries are given an additional ten years (until 2020) to adopt complete free trade and investment, their obligations are similar to those of their developed counterparts.

As countries have turned toward global markets, a paradoxical consequence has been the development of pressures toward increased regional integration. Increased global competition has led multinational firms to develop regional strategies to compete globally. To be internationally competitive, firms must have access to key inputs at the lowest prices. This leads to sourcing from nearby trading partners whose comparative advantage lies in such inputs. Similarly, firms seek to enjoy scale economies by selling to large regional trading partners.

In North America, for example, outwardly oriented policies by one of the "natural" trading partners of the United States, Canada, led to free trade arrangements to secure market access and lure foreign investment with the prospect of servicing a rich regional market. Meanwhile, U.S. manufacturing firms were attracted by the possibility of escaping restrictions on investment in Canada, which would allow them to rationalize their North American strategies. In Europe the initiative to establish a single market by 1992 was led by Eurocrats who were motivated by the goals of political union and stimulating growth. However, it was also supported by European firms whose executives felt that even fairly large domestic markets such as those of Germany, France, and the United Kingdom were inadequate home bases for global competition. The EC92 initiative was successful not simply in removing barriers, but also in reorienting the strategies of European firms that now treat Europe as a single market and as a single production base from which to service global markets. These strategies have been reflected in decisions regarding investment, plant location, and mergers and acquisitions. The changed emphasis in policies on trade liberalization and deeper integration provides an important context for evaluating current regional trading arrangements and comparing them to those that emerged earlier.

In the 1950s and 1960s developing countries concluded preferential trading agreements among themselves as part of their trade policy strategies, but these agreements often failed miserably (Hazlewood 1979). This might have been expected given their motivation; many of these agreements were driven by purely political rather than economic considerations.

To the degree that economic objectives were involved, the agreements were usually an extension to the regional level of domestic import substitution and planning policies that were proposed to achieve scale economies for protectionist policies. The theory was that participating countries would become more specialized and by relying on regional markets could develop international competitiveness. In practice, however, given the general philosophy of trying to produce everything at home, members tended to give each other access to their markets only for those products they imported from the rest of the world. In other words, the region as a whole became more self-sufficient, but in a most inefficient manner—by maximizing trade diversion.

Under these circumstances it was no surprise that preferential trading agreements among developing countries often failed. This was especially true when countries had similar patterns of specialization so that there were few opportunities for avoiding competition. However, even where there was scope for such specialization, once the extraregional trade was diverted the impact of the agreements was exhausted. It is difficult, if not impossible, to plan resource allocation in a single economy. It is even more complicated, if not impossible, to do so when there are several countries and resource allocation decisions are highly politicized (Langhammer 1992).

The forces driving these developments differ radically from those driving previous waves of regionalization in this century. Unlike those of the 1930s, most of the current initiatives represent efforts to facilitate their members' participation in the world economy rather than their withdrawal from it. Unlike those of the 1950s and 1960s, the initiatives involving developing countries are part of a strategy to liberalize the economies of such countries in general and to open their economies to implement policies driven by exports and foreign investment rather than to promote import substitution. The current moves toward regionalization are, by and large, not meant to thwart the allocative process of the market, but to strengthen its operation. They represent efforts to fill the functional needs of international trade and investment and the requirements of international governance and cooperation to which globalization gives rise. In addition, many important regional initiatives are not developing as arrangements with exclusive memberships in which insiders limit their contacts with outsiders. On the contrary, they are developing as inclusive arrangements in which members either allow outsiders to join or independently join them in developing similar arrangements.

