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Chapter Title: Problems with Overlapping Free Wade Areas

Chapter Author: Anne O. Krueger

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1 Problems with Overlapping Free Trade Areas

Anne O. Krueger

Preferential regional trading arrangements are in vogue. As of the end of 1994, GATT had received notification of 33 new agreements since 1990. Most of these arrangements are for free trade areas (FTAs), although the European Union has also been enlarging its membership. As of 1994, there were few members of GATT that did not belong to at least one preferential trading arrangement, and many belonged to more than one.[1]

Additional FTAs are currently under discussion and, in a number of cases, officially endorsed. Moreover, it is contemplated that some of these FTAs might be overlapping. The United States, for example, is already a member of NAFTA, also has an FTA with Israel, and has declared its intention to participate in an Asia Pacific (APEC) FTA. The APEC countries have announced that they will become an FTA by 2010 (for the developed countries) and 2020 (for the developing).[2] In the spring of 1995, there was even discussion of a North Atlantic Free Trade Area, which might entail U.S. membership in yet another FTA. In addition, the United States extends preferences unilaterally to countries eligible under the Caribbean Basin Initiative (CBI) and tariff preferences to developing countries under the Generalized System of Preferences. Chile, which has sought negotiations to enter into an FTA with NAFTA, has announced its intention to join APEC and to enter into an FTA with the European

Anne O. Krueger is Caroline L. and Herald L. Ritch Professor of Economics at Stanford University. She is also director of Stanford's Center for Research in Economic Development and Policy Reform and a research associate of the National Bureau of Economic Research.

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1. World Trade Organization (WTO 1995, 1). Notable exceptions, pointed out by the WTO, were Japan and Hong Kong, who belonged to no reciprocal preferential arrangement, although Japan did and does extend tariff preferences to developing countries.

2. From the communiqués from APEC, it is unclear whether "free trade area" means a discriminatory, preferential trading area or an area all of whose members practice free trade.

Union. Countries already signatory to MERCOSUR (which is a customs union among Brazil, Argentina, Uruguay, and Paraguay) have indicated their intention to join NAFTA.

In supporting the formation of FTAs, political leaders have generally reasserted their support for the open multilateral system and indicated that FTAs are intended to be "GATT-plus" (now "WTO-plus") arrangements that would go beyond the agreements already existing multilaterally and seek even freer trade among "like-minded trading nations."[3] A number of economists have taken this view, regarding the formation of PTAs as a step along the way to liberalizing trade multilaterally.[4]

Supporters of the open multilateral trading system, with its most-favored-nation (MFN) principle implying an absence of discrimination among trading partners, have raised questions about preferential trading arrangements. These questions have been based on the concern that the emergence of regional trading arrangements, including both FTAs and customs unions (especially the European Union), would erode support for the open multilateral trading system and hence serve as a WTO substitute, rather than as a WTO-plus arrangement. If this happened, the emergence of regional trading blocs would be accompanied by increasing trade frictions and perhaps rising trade barriers between blocs.

When attention is given to overlapping preferential trading arrangements, additional issues arise. Those concerns are the focus of this paper. To set the stage, section 1.1 reviews the prevalence of preferential trading arrangements as of the inauguration of the WTO. Section 1.2 reviews the salient issues that arise with respect to FTAs and customs unions in assessing the extent to which they are WTO-plus and likely to be conducive to further multilateral trade liberalization. Section 1.3 then points to the additional complexities that are likely to arise if overlapping FTAs become the order of the day. Next, consideration is given in section 1.4 to East Asia's interests in the international economy and the choices open to East Asian nations if the trend toward PTAs continues. Section 1.5 summarizes the argument.

1.1 Preferential Trading Arrangements

Preferential trading arrangements can take any number of forms. They may consist of unilateral preferences or reciprocal preferences. They may be partial or total with respect to the degree of preference extended to members. And they may be partial or total with respect to those portions of international trade

3. It is not clear why regional arrangements began proliferating in the 1980s. In part, the success of the European integration was a factor, as is discussed below. Historically, the United States announced its change of position after the GATT Ministerial of 1982, when the U.S. Trade Representative (USTR) was frustrated by failure to agree on the start of a new round of multilateral trade negotiations.

