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Volume Author/Editor: Takatoshi Ito and Anne O. Krueger, Eds.

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Chapter Author: Takatoshi Ito, Anne O. Krueger

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Introduction

Takatoshi Ito and Anne O. Krueger

For the entire world, but especially for East Asia, the rapid growth of the open multilateral trading system after the Second World War was invaluable, as the economies in that region chose a growth strategy involving integrating their economies with the rest of the world. Exporters from the region were able to expand their sales rapidly, in part because their domestic costs enabled them to export profitably, but also in part because world markets were expanding rapidly. Especially in the newly industrialized economies (NIEs) of Hong Kong, Korea, Singapore, and Taiwan, exports increased dramatically in absolute terms, and rapidly as a percentage of GNP. No observer of these economies can doubt the importance of an open multilateral trading system in accounting for their past performance or in determining their future prospects.

Until the 1980s, conventional wisdom was that an open multilateral trading system was the wave of the future; except for the European Community (now Union), attempts at forming preferential trading arrangements (PTAs) had largely failed or had been outer oriented and had little impact on trade flows (as in the case of the Association of Southeast Asian Nations—ASEAN). And the motivation for European preferences was clearly at least as much political as it was economic. In the 1980s, however, PTAs again began to emerge as significant factors affecting world trade. After the Canada-U.S. Free Trade Agreement, Mexico quickly signaled its desire to enter into a free trade agreement, and the North American Free Trade Agreement (NAFTA) was the result.

Within a short time after that, the American authorities announced their intention to extend NAFTA to a Western Hemisphere–wide arrangement; Brazil,

Takatoshi Ito is professor of economics at Hitotsubashi University, senior advisor in the research department of the International Monetary Fund, and a research associate of the National Bureau of Economic Research. 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.

Argentina, Uruguay, and Paraguay formed a preferential arrangement under MERCOSUR; many of the countries whose economies were in transition announced their desire to enter into the European Union, and the idea of a European economic area was enunciated; and the countries associated in the Asia Pacific Economic Forum announced their intention to find means for closer association. By 1995, the World Trade Organization (WTO) could claim that it had already received notification of more than 90 PTAs and that virtually all members of the WTO were signatory to at least one, and sometimes several, PTA.

For the entire world economy, the emergence of these arrangements raises important questions. Will these regional trading arrangements be "building blocs" toward more open multilateral trade? Or will economic integration within regions instead create "stumbling blocs" and take place at the expense of further multilateral liberalization? What factors are conducive to "open regionalism" and further strengthening of the multilateral system? And what sorts of arrangements and policies will instead detract from the global system?

For East Asian economies, integrated as they are with the rest of the world, understanding the factors that will determine answers to these questions is crucial. For several years, research has been underway, in the East Asian region and elsewhere, as to the factors affecting regionalism and its likely effects. The sixth annual NBER–East Asia Seminar on Economics (NBER-EASE) conference was therefore held on the subject in June 1995. This volume contains the papers presented at the conference, along with discussants' comments.

The first group of papers analyzes some key issues regarding PTAs. The first paper, by Anne O. Krueger, provides an overview of regionalism and outlines some of the concerns regarding regional arrangements. Krueger starts by pointing out that, unlike across-the-board trade liberalization, liberalization of trade preferentially among several countries that leaves external trade barriers unaffected has two effects. On one hand, there is the classic "trade creation," by which each partner country's high-cost industries (previously protected by a tariff) face competition from lower-cost firms in other countries party to the preferential arrangement. On the other hand, there is also "trade diversion," as partners to the agreement may shift from importing from third countries (outside the arrangement) to higher-cost partners whose products are not subject to duties. Whereas trade creation can be expected to increase real incomes and benefit the members of the PTA without hurting the rest of the world, trade diversion is costly to the importing country (which loses tariff revenue and pays higher real costs for its imports) and to the rest of the world.

Although PTAs in recent years have largely been regional, there is nothing in economic theory that suggests that regional arrangements will have any advantages relative to other kinds of PTAs, unless countries entering into a PTA have comparative advantages such that there will be much trade creation and little trade diversion. For the United States and Canada, the fact that Canadian exports to the United States consisted 80 percent of primary commodities while U.S. exports to Canada consisted 80 percent of manufactured goods, combined with the fact that the United States was by far Canada's largest trading partner (and Canada a large, but not so predominant, partner for the United States), suggested that the free trade agreement (FTA) might be a "natural." Other cases are not so clear, however.