Some major aspects of the new regionalism are listed in Table 23.1. It is striking that recent regional agreements have been strongly supported by corporate leaders. In Europe the initiative to establish a single market was promoted by large European firms that argued that a fragmented Europe deprived them of the scale economies they needed to be competitive. Similarly, the NAFTA was boosted by U.S. businesses both large (repre-

Table 23.1 Regionalism: Old and New

Old	New
Import substitution—withdraw from world economy.	Export orientation—integrate into world economy.
Planned and political allocation of resources.	Market allocation of resources.
Driven by governments.	Driven by private firms.
Mainly industrial products.	All goods and services, as well as investment.
Deal with border barriers.	Aimed at deeper integration.
Preferential treatment for less-developed nations.	Equal rules (different adjustment periods) for all nations.

sented by the Business Round Table) and small (represented by the U.S. Chamber of Commerce) (Fishlow and Haggard 1992). Major supporters of a free trade agreement in Canada were the Business Council on National Issues and the Canadian Manufacturers Association (CMA), and large Mexican industrial groups strongly backed the NAFTA. Private foreign investors have led the informal regional integration in Asia. In addition, in the APEC political leaders have explicitly institutionalized the role of business by creating an advisory Pacific Business Forum, which was established in June 1994. Both large and small firms from the eighteen member countries are represented in this forum, which is charged with providing proposals for facilitating trade and investment within the region.

Clearly, many multinational corporations view these regional arrangements as promoting their interests. This view reflects the role of these arrangements as responses to the functional demands of multinational firms in the current economic environment. In particular it is noteworthy that these initiatives are concerned with services and foreign direct investment (FDI), as well as goods trade. Also, for reasons outlined earlier, they focus on internal rules and regulations and on institutional mechanisms to ensure implementation and enforcement as well as removal of border barriers.

As they seek to attract capital and at the same time pursue programs based on export-driven growth, foreign firms become increasingly attractive to developing countries. They bring knowledge about the latest technologies and ready-made access to major markets. Moreover, in many developing countries. accompanying the shift toward more open trade policies has been a reduction in the role of the state through privatization. In this context foreign investors have become increasingly attractive as providers of capital, technology, and operational skills.

The demand for foreign investment emanating from the developing countries has corresponded with an increased supply from multinational corporations. As international competition intensifies, small cost advantages may have large consequences. Particular national locations are not necessarily well suited to the complete manufacture of complex products. With improvements in communications and transportation, firms are increasingly able to produce products by sourcing from multiple locations. Raw materials might best be sourced in one country, labor-intensive processes performed in a second, and technologically sophisticated processes performed in a third. Multinationals from many nations are therefore expanding their foreign investments.

Traditionally, FDI in developing countries was made to gain access to raw materials. Later, in countries following protectionist import-substitution policies, it was attracted by the prospects of selling behind trade barriers in a large internal market.[3] Although the motive of an attractive domestic market persists, as developing countries have lowered their trade barriers, investment has increasingly been motivated toward providing service to export markets (Wells 1992). Those able to offer export platforms have become most successful in attracting FDI.[4]

Implications

The increased importance of international investment naturally shifts attention from trade to investment barriers and focuses attention on national differences in the degree of ease with which foreign firms can enter new markets through both acquisition and new establishment, and on the effects of domestic regulations and taxes on the conditions under which such firms can operate. Similarly, firms that plan to source in one country and sell in others need security about the rules and mechanisms governing trade. Such firms also prefer secure intellectual property rights as well as technical standards and regulations that are compatible.

For developing countries, particularly those that were previously inhospitable toward foreign investment, establishing the credibility of new policies to attract investment and securing access to markets for exports has come to be of major importance. In addition, for some developing countries it may be easier to "import" new institutions and regulatory systems than to develop them independently. Although such institutions may not have the virtue of matching domestic conditions precisely, they offer the advantages of having been pretested and of providing international compatibility. For nations in eastern Europe, for example, adopting policies that conform to EU norms is particularly attractive because they can be seen as the first steps toward full membership in the EU. Finally, entering international negotiations can affect an internal debate, tilting it in favor of one side and against another. In many cases domestic forces interested in liberalization will find their hands strengthened if they can present their policies as part of an international liberalization agreement (Haggard 1995).

Given these developments, the reasons for the distinctive character of the emerging regional arrangements become clearer. They are motivated by

the desire to facilitate international investment and the operations of multinational firms as much as by the desire to promote trade. Although liberalization to permit trade requires the removal of border barriers—a relatively shallow form of integration—the development of regional production systems and the promotion of investment in services require deeper forms of international integration of national regulatory systems and policies. One example is eliminating differences in national production and product standards that make regionally integrated production costly. Investment also requires credible and secure governance mechanisms, and it requires secure access to large foreign markets that is unhindered either by customs officials or by domestic actions such as the adoption of antidumping policies. Since much of the investment relates to the provision of services, the regulatory regimes governing establishment and operation become the focus of attention. In sum, regionalism is a natural outgrowth of the shift toward globalization in developing countries.