4. Lawrence (1991) has been perhaps most closely associated with a defense of regional arrangements.

to which preferences pertain. They may be restricted to trade in goods or in goods and services, or they may apply also to factor mobility. And they may be limited to border measures, or they may entail setting rules and discipline for domestic regulations.

For the purposes of this paper, focus will be on reciprocal preferences.[5] Among these, two especially will be considered: customs unions and free trade agreements. For, in terms of the major trading countries and the Asia Pacific region, it is these two forms that are currently contemplated. And, although arrangements with respect to factor flows and harmonization can take place under either an FTA or a customs union, the essential differences center on the fact that a customs union entails a common external tariff among its members whereas a free trade arrangement allows each member to retain its own tariff structure. Moreover, attention will be devoted only to arrangements that are 100 percent preferences, since those are the ones that are contemplated under NAFTA, APEC, and any North Atlantic Free Trade Area.[6]

That difference, however, is crucial. It is crucial for two reasons. First, it is likely that FTAs are less suited to being WTO-plus arrangements than are customs unions. Second, it is not possible to have overlapping customs unions.[7] Countries are either inside a wall of common external tariffs or they are outside of it. Hence, the problems raised by overlapping preferential arrangements could not arise if they were customs unions. Attention returns to this point in section 1.3.

Table 1.1 gives a list of the reciprocal integration agreements in effect as of January 1995. The most striking feature of table 1.1 is the number of arrangements that already exist, including overlapping FTAs. Israel, for example, has FTAs with both the United States and the European Union. Norway is in the European Free Trade Association (EFTA) and has FTAs with the European Union and the Baltic states.

A second striking feature of table 1.1 is that, with the exception of the Israel-U.S. FTA, the arrangements are all regional.[8] While there is no reason in principle why preferential trading arrangements should be regional,[9] the vast ma-

5. This leaves out the Generalized System of Preferences, Lome Convention, CBI, and other one-way extension of preferences. It may be argued that acceptance of these preferential arrangements contributed to the erosion of the nondiscriminatory aspects of the world trading system, but it seems clear that concerns now center on reciprocal relationships, such as NAFTA and the European Union.

6. In theory, the optimal preference (if any) probably lies between zero and 100 percent.

7. A country can enter into a free trade agreement with a customs union. This has, in effect, been done by many countries in Eastern Europe and the former Soviet Union.

8. "Regional" does not always imply contiguous. Switzerland's agreements with the Baltic states and with other EFTA countries are not all geographically proximate.

9. Many earlier preferential arrangements were not regional. The system of Commonwealth preferences is perhaps the best-known example. Regional arrangements do take advantage of the fact that trading partners are closer to each other and hence face relatively low transport costs for cross-border transactions. However, in the 1990s, with transport costs accounting for a very small percentage of the value of trade, the advantage gained by proximity is probably quite small.

Table 1.1 Integration Arrangements as of January 1995

Europe
European Community (Customs Union)
- Austria
- Belgium
- Denmark
- Finland
- France
- Germany
- Greece
- Ireland
- Italy
- Luxembourg
- Netherlands
- Portugal
- Spain
- Sweden
- United Kingdom

EC free trade arrangements with
- Estonia
- Iceland
- Israel
- Latvia
- Liechtenstein
- Lithuania
- Norway
- Switzerland

EC association agreements with
- Bulgaria
- Cyprus
- Czech Republic
- Hungary
- Malta
- Poland
- Romania
- Slovak Republic
- Turkey[a]

European Free Trade Association (EFTA)
- Iceland
- Liechtenstein
- Norway
- Switzerland

Norway and Switzerland each have FTAs with
- Estonia
- Latvia
- Lithuania

Central European Free Trade Area
- Czech Republic[b]
- Hungary
- Poland
- Slovak Republic[b]

Nonregional
Israel–U.S. Free Trade Agreement

Table 1.1 (continued)

North America Free Trade Area
Canada
Mexico
United States
Latin America
Caribbean Community and Common Market (CARICOM)
Central American Common Market
Latin American Integration Association
Southern Common Market (MERCOSUR)
Middle East
Economic Cooperation Organization (ECO)
Gulf Cooperation Council (GCC)
Asia
Australia–New Zealand Closer Economic Relations (CER)
Bangkok Agreement[c]
ASEAN Preferential Trade Agreement

Source: WTO (1995, 26).

