REGIONALISM AND MULTILATERALISM
IN THE TWENTY-FIRST CENTURY

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"Who but a staunch protectionism could have anything against a 'free trade agreement'? 'Preferential trade agreements' sound less benign, while 'Discriminatory trade agreements,'" yet another name for the same thing, sound nasty." Martin Wolf, Financial Times, 28 October 1996.

The growth of regional trading blocs has been one of the major developments in international relations in recent years. Virtually all countries are members of a bloc and many belong to more than one; more than one third of world trade takes place within such agreements. Regional agreements vary widely, but all have the objective of reducing barriers to trade between member countries and hence, implicitly, of discriminating against trade with other countries. At their simplest they merely remove tariffs on intra-bloc trade in goods, but many go beyond that to cover non-tariff barriers and to extend liberalisation to trade investment and other policies. For want of as better term, I shall call them all Regional Integration Agreements (RIAs), and the process of creating them 'Regionalism'.

During the last decade the move to regionalism has become a headlong rush. Of the 212 agreements that had been notified by the beginning of 1999, 128 had come in since 1990 (WTO web-site). Recent regionalism has also shown some qualitative changes. First - in line with prevailing views about national economic policy - new wave RIAs – including the resurrections of some old agreements – have generally been more outward looking than earlier ones, and more committed to boosting, rather than controlling, international commerce. Second, integration has more frequently moved beyond reducing tariffs and quotas to so-called 'deep integration'. And third, we have seen the advent of trade blocs in which both high-income industrial countries and developing countries are equal partners – so-called North-South agreements. Along with these developments has been a change in rhetoric in which the principal debate has been about whether regionalism is either favourable or unfavourable to multilateralism. This latter question dominates our discussion below.

'New regionalism' of the kind just described has been as prominent in Latin America as anywhere, and so it is appropriate to review its progress in this region. I start this paper by trying to define regionalism and its obverse, multilateralism, more fully. I then consider some of the important recent results on regionalism; this is based substantially on a major World Bank study of regionalism and developing countries that I initiated some years ago with Maurice Schiff.[1] This discussion considers issues central to the member countries of RIAs in Part II and those pertaining to the members' interactions with the rest of the world in Part III. Finally, I pose some questions to you as policy-makers, both to focus our discussion at the Dialogue and because I want to know the answers.

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[1] A brief and accessible account of the World Bank project is given in World Bank (2000); a fuller account is forthcoming in Schiff, Winters and Hoekman (forthcoming). Among my previous attempts to consider some of these issues are Winters (1997, 1998a, 1998b, 1998c) and Schiff and Winters (1998a). I do not overload the text below with references, so interested readers should refer to these publications for further details.

PART I REGIONALISM AND MULTILATERALISM

Much of the current debate about regionalism is in terms of its merits relative to multilateralism. But what do these terms mean? By 'regionalism' I mean any trade agreement between a small number of trading partners to reduce mutual trade barriers; these are usually regional in nature but not be.

'Multilateralism' is much more difficult to define for our purposes – see Winters (1999a) for some agonising on the subject. One important approach, due to Ruggie (1992), focuses on process and behaviour—the "ism" bit. He sees multilateralism as a deep organizing principle of post-war international life with three defining characteristics:

- Indivisibility — the system is a whole in that the actions of one party affect all parties and each party acknowledges its allegiance to the single whole;
- Generalized rules of conduct—interactions between parties are governed by widely recognized general principles, rather than ad hoc or particularistic interests;
- Diffuse reciprocity—all parties expect to gain from the system, but do not demand precise reciprocity from every separate transaction.

The translation of these principles into concrete form in the international trading system is pretty straightforward. It is indivisible in that it permits an extremely dense and far-reaching network of trade links and of intergovernmental contacts and is viewed as having an existence separate from all the individual trade links between participants, and in that its separate existence is seen as valuable. The trading system's most obvious generalized norm is non-discrimination (MFN) which immediately and automatically extends bilateral agreements to all members. Reciprocity is diffuse in that governments do accept individual actions that appear not to be in their immediate interests, but it is generally accepted that, overall, every country has to gain.

On these criteria, regionalism clearly undermines multilateralism, as it defies MFN. It is also divisive, as it exacerbates tendencies for parties to focus more strongly on some links than others. One defense is that regionalism is subject to generalized rules that all have agreed, and that indivisibility should not preclude having some links stronger than others. The former merely recognizes that the world trading system is imperfectly multilateral, while in practice the latter depends on whether governments shift their focus from general to particular trade relations. Since RIAs certainly shift foci to some degree, regionalism does corrode the multilateralism of the global trading system, if only mildly at present.