Strategic Challenges

Almost all developing countries today are committed in principle to policies of increased trade and financial liberalization. But there remain important questions about the appropriate approaches to achieving these goals. One set of issues must be faced by countries individually. One key question is at what pace and in what order should liberalization be pursued? In particular, what kinds of institutional and competitive capacity need to be in place prior to full liberalization? This issue, which will not be explored in depth in this chapter, has been the subject of considerable debate, and there appears to be an emerging consensus that trade liberalization and domestic financial reform should precede liberalization of the capital account. A second question is what are the appropriate means for achieving liberalization? In particular, to what degree should countries act unilaterally and independently in setting their trade policies, to what degree should they pursue regional free trade agreements, and to what degree should they act only multilaterally? A third question relates to the nature of agreements that are signed. Should they cover only border barriers, or should they deal with the issues of deeper integration? Each of these issues is covered in turn.

International Agreements

Why do countries sign international trade agreements that constrain their behavior? If free trade is in a nation's interest, why not simply move unilaterally to remove border barriers? In particular, why would a sovereign state want to constrain its own behavior and subject itself to the possibilities of international sanction?

First, even though a nation may benefit from removing its own trade barriers, it can do even better if its trading partners also remove theirs, raising the demand for the nation's exports and improving its international buying power. Developing countries that sign agreements such as the GATT or regional agreements may gain improved access to foreign markets for their exports.

Second, international negotiations can strengthen the influence of the parties that gain from free trade. Although trade may benefit the nation, it may create losers in industries that compete with imports. If these losers are politically powerful, they may prevent a unilateral reduction in barriers. Trade negotiations help mobilize one group of domestic producers—exporters who gain from liberalization abroad—to offset the influence of producers and workers who compete with imports and thus make it politically easier for national leaders to adopt policies in the nation's interest.

Third, international agreements may make a nation's liberal trade policies more credible. Before firms will undertake the investments necessary to serve foreign markets, they need to be confident that access to these markets will be forthcoming. When countries, particularly those with a long history of protection, proclaim their newfound allegiance to policies of open trade and investment, foreign investors often react quite skeptically. By accepting commitments that could lead to international sanctions if broken, countries can persuade others of the permanence of their changes. Therefore, even small countries that are unable to change the behavior of their trading partners may gain from the lock-in effects of signing international trade agreements.

Fourth, international agreements and constraints can also prove useful where there is compelling evidence that international markets deviate markedly from the competitive model. One such type of market failure occurs when firms have monopoly or market power. Market failures may result if countries adopt policies that enhance the market power of their firms—so-called strategic trade policies—or raise their export prices by imposing the so-called optimal tariff. International oversight or rules that inhibit such behavior could, in principle, improve global welfare. Externalities or spillovers are a second source of market failure. As in a single nation's economy, some activities, such as pollution, may lead to inefficient outcomes when the polluters fail to take account of the social costs of their behavior. In an international economy there may be international environmental problems such as acid rain and depletion of the ozone layer that would not be countered efficiently if countries acted only independently.

Finally, agreements may allow for exploitation of economies of scale. One route calls for harmonization; another could entail mutual recognition. Where these benefits are great they may involve a trade-off. On the one hand, specific local regulations may match preferences more closely; on the other hand, international norms may yield benefits from scale economies.