[a]Turkey entered into a customs union (in nonagricultural goods) with the European Union on 1 January 1996.

[b]The Czech Republic and the Slovak Republic have entered into a customs union, and each has a free trade agreement with Slovenia.

[c]Thailand also has preferential trade agreement with Lao Democratic Republic.

jority of those to date have been. Even the proposed FTA encompassing the APEC countries, which spans both sides of the Pacific, is billed as being regional in nature.

As already noted, there are FTAs under discussion in addition to those listed in table 1.1, which were already notified to GATT/WTO by January 1995. Those arrangements would greatly increase the coverage of FTAs and, in addition, would change the "overlapping" aspect of FTAs from being an occasional phenomenon to being the rule rather than the exception.

1.2 Salient Aspects of Preferential Arrangements

Under Article 24 of GATT/WTO rules, preferential arrangements were and are permissible as long as preferences (1) are 100 percent, (2) cover substantially all trade, (3) do not raise protection against third countries, and (4) have a definite timetable for implementation. However, GATT panels deciding on whether particular arrangements meet these tests have seldom been able to reach decisions, and the legal requirements for satisfying these criteria are therefore subject to considerable debate.[10] De facto, however, when the United

10. See WTO (1995, chap. 1, esp. 5–18). Because GATT panels have often been unable to reach decisions regarding the conformity of proposed arrangements with Article 24, there are a number of suggestions for changing the rules in order to make the standards clearer. Insofar as the problems raised in this paper (and elsewhere—see Krueger 1995) are deemed serious, consideration might be given to restricting coverage of Article 24 to customs unions.

States or the European Union decides to enter into such an agreement or to enlarge an existing one, it is a sufficiently important member of the WTO that its decision will be endorsed, or at least not be found to be in contravention of the articles.[11]

Traditionally, analysis of the welfare effects of preferential trading arrangements has centered on the positive welfare effects of trade creation (when high-cost production in one member country is shut down as lower-cost competing goods from a partner country displace it) and the negative welfare effects of trade diversion (when a member country replaces imports from a low-cost source in the rest of the world with imports from a higher-cost member). The analysis has been extended in a variety of ways, including the potential increase in welfare in the case of trade diversion that might result from consumers' gain from lower prices for the imported good that might partially or more than totally offset the welfare costs of trade diversion, the possibility that increased competition will result in greater efficiency and lower costs for individual producers, and under increasing returns to scale the larger market that might result for goods produced under conditions of imperfect competition. Nonetheless, because formation of a preferential trading arrangement is clearly second-best to free trade, analysis of its welfare effects is necessarily ambiguous.

That a customs union will in general increase potential welfare more (or reduce it less) than an FTA has been pointed out elsewhere (see Krueger 1995). It is important, however, to note the reason, since it is central to understanding some of the difficulties that arise when contemplating overlapping free trade agreements. That is, rules of origin (ROOs) are a far more central feature of free trade agreements than they are of customs unions. That is because of the possibility of "trade deflection" that arises under an FTA and not under a customs union.[12]

Rules of origin, while inherently a part of FTAs, can serve protectionist purposes. The "triple transformation" rule, used by the United States with respect to Mexican textiles and apparel, for example, extends preferential treatment to Mexican exports of apparel only if the raw material has been transformed into thread, the thread into cloth, and the cloth into a garment, all within the FTA. It may be that such a rule is designed to ensure that foreign apparel does not enter through Mexico, but it is more likely that Mexican apparel producers may be enticed to purchase textiles from the United States, and even perhaps

11. The language of Article 24 is also very vague, so that few GATT panels charged with assessing the consistency of an FTA with the GATT have been able to reach a conclusion.