Economists, however, are more concerned with outcomes than with processes. Hence most economic discussion focuses on actual trade and trade policy, and in these terms the definition of multilateralism is surprisingly murky. I take multilateralism in this sense to be a function of the degree of discrimination and the overall degree of trade restriction, both negatively. Strictly only the first is necessary, but in its everyday use, economists and policy commentators clearly imbue the term 'multilateralism' with a sense of liberalism as well.

In the economists' sense regionalism clearly violates the non-discrimination axiom of multilateralism, but if it moves the world towards freer trade, perhaps it helps in the other dimension. At least the question is worth posing. In fact that question absorbs the largest part of the rest of this paper. I consider it in terms of both individual countries – does regionalism help them pursue efficient and liberal trade – and the system as a whole. The next section sketches some analytical results on the matter.

PART II: SOME RECENT RESULTS ON MEMBER ECONOMIES

Regionalism as trade policy

The basic economics of tariff preferences is fifty years old (Viner, 1950), but it is central enough to be re-iterated here. Forming an RIA almost always increases trade between its members: the issue, however, is whether it "creates" trade by allowing cheaper products from other bloc members to substitute for more expensive domestic production, or "diverts" it by substituting intra-bloc imports for imports from outside the group. The latter can happen when 'outside' goods would be cheaper if all suppliers faced equal tariffs, but the fact that 'inside' goods no longer face tariffs gives them a competitive edge. In that case, the preference-granting country ends up paying more for the imports, the increase being financed by monies that were initially going to the government in tariff revenues now accruing to producers in the partner countries. Part of this extra cost is a simple transfer from the taxpayers in the importing partner to producers in the exporting partner, but because the real cost of imports has risen (the partner is less efficient than 'outside' producers), real resources are also wasted by the diversion. When all the commodities covered by the RIA are considered together, if trade diversion predominates, an RIA can reduce all or some of the member countries' welfare.

Identifying and distinguishing between trade creation and trade diversion is not straightforward empirically. The greatest difficulty is deciding what trade would have looked like if no RIA had been formed – the counterfactual or what the Europeans refer to as the *anti monde*. This is more a matter of judgement than of science, particularly when it comes to considering whether regionalism is central or incidental to the general liberalisation of trade with all countries. The evidence on the balance between trade creation and diversion in trade blocs is mixed, but recent research that shows that, contrary to what was becoming received wisdom, diversion can be quite significant – e.g. Bayoumi and Eichengreen (1997). For the recent Latin American RIAs, however, diversion has usually been dominated by the trade creating effects of the partners' reductions of barriers against imports from non-partners that have accompanied the RIA – e.g. Soloaga and Winters(1999). Thus whether the latter is or is not part of the process of regionalism is critical to our view of it.

The traditional analysis of trade creation and diversion is based on a view of the world in which inter-country trade is driven entirely by differences in productivity and factor endowments. In fact trade can also arise from product differentiation and economies of scale, which reduce costs as production grows. In such worlds import barriers are additionally costly because competition between firms is weakened and consumers lose from the resulting cuts in output and increases in price. Then, international trade offers an important means of increasing competition by allowing new suppliers to enter markets. RIAs can generate such benefits by fostering trade between members, combining larger firm sizes (which increases economies of scale) with competition between larger numbers of firms (which increases competition). This is possible because by combining several national markets, the number of producers in each country might fall, while the number of sellers with reasonable access to each market rises (because producers from partner countries now have access).

These so-called pro-competitive effects are believed to have been strong during the course of European economic integration, but the empirical evidence is not yet complete that developing countries will be able to reap them in large amounts. Partly that reflects the latter's production structure, with fewer goods in which differentiation and economies of scale are important, and partly the fact that significant increases in competition eventually depend on far more than merely removing tariffs and import quotas. Also, of course, if the aim is large markets and buying from firms that supply large markets, no market is larger than the world as a whole. That is, pro-competitive effects will be larger from non-discriminatory trade liberalisation than from discriminatory or restricted liberalisation.

Making the Most of Regionalism

Why is regionalism so popular if it is just a pale imitation of non-discriminatory free trade? This sub-section considers just the basic international trade aspects of the question, and then asks how various design features of an RIA might affect its net benefits.

Among the trade reasons advanced for RIAs, are that members might:

- be better able to exploit market power against outsiders by co-ordinating their trade policies.
- place a very high value on access to partners' markets and feel that this is better assured by making access to their own conditional on reciprocation and that they prefer preferential access to non-preferential access.
- want to exploit the regional market as a basis for protected industrialisation.

I do not find these arguments convincing. The first is exploitative, the second amounts to trading inefficient market access with each other, and the third is refuted by experience.