These considerations all create the need for international agreements. Nations that are members of the WTO have agreed to bargain multilaterally to negotiate reductions in trade barriers. To ensure that these negotiations are credible, members have agreed to permit sanctions in the event they renege. To ensure that reductions are not undermined by domestic policies, they have also agreed not to harmonize policies, but to avoid measures that discriminate against foreign goods and to achieve their goals in the least trade-restricting way possible. In addition, efforts have been made to prevent firms from gaining monopoly power through predatory practices by means of rules against dumping and against nations' applying subsidies that may nullify their tariff reductions and inflict harm on their trading partners through the codes for subsidies. It is noteworthy, however, that although the GATT is based on nondiscrimination between its members (the principle of most favored nation treatment) and nondiscrimination between domestic and imported goods (the principle of national treatment), it does not require nations to have tariffs at similar levels or to adopt the same policies. Even with respect to border barriers, there is no level playing field. Aside from export subsidies, the GATT allows nations to respond to foreign subsidies and dumping only when these are seen to cause injury. It is not the goal of harmonization to create a level playing field that lies behind the trade rules, the goal is to make markets internationally contestable so that the benefits of international specialization can be most fully realized.

Given the existence of a forum for multilateral trade agreements and the ability to join the WTO, why might countries want to sign regional trade agreements? In particular, trade theory indicates that such agreements do not necessarily enhance welfare, since they may both divert and create trade, and indeed it has been argued that this effect could be quite powerful in the case of some Latin American countries that have high trade barriers.

However, those who point to the dangers of trade diversion generally compare liberalization with a preferential arrangement that entails complete multilateral liberalization. A more realistic comparison is between multilateral liberalization that is only partial and preferential trade liberalization, which could be much more complete. Under these circumstances, both measures are "second best," and we know that partial multilateral liberalization could actually reduce the efficiency of resource allocation. This can be seen easily in terms of the theory of effective protection, in which the reduction of tariffs on primary commodity inputs can actually increase effective protection on final products. In fact, during the postwar period, the world has moved toward free trade through two means. One, the multilateral, in which there has been full participation but partial liberalization and the other, preferential arrangements, in which there has been (almost) full liberalization but partial participation. In practice the two approaches have not been incompatible.

One reason for the coexistence of these approaches is that from a political standpoint it might be easier to persuade a government to liberalize with respect to neighbors than to do so multilaterally. Political feasibility may channel liberalization toward regional initiatives. This might particularly be the case in instances such as that of the European Common Market, in which political motivations made a European Customs Union feasible, whereas complete multilateral liberalization was not. Free trade opponents of preferential trading agreements assume that in the absence of regional free trade agreements multilateral liberalization will take place. However, there may be cases in which it is possible to liberalize in a free trade area when it is not possible to do so unilaterally or multilaterally.

It is generally agreed that because firms can act collectively more easily than consumers, firms are more powerful politically than consumers. This makes import liberalization politically difficult, because even in cases where the country as a whole will gain, the benefits will be enjoyed by consumers in the form of lower prices, while the costs will be born by firms that compete with imports. If consumers are poorly organized, import-competing firms lobbying for protection might have the upper hand. To offset this advantage, it might be necessary to have another group of producers—namely exporters—also supporting liberalization.

Indeed, we should generally expect exporting firms to support liberalization, but liberalization by participating in multilateral negotiations is not particularly attractive for exporting interests originating in small countries.[5] The offers of other nations are not likely to be influenced by the liberalization in a single country. Therefore, particularly in a system such as that imposed by the GATT in which all members are given most favored nation treatment unconditionally, it will be hard for exporters to see it as worth their while to lobby for domestic liberalization. Moreover, since the GATT has operated on the principle of special and differential treatment for developing countries, exporters from small developing countries have even less reason to promote domestic liberalization. This tendency toward free riding creates problems for exporters from large countries. These considerations are different in preferential trading agreements. Exporters will see gains in the form of more open foreign markets that are contingent on domestic liberalization, and are therefore likely to lobby more enthusiastically for such agreements.[6] If scale economies are important, the benefits from liberalization may be greater for small countries than for large countries. Accordingly, the bargaining power of large countries may be greater in regional negotiations. Indeed, Bhagwati and others argue that this can lead to placing undesirable demands on small countries under these circumstances (Bhagwati and Kreuger 1995).