12. Without ROOs, any FTA would in fact become a customs union. This can be most easily seen by assuming the absence of transport costs. If there were no ROOs in an FTA, importers would import goods through the country with the lowest tariff and then transship them (i.e., "deflect" them) to the country where they were in demand. As such, the tariff actually paid on each good would be the same throughout the FTA (and it would be the lowest tariff prevailing in any of the member countries).

divert textile imports from East Asian or other sources, in order to qualify for duty-free entry into the U.S. market.[13]

Rules of origin can be set in one of several forms.[14] These include a "substantial transformation" criterion, a change in tariff heading (CTH) criterion, a value-added criterion, and a specified process criterion. The substantial transformation criterion is essentially a common law criterion and, when contested, is decided by the courts. The CTH criterion appears somewhat more formulaic but in fact requires specification of what level of tariff heading is involved (eight-digit, four-digit, three-digit, etc.) and requires tariff headings to be updated with changes in technology.[15] Even the value-added criterion, which appears to be a more standardized way of proceeding,[16] raises enforcement difficulties,[17] as accounting methods must be agreed upon and audits are necessary to ascertain whether ROOs have in fact been met. And, of course, any process criterion (e.g., triple transformation) must be specified for each individual product. As Palmeter (1993) has pointed out, all of these rules give rise to problems of bureaucratic implementation and interpretation. In an important sense, however, the CTH criterion (by virtue of the ability to have a "not elsewhere classified" category) is the most inclusive. Under other criteria, new rules must be devised for new products.

Rules of origin are naturally far more important in FTAs than in customs unions, where there is already a common external tariff and so trade deflection is much less of a problem. They are also more important, the higher the external tariffs of member countries.[18] Moreover, they provide an opportunity for representatives of individual interest groups to lobby to avoid competition from imports. These groups can pressure to obtain an "export of protection" (through an ROO that will make it profitable to buy higher-priced intermediate goods in the partner country to satisfy the ROO), or they can lobby to ensure

13. See Krueger (1993) for a demonstration that ROOs can "export" the protection policies of one trading partner—in this case, U.S. protection of its textile industry—to the other, i.e., the Mexican producers who now find it worth their while to purchase U.S. textiles even if they cost more.

14. See Palmeter (1993) for a more complete discussion of these categories.

15. As pointed out by Palmeter (1993), agreeing on new tariff classifications across countries (predominantly in new high-tech industries) entails disputes about what the relevant tariff classifications should be. And, even under existing tariff schedules, there are many disputes over the appropriate tariff category for imported items.

16. See Lloyd (1993), who advocated exclusive reliance on a value-added criterion that, in his view, should be the same in all preferential trading arrangements. Difficulties with the value-added criterion include accounting problems that inevitably arise in allocating costs, problems that arise with respect to exchange rate changes, and the apparent discrimination against developing countries, whose relatively low wage rates for unskilled labor may imply that value added will be a smaller fraction of output price than is the case for goods produced in richer countries. ASEAN countries have a value-added (40 percent) ROO in their agreement.

17. There are also criteria couched in physical terms, as when cigarette producers in Australia were required to use 50 percent domestic tobacco in the production of cigarettes.

18. There are, nonetheless, ROOs in customs unions. E.g., semiconductors are considered to originate in the European Union only if the diffusion process is undertaken in the Union.

very stringent ROOs (thus preventing imports in some cases). Clearly, when U.S. auto parts producers insisted on a high percentage of value added (62.5 percent) as a criterion for conferring origin, the intent was to ensure that Mexican assemblers found it profitable to use U.S., and not foreign, auto parts. Textile producers presumably achieved a similar victory with their triple transformation rule. But when it was decided that using milk produced in one signatory to NAFTA to make cheese in another signatory did not confer origin, the intent was clearly protectionist for the dairy industry.

Even when ROOs are not highly protectionist in intent, they increase producers' costs and require administrative surveillance. It is estimated that when EFTA countries' producers provided documentation on origin to enter EU markets duty-free, the costs of providing the documents were the equivalent of 3–5 percent of the delivered cost of the goods. Producers chose on occasion to pay the duties rather than provide the documentation necessary to establish origin (see Herrin 1986). Accounting for joint costs, providing records as to which inputs were used in what goods, and otherwise establishing a record of costs sufficient to satisfy origin is not simple, unless the CTH criterion is used to establish origin.