Clearly, the benefits of regionalism are likely to depend on finding the best partners. However, the popular notion of a 'natural' trade partner is not useful in this regard. Neither large existing trade volumes nor low transportation costs are good reasons for artificially favouring a particular trade flow – Amjadi and Winters (1999) and Schiff(1999). The former show that while trade costs are high for Latin America's trade beyond the continent itself, the conditions necessary to reap any benefits from concentrating trade into a lower-cost intra-continental structure are absent. Bond ##(1998) also neatly points out that there is no presumption that infra-structure investment in Latin America should be devoted to facilitating intra-continental trade. RIAs might stimulate intra-continental flows, but because it is subject to higher policy barriers, it is extra-continental trade that offers the bigger returns to expansion. Thus reducing the latter's costs via investment is likely to be at least as useful as increasing the capacity for intra-bloc trade. Besides, ports devoted to trade with the world are inherently more flexible than roads or bridges devoted to local trades.

One interesting recent result is that if two countries form an RIA, the one which is (in a particular sense) more similar to the world average will tend to gain more than the one which is less similar – Venables (1999). If the two countries have above average incomes, this tends to lead to convergence between the two partners, but if they have below average incomes (i.e. the RIA is between developing countries), it causes divergence. There are also several reasons behind the obvious tendency for trade blocs to form between neighbouring countries (i.e. for regionalism to be regional): for example, to reduce trade costs by relaxing or abolishing border formalities or to assist in the collection of tax revenues.

One of the recurring themes of our work is a preference for North-South over South-South RIAs for developing countries. If a developing country is going to pursue regionalism, it will almost always do better to sign up with a rich and large country than a small and poor one. In trade terms, this is manifest in the fact that a large rich country will likely be a more efficient supplier of most goods and a source of greater competition.

Many Latin American countries are members of several RIAs. If they are all compatible this may be beneficial – it implies free trade with more countries. But there are also dangers. For example, the several RIAs may imply conflicting policies vis-à-vis third countries, they may have different regulations governing imports of the same commodity from different sources, or they may imply different technical standards. All of these increase the complexity, cost and uncertainty of trade. There is also a danger in hub and spoke arrangements, whereby one country has free trade with many others which do not have free trade between them. In this case, the former – the hub –

has very considerable advantages as a location for economic activity and might suck firms and investment out of its partners.

An important distinction is between free trade areas (FTAs) which have free trade between members and customs unions (CUs) which have that plus a common external tariff or, strictly, common trade policy towards third countries. FTAs are easier to create and can be institutionally very light, whereas CUs require the negotiation of the common external tariff and co-ordination of all future trade policy changes. FTAs, however, face the danger of trade deflection – goods entering the member with the lowest tariff and transferring tax-free to other members from there. Except for the extra transportation cost, this is efficient economically because it lowers the effective tariff, but it undermines the protective effect of members' own tariff structures. Therefore, governments seek to prevent it by imposing rules of origin (RoOs) to ensure that only locally produced goods get tariff exemption. Such rules are often cumbersome and protectionist and can greatly reduce the value of the FTA. CUs, by avoiding this problem, can induce a greater degree of integration – Krueger (##).

Another important difference between FTAs and CUs lies in the incentives they create for operating a liberal (i.e. low barrier) trade policy towards non-members; there is a tendency for FTAs to be more liberal than CUs. They have less market power and might compete with each other to reduce tariffs and so enlarge their share of the RIA's imports and hence tariff revenue. Once we recognise that lobbying influences tariffs, it becomes plain that it will afflict FTAs and CUs too. For both, there is a presumption that the exceptions to internal free trade negotiated as the RIA is formed will tend to reduce the degree of trade creation, and so reduce the potential benefits. Olarreaga and Soloaga (1998) and Olarreaga, Soloaga and Winters (1999) show the importance of these political factors in the determination of the internal and external trade policies of Mercosur countries. And in the case of CUs, the RIA will change the environment for future lobbying, although whether this will be towards or away from greater protectionism, however, is impossible to say *a priori.* Clausig (2000) discusses the trade-off between RoOs and external tariff levels in the FTA vs CU debate.

Finally, if countries have to use tariffs for revenue purposes, it may appear to pay small developing countries to combine into a single market to reap economies of scale and enhance competition, while raising revenue on trade with the outside world. In fact, this is not a watertight argument: raising revenue on a smaller tax base (i.e. on imports from non-members rather than all countries) requires an increase in tariff levels, which will be welfare worsening. Moreover, there are other potentially complex revenue issues to consider: e.g. how to raise the revenue lost by removing tariffs on intra-bloc trade and how to avoid fiscal competition between members reducing taxes below optimal levels.

