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Regional Trade Arrangements

Augusto de la Torre and Margaret R. Kelly

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The following symbols have been used throughout this paper:

... to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (e.g., 1991–92 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (e.g., 1991/92) to indicate a crop or fiscal (financial) year.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term "country," as used in this paper, does not in all cases refer to a territorial entity that is a state as understood by international law and practice. The term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

Preface

Regional trade arrangements have recently attracted growing interest, as existing schemes are either being extended or revived and new groupings are being formed. This study reviews recent initiatives and the experience with regional integration in industrial and developing countries and discusses the implications of the recent expansion of the trend for the multilateral trading system. Developments up to the end of 1991 have been included, prior to the scheduled conclusion of the Uruguay Round.

The study was prepared by the Trade and Payments Division of the Exchange and Trade Relations Department of the International Monetary Fund. The main authors are Augusto de la Torre and Margaret R. Kelly, with contributions from Bernhard Fritz-Krockow and Miranda Xafa. The authors are indebted to a number of colleagues, both in the Fund and in other national and international agencies, for their willingness to exchange views and provide information. The authors are grateful to Joslin Landell-Mills for her assistance in preparing the Occasional Paper from an earlier longer manuscript; to the editor, David M. Cheney, of the External Relations Department; to Peter Uimonen and Christine Hörbinger for research assistance; and to Marcela Toso and Elizabeth Mack for keyboarding. The authors alone are responsible for the study; their opinions do not necessarily reflect the views of the Fund.

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I Introduction

Regional integration is not new. It has been a continuing part of the post-World War II trade landscape. Recently, however, it has attracted increased interest. Existing arrangements have been, or are being, extended in their membership and deepened in their coverage; old arrangements are being revived; and new regional groupings are being formed. The three distinctive features of this trend are: the "conversion" of the United States to the regional approach; the emergence of regional arrangements among industrial and developing countries; and an apparent move away from inward-oriented toward more outward-oriented arrangements among developing countries, particularly in the Western Hemisphere. In developing countries, these developments are being accompanied in many cases by unilateral trade liberalization.

The renewed interest in regionalism, particularly in view of the difficulties in concluding the Uruguay Round of multilateral trade negotiations, has created a concern that the world trade system may gravitate toward regional trade blocs aligned around the European Community (EC), the United States, and Japan ("the triad"). From a global perspective, these developments are of vital importance for the rest of the world. The two major regional groups in Europe (the EC and the European Free Trade Association (EFTA)) and in North America (Canada, Mexico, and the United States) each account for roughly 30 percent of world GDP. Between them, they account for approximately 65 percent of world imports and nearly 50 percent of developing country exports. Japan and the dynamic Asian economies account for about 16 percent of world GDP. Although Japan is the only industrial country not a member of a regional arrangement—and preferential trading arrangements have been less important in Asia than in Europe and North America—during the 1980s intraregional trade grew at a faster pace in Asia than in the EC and North America.

To provide a background against which to examine the renewed interest in regional integration, this paper reviews the theoretical issues related to regional integration and discusses the new initiatives. It considers the experience with regional integration among industrial and developing countries before examining its implications for the multilateral trade system. The discussion focuses mainly on regional arrangements based on two-way trade preferences; one-way trade preferences granted by industrial countries to developing countries (for example, under the Generalized System of Preferences (GSP)) are not covered. Likewise, the paper does not discuss arrangements that focus primarily on the economic cooperation aspects of regional integration rather than on trade liberalization; nor does it discuss the extent to which regional arrangements achieve noneconomic objectives.

The recent surge in regional trade initiatives seems set to increase. While the renewed interest since the mid-1980s has been attributed, in part, to the increasingly cumbersome nature of multilateral trade negotiations, it is questionable whether the prospective proliferation of arrangements—which involves overlapping country membership, potentially inconsistent rules, and increased scope for conflict—is the most efficient way to move toward free trade on a global basis. Indeed, beyond a certain threshold an undue emphasis on regionalism would undercut the multilateral trade system and render it inoperative. The limits on the liberalization that regional arrangements can deliver in trade-sensitive sectors where protection is most ingrained raises further doubts about this approach.

Clearly, the risk of the world trade system gravitating toward preferential trading blocs aligned around the triad will increase if the Uruguay Round fails to be effective. Such developments, if accompanied by a "fortress mentality" that leads to an increase in protection, would undermine world welfare. The key element that could reduce this danger is the extent to which the world economy has become integrated through trade and through the globalization of investment and production.

The implications of protectionist trade blocs are examined in Stoeckel, Pearce, and Banks (1990).[1]

[1] The assumptions and structure underlying the model used in this study are discussed in Kelly, and others (IMF, forthcoming); compared with some other models, the estimated effects in this study of changes in trade policy are relatively high.