Krueger goes on to note that the differences between customs unions and FTAs may be important in determining whether the PTA is conducive to further multilateral liberalization (although both are permitted under WTO rules). In particular, under FTAs, countries retain their own individual external tariffs, and so FTA agreements must contain "rules of origin" to prevent "trade deflection" under which goods would be imported into a low-tariff country and transshipped to ones in which higher tariffs are applied. This, in turn, implies that third countries wanting to join an FTA cannot do so without negotiation of new rules of origin, which in itself is likely to limit the extent of FTAs, as contrasted with customs unions.

In the second paper, Esquivel and Tornell analyze the motives underlying Mexican entry into NAFTA. In that case, the motives of Mexican policymakers were largely of a "political economy" variety—they hoped to lock in the trade liberalization that had already been undertaken. The authors note that forecasts of the direct benefits from Mexican entry into NAFTA were not large (because so much trade liberalization had already been undertaken multilaterally) and argue that Mexican entry into NAFTA should be viewed as part of a long history of efforts toward trade liberalization. They show that the trade liberalization of the 1980s required the breakup of two powerful domestic interest groups, operators of state-owned enterprises and private producers in import-competing industries. Once oil prices declined, these two groups no longer colluded to support earlier import substitution policies, and once these were weakened, President Salinas was able to liberalize trade. The Salinas government pushed NAFTA in order to make a strong commitment for the future so that reversal of the liberalization would be extremely costly. The authors argue that NAFTA was partly responsible for aggravating some political problems, such as devaluation of the peso in 1994. But after the devaluation crisis at the end of that year, the authors argue, NAFTA was helpful in securing the U.S. support package and contributed to Mexico's ability to weather the crisis.

In the third paper, Kym Anderson considers the impact of intensified concerns about environmental issues and labor standards on the multilateral trading system and on PTAs. This issue is of great concern for NIEs and developing countries. NAFTA was the first agreement to bring developing and developed countries into the same PTA and was ratified only after "side agreements" were negotiated between the United States and Mexico with respect to labor standards and the environment. Some hold that the ability to "experiment" with new areas of trade regulation, such as labor and the environment, is an advantage of PTAs. Others, however, fear that such regulation may restrict trade, especially for developing countries.

As Anderson notes, the comparative advantage of developing countries derives in significant part from low labor costs. If "labor standards" are developed to raise labor costs in poor countries, it will be tantamount to increasing restrictions on trade with them. The same sorts of issues arise with respect to the environment. Anderson examines the reasons why these issues are becoming more significant in international trade negotiations. He then analyzes their potential impact on developing countries. As with so many other issues regarding PTAs, Anderson shows that these issues could be resolved in ways that need not adversely affect developing countries. He shows that the direct effects of these measures are likely to be small, but that the use of these measures could result in the erosion of the WTO system, to the detriment of developing countries. The latter would eventuate to the extent that protectionist interests align themselves with those advocating, say, labor standards, in order to use them as a device for protecting labor in developed countries.

In the fourth paper, Goto and Hamada examine incentive problems of forming or joining a free trade bloc in a game-theoretic framework. Suppose there are (say, four) symmetric nations that produce differentiated products under increasing returns to scale and monopolistic competition. When some (say, two) countries form a free, preferential trading bloc, the welfare of those countries will increase while the welfare of countries outside the bloc decreases. Then countries outside the bloc will have an incentive to form a "counterbloc." The authors proceed to consider a case of trade war between a large bloc and a small bloc in a Nash equilibrium setting. They conclude that "the hegemon has the capability to manipulate the terms of trade to its advantage. Therefore, it is optimal for the larger bloc to impose a higher tariff rate." Although we do not typically observe a trade war with increased tariffs, the paper points out the potential political danger of PTAs.

The second group of papers analyzes the economic effects of preferential regional trading arrangements. The first two papers in this group examine PTAs using conventional tools of analysis—the "gravity" equation for estimating trade flows. The next four papers focus on effects specific to East Asian countries.