Regionalism and Investment

Raising investment is a prominent objective of many regional agreements. The logic is that larger markets, greater competition and improved policy credibility will increase the incentives for investment and so raise incomes. The argument applies to all investment, but is most explicitly applied to regionalism as a means of attracting foreign direct investment. Ethier (1998) composes a paean to regionalism on this basis, although see Winters (1999b) for some reservations about his model.

Early Latin American RIAs were interventionist, co-opting regional integration into import substitution at a regional level. Such policies almost completely failed and have now been superseded by a much more market friendly approach. Part of the latter has been a greater emphasis on policies guaranteeing the fair treatment of investment. These guarantees are often embodied in Bilateral Investment Treaties (BITs), or, where they exist, the investment chapters of RIA agreements. BITs typically contribute to negative integration – i.e. precluding certain policies rather than requiring policies to actively encourage investment – but they may play an important facilitating role in investment flows.

Far more positive in intent is the common argument that RIAs add credibility to government policies in general and thus help to raise investment and attract FDI. But contrary to the prevailing enthusiasm, South-South RIAs are unlikely to do this and may, in fact, hinder investment if they are not accompanied by trade liberalization with the rest of the world. North-South RIAs, on the other hand, can enhance a Southern country's credibility, but typically, only if the RIA is likely to enhance economic performance in its own right and if the large Northern partner is willing to enforce investment-encouraging "club rules". The latter is more likely to be true if the policies on which a developing country wants to gain credibility are specified explicitly in the agreement and if the Northern partner has an identified interest in the Southern partner's success – e.g. alleviating pressure to migrate.

Recent analysis holds that the rate of return on capital (and investment) could well rise in all members of an RIA regardless of their capital abundance – e.g. Baldwin and Seghezza (1996). For example, if tradables are more capital-intensive than non-tradables, opening up boosts the demand for capital; lower tariffs and trading costs for capital equipment might reduce the price of investment goods; and creating a more efficient financial sector could reduce borrowing costs. Unfortunately there are few empirical studies of the impact of RIAs on investment—most trade blocs are so new that the data are simply not there. Where we do have evidence, it tends to suggest mild positive effects on investment, but there is no evidence that this translates in to higher economic growth. Firmer evidence is available that RIAs boost FDI, however, especially inflows of investment from non-member countries. In Latin American, both Mexico and Mercosur illustrate this.

The real key to investment is the general policy stance in areas such as sound macroeconomic policies, well-defined property rights, and efficient financial and banking sectors. Regional integration may foster investment if it significantly raises policy credibility and market size, but it needs to be accompanied by good policy overall.

Industrial Location and Growth

While economists have long been aware of the fact that industry tends to cluster into particular locations, they have only recently learned to model the phenomenon formally and thus to start to identify precisely the combinations of conditions that must be satisfied for it to occur. The theory arose from attempts to understand the possible effects of the enlargement and deepening of the European Union – Krugman and Venables (1990) – and so lends itself directly to the consideration of RIAs. The theory is, however, very young; the models do not yet appear to be very realistic and have not yet been accompanied by much empirical evidence. Thus they are more parables than forecasts. However, they do shed light on qualitative factors and they address such a major concern of policy makers, so it useful to explore their implications for developing countries.

Creating an RIA is likely to affect the incentives for industry to agglomerate, usually to increase them because it increases market size and allows more effective exploitation of the links between firms – Fujita, Krugman and Venables (1999). An RIA may attract industry into member countries at the expense of non-members, although if the RIA is small, such effects will also be very small. RIAs will also frequently cause industry to relocate between the members. For RIAs between poor countries this seems likely to increase inter-member inequalities because it makes it easier for firms to agglomerate in the more prosperous countries while still selling in the others. For RIAs involving richer members, on the other hand, the results are less clear cut, and it is quite possible that poorer members will experience strong industrialization following an RIA. For developing countries, integration with richer neighbors (North-South RIAs) looks far better from an agglomeration point of view than does South-South integration.

The same preference for North–South over South-South RIAs arises from the discussion of long-run growth. Modern growth theory – the theory of endogenous growth – stresses the role of knowledge in fostering productivity and growth. It also stresses that knowledge can be effectively transferred from one country to another through international contact and trade. Rich countries are knowledge-rich and so are likely to provide far more access to technology than are poorer trading partners: RIAs that switch imports from richer to poorer sources are very likely to have a perverse effect on countries' growth rates[2]. RIAs might also help countries boost their growth rates by supporting institutional reform, and again this effect seems likely to be stronger for developing countries joining with richer partners than with poorer ones.