This study demonstrates that the adoption of a "fortress" trade policy stance by either the EC or North America would have large negative effects on world GDP, on most countries, and on all regions, including the region that increases protection.[2] Such losses would increase if either trade bloc retaliated by increasing its own trade barriers in an attempt to defend itself. The study also demonstrates that trade liberalization is in the interests of both the EC and North America regardless of what the other does. Not surprisingly, the greatest gains would be achieved if all regions liberalized their trade policies multilaterally.

Since regional arrangements seem likely to become an increasingly important feature of the international trade system, they should be structured to minimize potential losses, while maximizing potential gains to both members and nonmembers. Theoretical and empirical considerations suggest that for this to occur, it is crucial that regional trading arrangements: (1) maintain an outward orientation; and (2) entail across-the-board intraregional liberalization. These two conditions broadly correspond to the provisions of Article XXIV of the General Agreement on Tariffs and Trade (GATT) (see Chapter VI). The potential costs of regional integration could be further reduced if members of such arrangements agreed not only not to increase, but also to reduce trade barriers against nonmembers. Clearly, a successful conclusion to the Uruguay Round would be the best way to ensure an outward orientation of emerging and existing regional arrangements and, thus, their compatibility with the multilateral trade system. Some have also suggested (Bhagwati, 1990b) that preferential trading arrangements should be open to new members to help convert these arrangements into building—rather than stumbling—blocks toward multilateral liberalization.

A separate issue relates to the form of preferential arrangement that is chosen. An outward orientation may be easier to achieve in free trade areas than in customs unions, since the former are less likely to constrain individual members to harmonize existing distortions or keep them from implementing unilateral reductions in trade barriers. If, however, members of a union agree to reduce their external trade barriers, a customs union could offer the advantage that the gains for members and nonmembers are likely to be higher the greater the integration among members.

The potential for regional integration among groups of countries to expand intraregional trade and thereby increase welfare depends on the economic characteristics and initial conditions in the countries involved. A number of considerations suggest that the potential for intraregional trade to expand is likely to be less for arrangements among developing countries than among industrial countries. In particular, developing countries are best able to exploit gains from trade based on differences in resource endowments and productive structures—a strategy best pursued in the context of unilateral and multilateral liberalization. This is not to suggest that there is no potential for an increase in intraregional trade among developing countries. As for industrial countries, this potential may be increased if, in addition to maintaining an outward orientation, developing countries involved in regional integration implement other measures to reduce market segmentation and establish the required infrastructure. Moreover, as industrialization and per capita incomes increase, so will opportunities for intra-industry trade. An open multilateral trade system, however, is the best way to ensure an expansion in economically beneficial trade among developing countries and to ensure these countries' access to industrial country markets in a nondiscriminatory manner.

[2]For example, if "EC 1992" is accompanied by an increase in external trade barriers (defined as a compromise between the community-wide average protection level for each group of manufactures and the policies of the most restrictive EC member), world GDP (in 1988) would decline by $108 billion, with declines in the EC, North America, and the Asia-Pacific area amounting to $52 billion (more than 1 percent), $40 billion (0.7 percent), and $16 billion (0.4 percent), respectively.

II Economic Costs and Benefits of Regional Integration

An assessment of the economic costs and benefits of regional integration depends on the yardstick against which these are judged.[3] Theoretical arguments and historical experience suggest that nondiscriminatory free trade is the "first best" policy option, both from global and individual country perspectives. This chapter identifies the economic benefits and costs of regional trading arrangements relative to the status quo, that is, relative to a policy of maintaining unchanged levels of protection.[4] There are two types of gains and losses: *static*—those stemming from a once-and-for-all reallocation of an existing stock of capital, labor, and other resources; and *dynamic*—those associated with the effects of regional economic integration on productive capacity and potential output (dynamic perspective). For simplicity, the discussion in this chapter focuses, unless otherwise specified, on the benefits and costs of customs unions—which entail liberalization of intraregional trade coupled with a common external trade policy vis-à-vis the outside world.

Static Effects on Members

The static effects of a customs union depend on the relative size of gains owing to trade creation and losses from trade diversion (and suppression).[5] Trade creation occurs when a member replaces goods produced domestically at a relatively high cost before the union with goods imported from another member at a relatively lower cost. Trade diversion—or suppression—arises when low-cost goods previously imported from the outside world are replaced by higher-cost imports from other members, or where external protection after the union is raised by higher-cost domestic production (trade suppression). Whether one outweighs the other is essentially an empirical question.