Countries may also join regional arrangements for defensive reasons. For example, once Mexico joined the NAFTA the Caribbean economies that are highly dependent on the U.S. market felt a disadvantage, and they have been driven to seek mitigation. Therefore, countries that suffer from

trade diversion could be better off joining such an agreement than staying out. Countries excluded from a preferential agreement may have incentives to join it. If the agreement is open to newcomers, there could be an expanding preferential arrangement that will eventually encompass the world. The incentive to join may increase as an agreement grows and becomes more effective. Richard Baldwin (1993) describes this as the domino effect. He shows how the trade diversion (and the increased efficiency) of countries forming an agreement can raise the costs for other competitors of not joining. This can increase the interest of export firms in the excluded country in joining the agreement, thereby spreading the process of liberalization. Key issues under these circumstances are the conditions under which accession is granted.

The domino effect Baldwin has identified may well be combined with another that may lead liberalization to proliferate—the incentives for a country that is prepared to liberalize to do so in a piecemeal fashion by joining a number of free trade agreements. Countries benefit from being the hub of a network of free trade agreements. Israel has free trade agreements with both the United States and the EU. Firms exporting from Israel, for example, receive preferential access to both the United States and the EU. By contrast, firms in the United States and the EU receive preferences only in the Israeli market. At the same time, by being open to more than one trading partner Israel experiences less trade diversion than it would have had it joined just one such agreement. Ultimately, in fact, the best situation for a single small country is to enjoy preferential access to all markets in the world while having open borders. If these incentives are present for every country, the system could move to free trade.

Countries trying to achieve this state face complicated timing decisions. It is necessary to have some preferences remaining to bargain away for access to each new partner, and as countries conclude these agreements the value of the preferences they confer diminishes. One of the advantages of simultaneous multilateral liberalization is that it reduces the incentive to hold back, since a country can keep track of all the concessions it receives in return for its own.

If full free trade is the outcome, why do the countries not get together and coordinate their actions? This may eventually happen, but particularly at the start there is a temporary advantage to the first movers from the preferential access they achieve. Indeed, a noteworthy aspect of liberalization, particularly in Latin America, has been the tendency of countries to join several free trade agreements simultaneously.[7] In the Western Hemisphere it appears that these will now be consolidated into a single Free Trade Area of the Americas.

Another fear is that in a customs union insiders with a stake in higher protection will capture the decision-making process of a more powerful entity and thus have increased power to thwart liberalization. This will particularly be the case for customs unions in which trade policy decisions require unanimity. For example, assume Spain and Poland compete in producing product A. If both are outside the EU they will lobby the EU to lower its tariffs on A. Once Spain achieves access, however, its incentives will change, and to preserve its preferential access it might oppose lower tariffs for Poland.

Moreover, a multilateral system with a few large players could be more susceptible to such foot-draggers. For a long time France opposed agricultural liberalization during the Uruguay Round. Since France was able to affect the position of the European Community (EC) as a whole, reaching agreement proved difficult. By contrast, had France been isolated an arrangement that simply bypassed or excluded it might have been possible.

However, larger customs union arrangements may be more difficult to capture than arrangements between single nations, because they are more likely to contain countervailing interests. It is true that France might have been opposed to agricultural liberalization, but other nations within the EU were not. Indeed, in the end France was forced to compromise, partly because of pressures from other members of the EU with an interest in agricultural liberalization. Moreover, a customs union such as the EU has relatively low external tariffs, and accession by more protectionist countries makes them more liberal. This was the case for Spain and Portugal, for example, in most industrial products.[8]

A third concern is the diversion of scarce political capital. Trade policymakers involved in negotiating and operating regional agreements will have less time and fewer resources available for multilateral negotiations. A related worry is that advocates for free trade with particular interests may be satisfied by liberalization with a few key countries and therefore not support multilateral liberalization. The United States is the market Mexican exporters most care about. If the only way the Mexican glass industry could sell in this market were for the United States to lower its tariffs multilaterally in accordance with the GATT, Mexican glass exporters might work hard for a GATT agreement. In a coalition with other exporters, they might tilt Mexican support for the GATT. If they gained access to the U.S. market through the NAFTA, however, their interest in the GATT might subside, and the lobby for multilateral liberalization would be weakened.

However, a regional arrangement might actually build up the political support for liberalization by doing it gradually rather than all at once. A regional arrangement might reduce the number of import-competing sectors and increase the number of exporters. This could, in turn, tilt the internal domestic political debate in favor of full liberalization.