The direct evidence on trade and growth is subject to some serious methodological reservations – see Rodriguez and Rodrik (1999) - but that on RIAs and growth is actually pretty consistent. There is little evidence that RIAs between developed countries stimulate growth, but there is absolutely none that RIAs between developing countries do so – see, most tellingly, Vamvakidis (1999). Given that one needs long runs of data to explore economic growth, we do not really have any sound empirical evidence on North-South RIAs. Casual consideration of the recent performances of, say, Portugal, Poland and Mexico, however, suggests that serious North-South integration may foster the Southern partners' growth, reinforcing the views above about the relative merits of the two types of partners for developing countries. As above, however, there are formidable problems in defining an *anti-monde* to underpin such statements.

Integrating Domestic Policies

The discussion so far has concentrated just on trade and investment policies, the standard building blocks for analysing international intercourse. But as trade barriers have come down policy makers have started to understand the very important role that domestic regulation plays in economic integration. Cooperation on domestic policies can substantially increase the gains from forming a trade bloc. It can lift barriers that insulate national markets for similar goods and services and deliver economic benefits many times those available from mere trade agreements. Inter-governmental cooperation in designing and applying domestic policies such as taxes, health and safety regulations, environmental standards—so-called policy integration—can increase competition in domestic markets by reducing transactions costs and allowing new suppliers to enter markets. Cooperation on domestic policies can also help to overcome market failures and help to ensure that trade restrictions are not re-imposed through the back door.

However, most RIAs have only "shallow" policy integration aims. Their objective is not economic union (which requires institution-building of a type we term "deep integration"), but to increase competition through inter-governmental cooperation to reduce market segmentation. The FTAA is discussing policy integration, and some existing Latin American agreements also speak of pursuing it further. However, without specific timetables for progress and further negotiation, none is likely to make great progress. Experience suggests that negotiated policy integration is very demanding both politically and technically. Moreover, RIAs are not the only game in town. Indeed, independent decisions to adopt policies used elsewhere and to pursue multilateral efforts on international technical and regulatory standards have been more common than regional efforts. Developing countries can do much to achieve the benefits of policy integration unilaterally by adopting international standards and recognizing the regulatory norms of their major markets, such as the EU and US.

One puzzle is 'why combine policy integration and trade integration into the same institution?' The trade component of an RIA can provide specie to help overcome opposition to institutional and domestic policy reforms, and policy integration can assist the implementation and

[2] This is an implication of Coe, Helpman and Hoffmaister's (1997) work, although not one they bring out. Fukase and Winters (1999) explore it more fully.

enforcement of RIA trade policies. Of course, such linkage does not excuse selecting sub-optimal trade and domestic reforms, but if both are desirable in their own right, combining them might be politically efficient.

Wherever possible policy integration that reduces regulatory costs should extend beyond RIA partners to non-members—so that the increase in competition is maximized and policy integration benefits all trading partners. Formal inter-governmental agreements—such as mutual recognition arrangements for product standards and testing—may be necessary for policy integration, but special efforts should be made to ensure that these do not perpetuate or increase discrimination. Discriminatory policy integration - such as including preferential rules of origin in mutual recognition agreements - should be resisted.

Competition between regulatory regimes coupled with mutual recognition is often the most efficient route to policy integration. Some element of harmonization may be called for if there are spillovers—such as a threat that the competitive relaxation of merger regulation will lead to a "race to the bottom"—or to safeguard public health or safety. These are generally best limited to minimum standards based on global norms. RIAs can serve as focal points for adopting and enforcing global minimum standards, but regional standards that diverge from global norms will be optimal only if there are region-specific characteristics.

The WTO and other multilateral institutions can play a large role in policy integration. The WTO agenda is as broad—and often broader—than that of most RIAs, and more can be done in the WTO context than is often recognized by trade bloc proponents. It could help further by adopting a rule extending the MFN principle to policy integration initiatives—such as customs clearance documentation and procedures—that do not require formal inter-governmental equivalency or recognition agreements. It would also be desirable in theory for all countries to have the right to negotiate membership of any policy-integration initiative, but as I argue below, this can not be operationalized effectively.

Policy integration proposals are very specific and should be evaluated on their individual merits. Care should be taken that they are for the general good, and that other than as part of a necessary coalition for achieving reform, efforts to link them to trade liberalization should be resisted. While integrating domestic policies may sometimes require formal agreements, there is no fundamental reason why this should require trade preferences. The EU and US have, for instance, drawn up a series of mutual recognition agreements for sectoral product standards completely outside an RIA context. To date, however, developing countries have been entirely excluded from such initiatives.

Regionalism as Politics

Countries sometimes form trade blocs for so-called non-economic reasons, such as national security, peace, and help in developing political and social institutions. These are public goods, and so are unlikely to be efficiently provided in the absence of some form of intervention - of which creating an RIA is one. Such political objectives can be important for RIAs, sometimes overwhelmingly so, but it is still desirable that they be achieved efficiently and that policy makers pay heed to their economic cost.