Before turning attention to problems with overlapping FTAs, one last phenomenon should be noted. The European Union, by far the most successful, visible, and long-lasting preferential trading arrangement, was mostly of the GATT-plus variety, at least until the 1980s (when the protectionist effects of the Common Agricultural Policy [CAP] began to outweigh the trade liberalizing effects of successive rounds of multilateral trade reductions). That is, while the members of the European Union were eliminating trade barriers among themselves, they were also reducing external trade barriers. Thus, although intra-EU trade grew very rapidly after the Treaty of Rome, EU trade with the rest of the world also rose rapidly. Indeed, until the late 1970s EU external trade as a percentage of EU GDP rose during the period of increasing European integration. In 1958, just as the Treaty of Rome was taking effect, intraregional European trade constituted 52.8 percent of its total trade, and extraregional trade 47.2 percent. By 1993, the intraregional share was 69.9 percent, and correspondingly, the share of European trade with non-EU countries had fallen to 31.1 percent. However, in 1958, extraregional trade of the members of the European Community accounted for 15.8 percent of GDP; in 1979, the figure was 16.1 percent. Only in the late 1980s did the share of European GDP accounted for by external trade begin to fall (WTO 1995, 39, 40). Much of the European Union's increased trade with the rest of the world was attributable, of course, to the multilateral tariff negotiations conducted under GATT auspices, with their liberalizing impact on trade flows.[19]

19. That European external trade as a percentage of GDP has fallen may be accounted for by several factors. One is probably the decrease in oil prices after the mid-1980s, which no doubt reduced the recorded importance of petroleum imports in Europe's overall trade. It is likely, however, that pressures associated with mounting production and declining imports of agricultural commodities resulting from the CAP were also a significant contributor to this decline.

It is likely that the European success in integrating internally while simultaneously liberalizing externally accounts for a large part of the apparently uncritical acceptance of preferential trading arrangements by much of the rest of the world.[20] Indeed, for the United States to endorse preferential trading arrangements in the 1980s was a significant reversal of policy,[21] and one that would probably not have occurred had preferential trading arrangements not been associated in policymakers' minds with continuing external liberalization.

1.3 Prospective Difficulties with Overlapping FTAs

It was already noted that there cannot be overlapping customs unions: by definition, a common external tariff means that countries are either members and maintain the common external tariff or they do not. By contrast, overlapping FTAs are possible precisely because each member of an FTA retains its own external tariff. For that reason, the problem of overlapping preferential trading arrangements is one that arises under FTAs.[22]

It has elsewhere been shown that ROOs under FTAs can be trade diverting and, indeed, can "export" protection from one trading partner to another. To see this, assume that the United States has a tariff on automobiles and negotiates an ROO on Mexican assemblers of automobiles. Assume further that, prior to the FTA, Mexican auto assemblers imported parts from third countries with no tariffs. It is easy to see that it could well become attractive for Mexican assemblers to import (high-cost, protected) U.S. auto parts in order to qualify for tariff exemptions when exporting their autos to the United States. As such, in entering an FTA with Mexico, the United States could "export" its protection of auto parts to cover the Mexican market as well.[23]

With one FTA, the problems associated with ROOs are already troublesome, in that they are complex and highly opaque.[24] As can be seen from the discussion in section 1.2, there is no uniform way to set ROOs comparable to concepts such as a "uniform tariff." Moreover, since ROOs are adapted in each

20. In the late 1980s, when "Europe 1992" and the creation of the Single Market was under way, there was some alarmist discussion of the possibility of "Fortress Europe." Since most decisions made under the 1992 initiative were liberalizing, this concern rapidly diminished.

21. At the Bretton Woods conference and subsequently, the United States supported the open multilateral trading system and initially insisted on no exceptions. The United Kingdom, however, wanted to continue its Commonwealth preferences, and the resulting compromise was Article 24 of the GATT articles. See Dam (1970, 42).