It is of course not necessarily the case that countries are forced to choose between regional and multilateral liberalization. Indeed, both types of liberalization can be achieved simultaneously, and they could be complementary strategies. Nonetheless, there is also a danger that countries could

join customs unions in particular, and thus retard the pace of their multilateral liberalization because of the opposition of such liberalization by other members of the union.

Deeper Integration

Should these issues of deeper integration become part of the regional or multilateral trading agenda? Consider first the multilateral agenda. For developing countries the stakes in how these new issues of deeper integration are handled in the international system are exceptionally high. Many in developing countries resisted the idea that the rules of the GATT should be extended to cover services and intellectual property and were willing to agree only in return for concessions in areas such agriculture and textiles. Likewise, many are understandably wary that adopting measures on the environment or labor could actually retard their development.

A second concern is that these issues could become a pretext for protectionism that denies developing countries access to international markets. This could be the result unless sufficient recognition is given to the limited capacities of many developing countries to implement standards, regulations, and other policies in these areas. As a result of these concerns, a common response by developing countries has been to resist the introduction of these issues into the multilateral trade agenda. It is common, for example, on issues of both environmental and labor standards for developing countries to point out that when they were poor, the developed countries of today did not adhere to the standards they are trying to require of others. Similarly, others feel that in a world dominated by developed-country multinationals the adoption of tough competition rules and international investment standards could preclude government assistance for firms headquartered in developing countries.

However, there are problems with these rejection responses because, as countries without much international power, developing countries have an interest in seeing these issues decided in a multilateral setting with their participation. The absence of clear international rules could well provide opportunities for protectionists to influence their domestic policies. In addition, developing countries themselves have interests in a more competitive international market, a cleaner world, and labor standards that enhance welfare. Therefore, there appears to be a need for compromise in this area that is not easy to attain.

A second arena for deeper integration is regionalism. Traditional theorizing about regionalism considers these arrangements in the context of a paradigm in which trade policy is characterized by changes to border barriers. Regional arrangements are modeled either as customs unions (in which members have free trade internally and a common external tariff) or as free trade areas (internal barriers are eliminated, while external tariffs differ). In the view of traditional analysis, therefore, the dominant goal is the maximization of global welfare, and this will be achieved in a competitive international economy by multilateral free trade. Against this paradigm, preferential free trade arrangements are judged to be "second best" and therefore inferior to multilateral free trade.

Although the removal of internal border barriers is certainly an important feature of these arrangements, focusing only on these barriers overlooks much of what regional arrangements are about. The traditional perspective is at best incomplete and at worst misleading. A more comprehensive view of these emerging arrangements acknowledges that they are also about achieving deeper integration of international competition and investment. Once tariffs are removed there remain complex problems between nations relating to different regulatory policies. In a national context there is an extensive theory dealing with the question of how to assign authority over different aspects of fiscal policy to different levels of government—the literature on fiscal federalism.

No single answer seems to result from a general consideration of the factors that will affect this choice. There will inevitably be tensions between, on the one hand, realizing scale economies and internalization by increasing the scope of governance and, on the other hand, realizing more precise matching of tastes and choices by reducing that scope. What does seem clear, however, is that the answer will not always be the nation-state or the world. It is bound to differ, depending on the nature of the activity to be regulated. In some cases—for example, reducing global warming or establishing global financial networks—the appropriate level may be the world; in other cases, it could be the local community. The answers to this question are ambiguous, and they will not be independent of technology, history, incomes, and tastes. Indeed, there is no reason, a priori, to assume that the provision of regulatory regimes and other public goods should be the sole responsibility of the nation-state. Some goods and rules are better provided locally, although bilateral and plurilateral international arrangements may be more appropriate for providing others.