Political benefits such as peace and security can sometimes swamp the simple material considerations that usually determine economic policy. Moreover, since such benefits are typically shared by only a limited number of countries —usually neighbors— they are likely to be better sought on a regional basis than multilaterally. Thus this issue forms a relatively more important part of the analysis of RIAs than of some other international issues. Schiff and Winters (1998b) show that under some circumstances, the formation of an RIA may be an effective way to deal with security tensions between neighbouring countries; the argument is essentially that mutual trade fosters peace between countries and regionalism fosters trade. They show that for such a ‘political’ RIA, the optimum tariff on imports from non-members declines over time, and also as integration deepens. Mercosur may have experienced such political benefits on relations between its two major members.

Joining an RIA with large democratic countries can help a developing country to achieve or uphold democracy if the RIA imposes “club rules” such as democracy and civil rights on its members. This assistance is likely to be more effective if the other members are large economically because larger partners are generally able to impose greater costs on (withdraw greater benefits from) recalcitrants than are smaller ones. It is also likely to be more effective if the developing country in question is of a reasonable size, and if its potential partners are close by. A partner country is likely to be far more concerned about possible spillovers from events in a significantly sized and nearby developing country than elsewhere. Mexico may be one example of this sort of effect; Mercosur’s role in Paraguay in 1996 is another.

A concern in many RIA members is whether increased regional integration will weaken the nation-state. On the contrary, pooling sovereignty and undertaking collective action can enhance the effectiveness of the state in small or even medium sized, nations. They can assist in solving economic problems, strengthen countries against third-country security threats, and increase international influence by lowering negotiation costs and/or increasing bargaining power in dealings with the rest of the world. Caricom is the archetypal success in negotiating terms – Andriamananjara and Schiff (1999)##. As I argued above, however, cooperation of this kind does not usually require trade preferences.

PART III REGIONALISM AND THE REST OF THE WORLD

As we have seem regionalism affects multilateralism through its effects on the bevahiour and performance of the member countries, but perhaps more directly it also affects the interactions between countries within the international economy and community. This section considers some of the latter aspects. Regrettably, many of the arguments are essentially speculative. First, we just do not have enough observations of long-lived regionalism to make empirical judgements. Second, as we enter the twenty-first century we are dealing with a completely new world of many active trade blocs as opposed to the twentieth century model of a multilateral world with a few blocs.

The Excluded Countries

RIAs are, by nature, exclusive clubs. After all every country in the world is excluded from nearly every RIA in the world, and every RIA excludes nearly every country. Their discrimination against excluded countries is real and, according to the latest evidence, causes significant trade diversion in some cases. Trade diversion is mainly a cost to the partners who pay more for their imports, but in two sets of circumstances, it can be costly to the excluded countries which lose exports.

First, if exports generate super-normal profits, losing them is costly because the income lost exceeds the value of the resources freed up by not having to produce them any more. One example would be if the exporter could charge monopoly prices. A second, more important one, is where exports are taxed, because the tax-inclusive price received for them exceeds the cost of the resources used up in production. Export taxes are rare, but trade theory teaches us that import taxes are export taxes – it is the act of trading (turning exports into imports) that is taxed and it doesn’t matter which side of the transaction formally faces the tax. Thus, any of the many countries with significant tariffs will lose welfare if its exports fall exogenously.

The second case where trade diversion hurts exporters is if the decline in demand forces down export prices – i.e. worsens the exporter’s terms of trade. Chang and Winters (1999) present new evidence that this is significant empirically for Brazil’s imports of goods following the creation of Mercosur. The prices of US exports fall so far that the USA could lose over half a billion dollars per year in economic welfare!

Stepping Stones, Dominoes and Open Regionalism

Possibly even more important than the static losses suffered by excluded countries is the issue of whether RIAs are steppingstones toward the long-run goal of globally freer trade, or millstones slowing progress towards it. The world of many trade blocs is still too new to allow a definitive empirical answer to this question, and economic theory is not completely clear on the matter, but my reading of the case is that there are significant dangers that regionalism could start to undermine the multilateral trading system – Winters (1999a). Certainly, it hits at one of the corner stones of procedural multilateralism – the equal treatment of all.

In terms of outcomes, the majority of analyses of the effects of bloc-formation on the tariffs that non-co-operating governments would charge each other suggest that tariffs tend to increase with the spread of regionalism. In some cases regionalism has been argued to bring other countries to the negotiating table to agree a new round of multilateral trade liberalisation – e.g. the formation of the EEC and the Kennedy Round – but I would argue that this is far from certain and that using such coercive tactics to get others to reduce their tariffs is extremely dangerous.