22. There can, of course, be an FTA between a customs union and nonmembers. There was an FTA in manufactures between the European Community and EFTA.

23. The same result could occur if Mexico agreed to a common external tariff higher than that which had prevailed prior to the preferential trading arrangement. Such an increase in tariffs, however, is transparent and could be appealed under GATT/WTO rules. Under an FTA, there is no similar mechanism for compensation (by the lowering of other tariffs) since no tariff has been raised!

24. Rules of origin take up around 200 pages of the NAFTA agreement. Bargaining over them was prolonged, and the final NAFTA agreement resulted only when exact formulas for ROOs for automobiles and textiles and apparel had been agreed upon.

case to the particular tariff structures of the trading partners in an FTA, negotiations must take place on new ROOs for each new applicant to join the FTA.

That property of a single FTA is a major problem with overlapping FTAs. Each new entrant provides an occasion for lobbyists to seek insulation (through restrictive ROOs) and to generate delays as each applicant seeks admission. While in principle very liberal ROOs might result (with a consequent lowering of average protection), the lack of transparency of the process, combined with the necessity for detailed negotiations, renders it likely that special interest groups will seek at each negotiation to secure ROOs they perceive to be favorable to them.

Consider, then, how much more difficult the case as the number of FTAs in which a country has membership increases. ROOs agreed upon under NAFTA, for example, might differ from those agreed upon in APEC. And, should APEC expand, the ROOs there could change in unpredictable ways. Representatives of individual industries would pressure for ROOs serving their particular interests in ways that even the most ardent free trade negotiators would have difficulty disentangling.

A minor example of this possibility recently arose in the United States, when California winegrowers discovered that Mexico's FTA with Chile provided for Mexican tariffs on imports of Chilean wine to go to zero on 1 January 1997, while NAFTA provides a later date for zero tariffs on U.S. wines. The USTR dispatched negotiators to both Chile and Mexico in an effort to "correct" this problem! For ROOs that are not the same across all trading partners, similar problems are likely to emerge.[25]

Under U.S. trade law, it is already true that a particular commodity can have different "origins" for purposes of NAFTA, the CBI, labeling, and the Multi-Fiber Arrangement! Trade lawyers specialize in litigation over the origins of particular imports even without overlapping FTAs. With overlaps, even more export of protection and disputes with customs over origin and satisfaction of ROOs would likely result. Inevitably, the customs clearance process itself would become more complex, if not more prolonged.[26] And possibilities for further integration through "borderless" preferential arrangements and the elimination of border barriers (presumably one of the raisons d'être for the regional nature of a preferential trade agreement) would be eliminated.

In addition to these problems, the political economy of preferential trade agreements is less conducive to further trade liberalization than is that of customs unions. For, insofar as protection is exported through FTAs, all the re-

25. There is also a problem that successive entrants may result in repeated trade and investment diversion. There are already reported instances of factories that moved to the Caribbean to take advantage of U.S.-extended preferences under the CBI that then relocated in Mexico under NAFTA. One can well imagine yet further moves if countries such as Chile, Colombia, Brazil, and Argentina enter sequentially.

26. The existence of different rates of duty for imports from different countries also gives rise to additional scope for false invoicing (to show origin in the country subject to lower duties) and to corruption, as officials may misclassify goods to give lower rates of duty.

sulting increase in trade represents an increase in the economic size, if not the number, of producers who have (and can readily perceive) a vested interest in opposing moves toward trade liberalization and the open multilateral system.[27]

Thus, FTAs are suspect simply because of the greater complexity of ROOs under them than under customs unions. Overlapping FTAs are doubly suspect, in light of the additional complexity and opacity they bring to trade measures.[28]

When it is recognized that overlapping FTAs would also lead to competition among producers facing different costs of production (because of the imported items subject to duty at different rates in the individual countries), further questions arise. A particular type of overlapping FTA system has been referred to in the literature as the "hub and spoke" system—under which producers in a country that has multiple FTAs may have cost advantages over producers in each of the "spokes," which have FTAs only with the center country.[29] Whenever there are "artificial" cost differences (due to differences in tariff height in this case) between competitors or between locations, economic inefficiencies must result, and FTAs—especially overlapping ones—seem by their very nature to be likely to be conducive to these inefficiencies.[30]