Recognizing the deeper nature of these agreements also provides challenges for appraising their effects on welfare. The nature of policy changes under these arrangements suggests that the normal presumptions about trade creation and diversion may not hold. It is generally presumed, for example, that preferential trading arrangements will reduce exports from outside the region. However, deeper internal agreements could actually stimulate such trade. For example, if members were to agree on tougher pollution controls or labor standards, their imports of products from nations with more lenient standards could rise. Similarly, the adoption of a common standard in a regional arrangement might make it less costly not only for domestic producers, but also for producers outside the region to sell their products. Likewise, the adoption of constraints on national state aids

would provide benefits for both internal and external producers that compete with firms that might once have received such subsidies. Tougher enforcement of antitrust policies could provide improved market access for both internal and external producers.

In empirical studies a reduction of external trade is generally an indication of trade diversion—that is, that a member of an agreement is buying products from a less-efficient internal source. However, deeper agreements could actually make regional firms more efficient. This might lead to a reduction of external trade, but it would not represent trade diversion that would reduce welfare. For example, changes in domestic regulations could give internal firms cost advantages over outsiders that would result both in fewer imports from outside the region and in lower internal costs. This concept has important implications for proposals that outsiders be compensated for their loss of trading opportunities when preferential trading arrangements are formed.

It is also possible, however, that even without raising border barriers or increasing internal trade, deeper regional agreements could become more closed to outsiders. One example would be the adoption of a common standard discriminating against external imports and raising internal costs. Another might be the adoption of common cartel-like industrial policies in the region as a whole, which would limit external producer access.

As these examples indicate, from an efficiency standpoint deeper international agreements could be better or worse than the domestic policies they replace or discipline. Deeper does not necessarily mean better or more efficient. First, the choice of the level of government is a matter of judgment and of balancing the costs and benefits of more centralized government. Mistakes could be made, and policies implemented by international agreement could violate the principle of subsidiarity. Second, much depends on the specific policies adopted. It could be much worse to harmonize on the wrong policy than to retain national policies that are not linked.

The European example is illustrative of the argument that deep integration—that is, the achievement of harmonized regional policies—could lead to either more or less protection depending on the specific nature of the policies. In particular, the EC's choice of trying to thwart market pressures in sectors such as agriculture, steel, and coal led to a Europe that was more protectionist to the outside world. In addition, the efforts by the EC to wrest control of external voluntary restraint arrangement (VRA) policies away from individual countries have probably also led to more protection for the EC as a whole. Similarly, the availability of antidumping rules has permitted producers to enjoy one-stop shopping for protection that might have been more difficult to achieve in markets that were more fragmented. There is therefore ample evidence of contamination.

On the other hand, market-conforming measures have had the opposite effect, leading to increased trade opportunities both internally and externally. European disciplines regarding state aids and other measures, which favor domestic producers, provide benefits for all who compete within Europe. Similarly, the achievement of common standards reduces costs for all who wish to sell in the market.

In sum, although traditional trade theory provides us with interesting insights into both the benefits and the costs of regional arrangements and their dynamics, the deeper aspects of these agreements suggest that they need to be viewed through more than the narrow prism of conventional trade theory. Some emerging regional arrangements are moving to deal with measures that have not been dealt with by the GATT. Some opponents of these regional arrangements actually see the "deeper" integrative aspects of these arrangements as pernicious and undesirable. They view these as mechanisms for foisting inappropriate rules and restraints on weaker, smaller—and, in particular, developing—countries. Jagdish Bhagwati, a free trade opponent of regional arrangements, views them as "a process by which a hegemonic power seeks (and often manages) to satisfy its multiple trade-unrelated demands on other weaker trading nations more easily than through Multilateralism." Free trade arrangements seriously damage the multilateral trade liberalization process by facilitating the capture of it by extraneous demands that aim not to reduce trade barriers, but to increase them (as when countries seek to deny market access on grounds such as ecodumping and social dumping) (Perroni and Whalley 1994; Bhagwati and Krueger 1995).

It is indeed likely that in negotiations between countries of differing market sizes an asymmetrical power relationship will exist. However, this does not mean that poor, small countries will lose in these associations. Indeed the power asymmetries reflect the fact that the gains, particularly those from realizing scale economies, are likely to be relatively larger for the smaller countries. Similarly, economic integration generally leads to convergence, with poorer economies growing more rapidly than richer economies. Moreover, small countries join these agreements voluntarily.