It is also possible that one act of regionalism would be met by another – giving rise to so-called domino regionalism. This seems to lie behind much of the spread of regionalism over the 1980s and 1990s) – for example, when Canada sought access to the US-Mexican talks that eventually created NAFTA, and with several Latin American and Caribbean countries seeking accession afterwards; with Chile and Bolivia seeking association with Mercosur; with Mediterranean countries racing to get Euro-Med Agreements; and even perhaps with a number of late entrants seeking membership in the Cross Border Initiative in Africa. It is important to note, however, that under such conditions one can not infer that, because regionalism is spreading, it is benign. If everyone is in a gang, you may want to belong to one yourself, but that does not make gangs a good thing.

One of the analytical problems with domino regionalism is that although enlarging an RIA might increase the incentives for new members to join, it does not correspondingly increase the incentives for existing members to let new ones in. Particularly if RIAs discriminate against excluded countries, insiders will want to stop expansion well short of the whole world – there is no point being on the inside if there is no one on the outside to exploit. For example, NAFTA has rejected overtures from many countries, and APEC had a moratorium an accession from 1993 to 1996, although in fairness, these instances were probably more to do with avoiding the strains of additional adjustment for members (especially the USA) than any exploitative intent.

It is sometimes argued that one way around the problem of blockaded entry would be to insist on open access to all RIAs – i.e. that any country that could adhere to the rules of an RIA could join it and reap its benefits. In theory, this may be true, but in practice, given that accession has to be negotiated because the rules of nearly all RIAs entail more than just tariff reductions, there is no operational way to insist on such access. Related, is the concept of ‘open regionalism’, which has several definitions – Bergsten (1997). I see this as more a slogan than an analytical tool, for, according to the definition, it either reduces to something else (e.g. concerted unilateralism or multilateralism) or it does not separate ‘good’ RIAs from ‘bad’.

Trade Blocs and Trade Negotiations

If RIAs made trade negotiations easier, perhaps they would help the world evolve toward freer trade. [LW1]Co-ordinated coalitions may have greater negotiating power than their members individually and such coalitions may facilitate progress just by reducing the number of players represented in a negotiation (Krugman 1993##, Kahler 1995##). But this result is not guaranteed.

For example, a negotiation comprising one dominant partner and a competitive fringe of small countries might be easier and proceed further than if the fringe coalesced into a significant counter force. However, if the blocs are genuinely unified it is probably reasonable to expect negotiations to be easier with fewer partners.

Unfortunately, however, this condition is rarely met, so that any gains from having fewer players in the last stage of a negotiation are offset by the complexity of agreeing joint positions in the first phase.[LW2] The difficulties of achieving a European position on agriculture and cultural protection in the Uruguay Round are well known, and formulating EEC positions in the Tokyo Round proved complex (Winham 1986##). Moreover, two-stage negotiations need not be more liberal than one-stage ones (Basevi, Delbono and Mariott 1994-JOICE##). To be sure, Germany and the United Kingdom pressured France to agree to the agricultural deal in the Uruguay Round, but the liberalizers had to make potentially trade-restricting concessions on "commercial defense instruments" to clinch the deal.

The CUs that attend the next round of global trade talks will need to establish procedures for determining their negotiating positions. SACU's previous practice of delegating all responsibility to South Africa begins to look less tenable as divisions emerge between members, and Mercosur has yet to devise really robust internal decision-making capacity. Thus, at least into the foreseeable future, RIAs do not seem likely to facilitate even a traditional trade negotiation.

Moreover, as WTO has extended its reach, it has embraced subjects in which most central CU authorities have no mandate to negotiate. Mixing national and CU responsibilities seems unlikely to simplify matters, and it is not realistic to expect member countries to surrender sovereignty on sensitive issues to regional bodies just because trade negotiations are in train.

Tough Issues

RIAs are also suggested as ways of developing blueprints for technically complex issues before they come to the global level, or as ways of tackling politically difficult issues that can not yet be agreed globally. In fact, this is not as widespread as is sometimes thought – RIAs often avoid difficult issues. Moreover, is regionalism actually more effective in liberalizing deeply than multilateralism? Has global liberalization actually been ruled out or, if RIAs were not an option, would a little more time and effort yield global progress? Having got the ball rolling, will RIAs later slow it down for the reasons discussed above? On a prescriptive note, to the extent that RIAs are justified in terms of opening up otherwise closed sectors, it is important to ensure that the subsequent switch from regionalism to the multilateral track is managed effectively. The necessity for, and the means to achieve, this switch should be written into the initial terms of RIAs.