To be sure, if producers in country A are aware that their competitors in country B are advantaged because some imported inputs cost less by virtue of B's membership in an FTA of which A is not a member or because B has lower tariffs on imports from the rest of the world, they may put pressure on their government to reduce its own external tariffs.[31] However, insofar as new activities are located, or existing firms choose expansion locations, in particular countries because of artificially lower costs, there will be two consequences. First, economic inefficiencies associated with different costs will result. Second, there will arise further pressure against subsequent multilateral trade liberalization as those choosing locations on the basis of these artificial cost differences oppose measures that reduce their advantages. There is even the possibility (although one suspects that pressure groups are sufficiently aware

27. For those exporters who would support free trade, the value of further multilateral trade liberalization is diminished with every new entrant into a preferential trade arrangement, so that exporters' support for multilateral liberalization is likely to diminish as vested interests profiting from trade diversion increase.

28. It has been reported that despite Chile's uniform tariff, there are increasing delays in customs as officials attempt to determine which preferential schedule, if any, a particular imported consignment should enter under. As Chile has extended preferential arrangements, the problem has increased in severity.

29. See Hoekman and Leidy (1993) for further discussion. The issue was earlier raised in considering Korea's interests in an FTA with the United States. See Park and Yoo (1989).

30. If producers in different countries with different input costs continue competing, one of the competitors may be able to use the "artificial" lower costs to offset part of the "natural" comparative advantage the other producer has.

31. This has already happened in Canada, where tariffs were reduced on a number of items because Canadian producers recognized that they were confronted with cost disadvantages vis-à-vis American producers because of lower American tariffs. It is also reported that some Australian producers have demanded lower tariffs on imported inputs as they face competition from New Zealand producers.

of their interests to avert it) of repetitive trade diversion as new members are added with new ROOs to an FTA, or as a member of one FTA then joins a second one!

Related to the above, questions arise about the pulls for foreign investment under overlapping FTAs. The same considerations that may bias location choice for local producers will surely affect potential foreign investors as they seek out low-cost locations. While comparative advantage for a particular activity may be sufficiently large in a particular country that distortions introduced by different cost structures (determined by each country's particular FTA memberships) do not affect location, there are surely instances in which differences in input costs (among goods whose prices ought to be similar except for transport cost margins) would dominate the decision. Again, it must be concluded that possibilities for the play of special interest groups, increased trade diversion, and consequent opposition to further multilateral trade liberalization are likely to increase as the prevalence of overlapping FTAs mounts.

Questions may also be asked about different FTAs in which members have different macroeconomic balances. The evidence from the past 50 years clearly demonstrates that more open economies (such as Mexico's in 1994 and Europe's in 1992) are more vulnerable to even small differences in macroeconomic and exchange rate policies. Countries whose major trading partners have very different inflation trajectories already have problems with exchange rate management. With overlapping FTAs, these problems can only increase. Successful FTAs will be trade liberalizing among members, but that in turn implies that they must increase the sensitivity of producers within the FTAs to differences in macroeconomic policies. One can only ask what the consequences would be for a country affiliated with two FTAs, if in one FTA price levels were reasonably stable and in the other the inflation rate was 5–10 percentage points higher. With shifts in macropolicy among FTA partners in one or the other bloc, individual producers would surely be subject to greater shocks than would be the case were macroeconomic policies more closely aligned. While this consideration carries force in FTAs and customs unions generally, the possibilities for differing policies among countries in different, but overlapping FTAs seem to offer even more scope for difficulty.

1.4 Implications for East Asian Countries

East Asian countries have been successful in reaching high levels of productivity and economic growth in part because of their willingness to integrate with the international economy. In part, that willingness itself originated in the early recognition that trade was essential for those countries in light of their own factor endowments and comparative advantages.

Continued growth in East Asia, as elsewhere, will depend on a variety of factors, including measures to increase the efficiency with which markets function and to reduce regulatory burdens. But no one can doubt that East Asia's

future growth prospects will be much brighter with a healthy international economy than they would be were the international economy to stagnate.