Indeed, if the NAFTA or the Canada-U.S. Free Trade Agreement (CUSTA) had been seen as U.S. initiatives, they would have been doomed politically from the start. In both cases the governments and firms of these countries saw these agreements as in their own interests, and not simply because they feared American protectionism. The same is true of the eastern European nations that are voluntarily seeking to join the EU and those in Latin America that are seeking a hemispheric arrangement with the United States. Finally, particularly in agreements with the EU, aid has been made part of the package.

Moreover, although countries seeking to join these arrangements may have to make "concessions" by adopting some rules and institutions that may not suit their needs perfectly, they also enjoy benefits from adopting institutions without having to incur the costs of developing them. Just as

several European countries have sought to import the anti-inflation credibility enjoyed by the Bundesbank by pegging their exchange rates to the German mark, so countries can make their regulatory policies more credible through international cooperation.

The strong role played by corporations in promoting regional integration has been noted. Recognizing this role provides insight into both the promise of and the problems with the current regional initiatives. The promise is represented by moves toward deeper economic integration than is currently feasible under the GATT. Regional agreements can make progress in harmonizing domestic policies and providing more credible and more effective supranational governance mechanisms than the WTO. On the other hand, there is the concern of regulatory capture: that under the influence of companies new systems of rules will be set to help insiders and hurt outsiders. Skeptics such as Bernard Hoekman (1992), Anne Kreuger (1993), and Raymond Vernon (1994) are particularly concerned that although they masquerade as free trade agreements, the new arrangements have been severely compromised by intricate rules of origin and other loopholes that may actually represent a retreat from freer trade rather than a movement toward it.

In addition to the traditional problem of trade diversion, there are two other major risks with regional agreements. The first is that they could implement new forms of protection not by erecting new tariffs, but by implementing rules of origin and administering antidumping and countervailing duties that have protectionist effects. The second is that some countries may join regional arrangements even when the rules they provide are inappropriate for their levels of development.

Notes

1. Originally the charter for the International Trade Organization covered a broader range of issues, including restrictive business practices and labor standards, but it was never adopted.

2. To be sure, these principles were not always fulfilled, as exemplified by the failures to liberalize agricultural trade and the discriminatory treatment of exports of textiles by developing countries in the Multi-Fiber Arrangement.

3. In the 1970s, therefore, the developing countries receiving the largest foreign investment flows were Brazil ($1.3 billion annual average inflow), Mexico ($600 million), Egypt ($300 million), Malaysia ($300 million), Nigeria ($300 million), and Singapore ($300 million). See United Nations Center on Transnational Corporations (1992: 317). Of these only Singapore was an open export-oriented economy.

4. Between 1980 and 1990 the list of developing countries receiving the largest annual average inflows of FDI was headed by Singapore ($2.3 billion), followed by Mexico ($1.9 billion), Brazil ($1.8 billion), China ($1.7 billion), Hong Kong ($1.1 billion), and Malaysia ($1.1 billion). Of these only Brazil has not emphasized export-oriented investment.

5. Economic theory tells us that letting in more imports will tend to stimulate exports through various channels. First, increased imports could lower the exchange rate and promote exports. Second, cheap imported inputs could improve export competitiveness. Third, if resources are freed from import activities, they can be used in export industries. These arguments are very subtle, and effects operate through indirect channels that are not readily appreciated. This makes unilateral liberalization politically difficult even when it is economically beneficial.

6. The same would be true for multilateral liberalization if it was made conditional rather than unconditional.

7. Between 1990 and 1994 Chile signed free trade agreements with Mexico, Argentina, Bolivia, Venezuela, Colombia, and Ecuador; Mexico signed NAFTA and free trade agreements with Chile, the Caribbean Community (CARICOM), Costa Rica, Bolivia, Colombia, and Venezuela; Argentina signed agreements with Brazil, Chile, Bolivia, Venezuela, Ecuador, and the MERCOSUR; and Bolivia signed agreements with Uruguay, Argentina, Peru, Chile, and Brazil. See Inter-American Development Bank (1995: 217).

8. In the case of some agricultural products, the United States and other nations demanded compensation.

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