The gravity equation relates bilateral trade flows to such variables as distance between trading partners (presumably as a proxy for transport costs), sizes of trading partners, and relative per capita incomes. Wei and Frankel examine the "openness" of regional trading blocs (explicit or implicit) using various versions of the gravity equation: trade between countries i and j is regressed on per capita incomes, distance, and dummy variables for (1) countries that are adjacent to each other, (2) countries with a common language, (3) countries in a common regional bloc, and (4) two countries, one of which is in a regional trading bloc and the other not. A negative coefficient on trading bloc variables is interpreted as "trade diversion," while a positive coefficient is interpreted as "trade creation," with its positive welfare effect.

Wei and Frankel find that Western Europe and East Asia (treated as an implicit trading bloc) are "trade creating" while APEC and the Western Hemisphere are "trade diverting" blocs. When changes in the dummy variables over time are examined, these same conclusions hold, and East Asia appears to have grown more open over time.

Bayoumi and Eichengreen use the gravity equation to analyze the effects of the European Union. They argue that, for some purposes, the usual form of the gravity equation is biased, in that the dummy variables may pick up any factors not directly measured and, thus, are suspect in their use as indicators of the effects of PTAs only. The authors therefore use a difference approach, estimating coefficients on dummy variables when it is changes in trade levels that are examined, rather than the levels themselves. They examine the formative period for the European Economic Community (EEC) and European Free Trade Association (EFTA) and find that trade among the EEC countries grew little more rapidly than would have been predicted by the other variables in the gravity equation. However, in the period after it started, from 1959 to 1961, the coefficient is much larger, which they interpret as implying considerable trade creation. For the period 1953–73 as a whole, they estimate that trade among the original six countries in the EEC grew 3.2 percent per annum faster than it would have without the Treaty of Rome. There is a slight reduction in EC trade with the rest of the world.

Bayoumi and Eichengreen then estimate the extent to which there was trade creation and trade diversion for EFTA, and for various periods with other industrialized countries. They also consider the effects of enlargement of the Community with the entry of the United Kingdom, Ireland, and Denmark. They estimate that between 60 and 90 percent of new trade with the European Community was trade creation, although some trade diversion also occurred. Overall, Bayoumi and Eichengreen conclude that the European arrangements significantly affected trade and that most of the effect was in the initial years. They find enough trade diversion that they believe there is an "important caution" for countries in other regions contemplating forming or joining PTAs.

The next four papers examine these issues in the context of East Asia and the Pacific. Chinn and Dooley examine the channels of impact of capital flows from advanced and emerging markets to domestic financial markets. Their working hypothesis is that (1) capital inflows tend to increase bank credit; (2) the increase in bank credit means that more risky projects are likely to be funded, so the financial system will likely become less robust; and (3) expansion of bank credit, rather than money, results in increases in investment.

Yamazawa's paper gives an overview of the developments in the Asia Pacific Economic Cooperation (APEC). APEC, which started as a loosely connected consultative group, seems to be heading toward a kind of trading arrangement. In November 1994, APEC leaders agreed and declared (the Bogor declaration) that free and open trade and investment in the APEC region would be achieved by 2020 (or 2010 for industrialized countries). It was presumed that the liberalization would be achieved *without* preferential arrangements (i.e., mostfavored-nation [MFN] status would be extended to the rest of the world). It remains unclear, however, how quickly countries will lower tariffs and whether the MFN principle will always be maintained. APEC members are divided on the question of whether implementation of the Bogor declaration requires a binding commitment with a target date for each step or whether it should be left to unilateral actions based on peer pressure. Yamazawa's paper analyzes political and economic arguments on some of the controversial points and describes the extent of the APEC initiative envisioned currently.

Lee's paper examines the effects of Mexican entry into NAFTA on Korean trade with the United States. He points out that, although the overall effects of Mexican entry into NAFTA on third countries were estimated to be small initially, they might be significant for countries whose exports to the United States compete more directly with those of Mexico. In that regard, Japan might be expected to be much less affected than Korea, as Japanese exports compete much less with Mexican exports in the U.S. market. Lee computes an export similarity index for trade between East Asian economies, Mexico, and the United States and finds that Korean exports competed relatively little with those from Mexico; the index is far higher for Taiwan and other East Asian economies. Other measures, such as revealed comparative advantage and trade elasticities, tend to confirm this result. He thus concludes that, at least on a static basis, there does not appear to be much evidence that Korea will suffer from trade diversion to Mexico under NAFTA. He qualifies his conclusions, however, by noting that he did not examine any "dynamic" effects and that these may be important.