For that reason, East Asians have a strong stake in the open multilateral trading system. Political support for the WTO and leadership in strengthening the open multilateral system constitute perhaps the most important line of defense against the possibly protective effects of regional trading arrangements. This would entail support for settling the "new issues" on the WTO agenda, strengthening disciplines in services and agricultural trade, and facilitating the achievement of multilateral agreements on these issues.

Beyond that, it is important for East Asian countries to ensure that their own regional arrangements do not discriminate preferentially. Asia as a whole has a lower share of intraregional trade than does Europe, and an index of the intensity of intratrade (taking into account both the share of regional trade in total trade and the share of total trade in GDP) gives Asia a much lower index than the United States (Anderson and Horheim 1994, 134). Moreover, East Asia's growth has been associated with a *reduced* share of intraregional trade (see Petrie 1994, 118). In part, that is because much of the intraregional trade historically was in raw materials. As countries began developing manufactured exports, the scope for trade within the region lessened. Worldwide markets would appear to be especially vital to the prospects of developing countries in Asia, as they grow through an outer-oriented trade strategy.

The APEC initiative, which has promised free trade for the developed countries in the region by 2010, and for the developing countries by 2020, raises interesting questions. On one hand, leaders have been careful to talk about "open regionalism," which implies the absence of preferences. If countries will individually adopt free trade multilaterally and remove all tariff and other trade barriers by those target dates, there will clearly be no preferences, but there then arises the question as to why the grouping is "regional." If the region had a higher than average share of intraregional trade to start with, removal of remaining tariff barriers multilaterally might nonetheless strengthen trading ties within the region relative to those with the rest of the world. Given the region's below-average intraregional trade, however, it is difficult to understand how the arrangement would be regional.

Despite these questions, there is little doubt that Asia's interests lie in an open trading system among all nations of the world and that preferential arrangements within Asia would, in Asia's self-interest, need to be "building blocs," and not "stumbling blocs," to further liberalization of trade globally.

1.5 Conclusion

It has elsewhere been argued that customs unions, which do not raise protection against nonmembers (and are therefore consistent with WTO rules), cannot be any less economically efficient than FTAs and will be more conducive to support for further multilateral trade liberalization (Krueger 1995). They

also greatly reduce the opportunities for supporters of protection to exercise influence whenever accession of a new member to the agreement is proposed.

The arguments appear to apply with even more force to overlapping FTAs as contrasted with customs union enlargement. The initial vision behind the U.S. switch in stance toward support for preferential arrangements that are GATT-plus was that these agreements would be conducive to such large gains that others would be induced to join, thereby achieving further liberalization of trade. It is difficult to imagine that a series of overlapping FTAs, with different ROOs attendant for different countries' access, the need for individual producers to know and keep records for a variety of ROO requirements, and the complications associated with negotiations for accession of additional members, will lead to that WTO-plus world.

If, instead, a customs union were formed, requirements for accession would be straightforward: adopt the same external tariff. Moreover, trade diversion within the union must be less, and there cannot be uneconomic choices induced by tariff differentials that then increase resistance to further liberalization (although trade diversion and, with it, resistance to liberalization can still occur). One can imagine enlargement of a customs union until it encompasses the entire world and, with it, increased trade liberalization the entire way.

If, instead, more and more overlapping FTAs form, with complex ROOs, no further accessions are straightforward, and the end of the process is not membership of all and an open multilateral free-trading world.[32] If all that remained were requirements that producers satisfy ROOs, that would nonetheless require border inspections, more complex customs procedures, and costs to producers for providing the documentation. The problems of proliferating overlapping FTAs deserve considerably more critical attention than they have so far received.

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32. Even if every country were in at least one FTA with every other country, the existence of ROOs would protect some aspects of each country's tariff structure. There are also concerns that as FTAs proliferate, there would be a tendency for countries to use their antidumping and antisubsidy measures (which are GATT sanctioned) more vigorously on countries not party to their preferential arrangements. If that happened, the protectionist content of preferential arrangements could significantly increase.

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