One danger of the regional approach is that the major powers seek to use RIAs to reinforce their initial positions in future multilateral negotiations. If major players have greater politico-economic power within their own regions than in the world in general, it is easy to imagine their building up coalitions for their own policies before taking issues into a multilateral round. Arguably, the United States used approaches by potential partners in the Americas and Asia to broaden the negotiating agenda for its relations with Europe (Ostry, ##1998), while Europe did the same with the EEA and its Europe Agreements.

The benefits of developing regional blueprints depend heavily on whether they are liberalizing (Bhagwati, 1993- de Melo/P##) and whether they are otherwise well suited to developing country needs and capacities. Major powers already use access to the GSP to impose environmental and labor conditions on developing countries; the EU looks for action in such areas and on intellectual property in the Europe Agreements and the US has used NAFTA as a tool for enforcing Mexican labor and environmental standards. By undermining the natural cohesion of developing countries on these topics in the WTO, RIAs could lead to very different outcomes than will straight multilateralism. It is likely that the outcome will suit developing countries less well, and may be less open and liberal as well.

Moreover, there are dangers in such tactics. First, even if the majors' aspirations are desirable in their own terms, building up rival teams can make final negotiations more, rather than less, difficult. Second, even when only one regional bloc is advocating a policy, other countries might sufficiently resent the pressure to adopt it that they pull back. Developing country *de facto* rejection of the OECD draft Multilateral Agreement on Investment in 1998 contains at least elements of this. Third, the time it takes to build regional coalitions can delay multilateral talks. Fourth, coalitions rooted in formal RIAs are here to stay, so that if multilateral processes fail, the blocs remain. This is quite different from a negotiating coalition, which dissolves if it fails to gain its objectives.

To be sure, progress is required in "new" areas such as standards, but it is frequently better pursued independently of tariff preferences. Thus, while we may as well learn from RIAs about how to tackle particular aspects of liberalization, this is not a convincing reason for pursuing regionalism per se.

Regionalism and the WTO

One can not treat the issue of RIAs and the rest of the world without considering the way in which the WTO handles RIAs. While far from perfect, the current rules for industrial countries are probably about as good as we can get, but they are currently very poorly enforced. Those for developing countries are looser and make it even easier to create welfare-reducing RIAs. I advocate unifying the rules on the industrial country model and enforcing them more actively. But rules can not define benign regionalism: responsibility for ensuring that RIAs do not harm their members falls squarely on the governments that pursue them. In this they would be aided by a very much clearer set of studies of the economic effects of regional blocs than the current legalistic approach requires.

PART IV PROVOCATIVE QUESTIONS FOR POLICY-MAKERS

I was asked to prepare some provocative questions for you as policy makers, to focus your discussion on concrete aspects of the regionalism issue. I hope the questions below do this, but I also look forward to hearing your answers/discussions for my own purposes. The questions are crucial to the assessment of regionalism and yet very hard to analyse with only 'outside' data at one's disposal.

1. How many political and bureaucratic resources are used up in negotiating and operating regional arrangements? How do you know that they are better spent in this way than on unilateral or multilateral trade policy, or on something altogether different?

2. Is the FTAA more attractive to you than a deep multilateral (WTO) round of trade liberalisation would be? If so why? Because:

   It offers deeper liberalisation (how?)
   It offers a more manageable liberalisation (in what way?)
   It brings political benefits relative to either neighbours or the USA?

If not, why? And would you be prepared to reduce effort and/or progress on the FTAA in order to further a WTO round?

3. Rules of Origin are potentially a major distortion to production decisions. What are the problems you would face

in using the same RoOs for all your RIAs,
in using the same RoOs for intra-RIA trade as for non-preferential trade,
for using only the change of tariff heading rule?

4. Following the negotiation of the FTAA, would you be pleased if the other members reduced their tariffs on non-members' exports to zero?
5. Would you be prepared to punish a member of one of your existing RIAs for charging tariffs on your exports by
   Charging tariffs on an equivalent volume of its exports
   Charging tariffs on a greater volume of exports
   Withdrawing other concessions under the RIA
   Ejecting the country from the RIA?

Suppose the RIA were the FTAA. What, then, if the violating member were the USA?

6. Have you suffered declines in exports or export prices as a result of your neighbours' RIAs? If so, what did you do about it?
7. Does an increasing focus on exporting to regional markets expose you to more or less uncertainty about exports and incomes?
8. Have you any industries that have grown up exporting to regional partners and then graduated to significant world exports?

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[LW1]See previous comment about message-laden headings. I think we do need a heading here

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[LW2]important point. You can always with enough work set a negotiating position. The issue is what do you do when the other side says ‘no’. These coalitions need a solution and the don’t have one.