In her paper, Chia analyzes the economies belonging to ASEAN and examines the various types of regional integration that affect them. She starts by noting that ASEAN had noneconomic objectives, especially as a security bloc, and that any analysis of ASEAN must take those goals into account. She then notes that ASEAN countries have always been highly open and outer oriented and that efforts at PTAs only started in 1977, and even then with very mild preferences; by 1986 only 2.6 percent of items were granted tariff preferences within the region. The ASEAN Free Trade Area (AFTA) was designed to further economic integration, with common effective preferential tariffs to be phased in over 15 years, although there are questions, reviewed by Chia, as to how effective these will in fact be.

ASEAN countries have also cooperated on a variety of issues, although competition between economies has limited the extent of cooperation. Chia considers the concept of ASEAN "growth triangles" as subregional areas in which cooperation might proceed considerably further. She believes that growth triangles can sometimes overcome some of the problems encountered in extending regional cooperation, and she lists some of their advantages. As Wei notes in his comments, however, this is a preliminary finding and subject to a number of questions.

The third group of papers takes up trade-related issues of individual countries or products in relation to institutional trading relations. The paper by Jwa provides an overview of the Korean industrial structure and policy issues related to it. The conventional wisdom in Korea is that Korean firms are "overdiversified" into technologically unrelated sectors. Yang's international comparison supports this view. The Korean government therefore wants to encourage specialization, believing that it is necessary if Korean firms are to be competitive in world markets. Jwa argues that the structure of Korean firms may be rational, and not overly diversified given the Korean context. He provides empirical evidence as to the extent of scale and scope economies in individual Korean industries, and in the Korean economy as a whole.

One aspect of the question of NAFTA's effects on East Asian countries concerns the likely impact on U.S. bilateral trade relations with those countries. Chen and Liu consider the effects of U.S. bilateral trade relations on Taiwan's exports. The United States and Taiwan have entered into a series of bilateral negotiations (as has also been true for Japan, Korea, and other countries, although Taiwan has not been a member of GATT). Various products were put under voluntary export restraints in response to U.S. pressure in the 1960s and 1970s. In the 1980s, more disputes centered on the opening of the Taiwanese market to U.S. products. Chen and Liu document several instances of preferential treatment of U.S. imports, as well as the number of cases in which tariff concessions were requested by the United States and granted by Taiwan. They then undertake regression analyses to search for the determinants of U.S. demands and Taiwanese concessions. The most remarkable finding is that Taiwan's high-tech industries are more likely to be targeted by the United States but they are the industries where Taiwan is most likely to resist pressure. The authors conclude that "the United States tends to refrain from demanding tariff concessions in sectors dominated by public enterprises in Taiwan and in sectors in which wages are relatively low in Taiwan. "The United States tends to demand tariff cuts in sectors in which the United States has revealed comparative advantage. They also find that "existing tariff and nontariff barriers in Taiwan, which are important determinants of U.S. demands for tariff cuts, are not as important in determining the final outcome of negotiations."

In the final paper, Hayami and Godo consider some aspects of Japan's trade policies with respect to rice. This is another instance in which bilateral trade relations between the United States and a major trading partner have been important. Rice was a major stumbling block for Japan's agreement to the outcome of the Uruguay Round. Japan had maintained a total ban on imports of rice until 1993, when emergency imports became necessary to augment a poor domestic crop. In the second half of the 1980s, the American Rice Millers' Association petitioned the U.S. Trade Representative to take action against Japan's rice import ban. The petition was turned down on the condition that the issue be resolved in the Uruguay Round trade negotiations. On the domestic front, the Japanese Diet had adopted resolutions to oppose any imports. With this backdrop, how to deal with opening up rice imports was a major policy issue for Japanese trade authorities at the height of the Uruguay Round negotiations. Hayami and Godo survey the debate in Japan and argue that tariffication of the barriers to rice imports would have had a number of advantages over the minimum access route (which specified that a certain small percentage of Japan's consumption should be imported) that was the compromise in fact chosen.

Since the June 1995 NBER-EASE conference, there has been some slowdown in the momentum for further regional movements. However, the issues analyzed in the papers presented here, as well as additional questions that arise in the context of overlapping PTAs and relationships between the WTO and PTAs, will remain central to analysis of trade policies for the global economy.