On the supply side, gains from trade creation most frequently occur as resources previously engaged in costly production for the home market are reallocated to producing exports that enjoy preferential access to other members' markets (intra-union or internal trade creation). Gains may also arise by stimulating the production of exports for the outside world (extra-union or external trade creation). On the demand side, consumers gain from trade creation because of lower prices and a greater variety of goods and services. Losses from trade diversion accrue to consumers as imports are now purchased from suppliers within the union that are less efficient than suppliers outside the union. The higher cost of these goods offsets the lower internal market prices attributable to lower intra-union trade barriers. From the point of view of the member country, this trade diversion means that tariff revenues for the government (or quota rents to importers) are now paid implicitly as a subsidy production in other member countries. (The losses associated with diverting trade from more efficient suppliers outside the union may, however, be offset to some extent by improved efficiency in production in a member country, resulting from the availability of duty-free imports of intermediate inputs from other member countries.)

Trade diversion may also affect the terms of trade in favor of members of unions whose trade constitutes a large share of world trade. By buying fewer imports from—and selling fewer exports to—nonmembers, a large union would, other things being equal, lead to lower world prices for its imports and higher world prices for its exports.

[3] Xafa (forthcoming) provides a comprehensive survey of the theoretical literature on economic integration, including the possible implications of the "new trade theory." Gunter (1989) and El-Agraa (1988) provide other surveys.

[4] Other policy counterfactuals against which the benefits and costs of regional trading arrangements may be measured include unilateral liberalization—opening up of one's market to international trade without discriminating between trading partners and irrespective of their actions—and multilateral liberalization—reciprocal trade concessions among contracting parties to the GATT. Theoretical arguments and historical experience suggest that nondiscriminatory free trade is the "first best" policy, both from a global and individual country perspective. The greater benefits of nondiscriminatory free trade, relative to regionalism, would not have to be foregone, however, if regionalism is conducive to, and supportive of, multilateral liberalization.

[5] The economic analysis of customs unions in terms of their trade-creation and trade-diversion effects dates back to the pioneering work of Viner (1950), Meade (1955), and Lipsey (1957).

The terms of trade will not necessarily improve for each member; whether they do or not depends on the structure of trade and demand and supply elasticities.

Some gains from a customs union would also arise from cost savings from lower trade costs. In this case, members would capture the natural rents from being able to export to other members at lower transport costs than for exports to the rest of the world.

An additional source of static gains for exporters in the union are the rents from preferential market access (Wonnacott and Wonnacott, 1981). While exporters from the outside world sell their products to the union at the international market price, exporters from within the union can charge the price in effect in the market of the member country, that is, the world price plus the external tariff or the markup made possible by nontariff barriers. Of course, the counterpart to this rent is, for the importing member country, trade diversion and a loss of tariff revenue (or of importers' quota rents).[6] But the exporting country would realize a net gain, provided that the exporter's rent is greater than the dead-weight loss associated with expanding production of exports to the union at a marginal cost higher than world market prices.

In contrast with a customs union, a free trade area does not commit members to a common external trade policy and thus allows them to minimize trade-diversion effects. By lowering tariffs unilaterally, a member of a free trade area can switch imports back to more efficient suppliers; this action would, however, simultaneously undercut the value of its trade concessions (and thus of available rents) to other members. Rules of origin (typically based on national value-added requirements) are generally established in free trade areas to prevent "trade deflection," whereby goods originating in nonmember countries are transshipped from the member with lowest external protection to members with higher levels of external protection. In contrast with free trade areas, customs unions appear to be more conducive to higher degrees of economic integration among members, especially when endowed with supranational structures for common decision making.

Transitional adjustment costs would be incurred as the economies in the union move from one equilibrium position to another. These costs may be substantial in the short run, with transitional welfare losses reflecting temporary labor unemployment and idle capacity during a period when firms—faced with competition from other regional suppliers—go out of business, while resources are reallocated to better uses only sluggishly. Clearly, such transitional losses would be less the greater the degree of labor and capital mobility within and among the members of the regional group.

The net static effects of a customs union on members' welfare depend on the relative importance of the elements discussed. If the focus is only on trade-creation and diversion effects, some key parameters that would maximize net gains may be identified *a priori*. Trade diversion would be minimized where initial protection is either very high or very low. Initially very high or prohibitive import barriers ensure diversion of few or no imports. Initially very low protection levels ensure that imports from within the union would only be marginally more costly than those from outside the region they displace. (Initially very low protection may also imply small gains from trade creation.) Diversion is also minimized if regional partners are important trading partners with each other prior to forming a preferential trading arrangement. Trade creation is greater the more responsive supply and demand conditions are in member countries to changes in prices induced by intra-union liberalization. This responsiveness would be positively related to the degree of flexibility in labor and capital markets, with the stage of development of securities markets of particular importance in allowing structural adjustment through, among other things, mergers and acquisitions.

Net gains will also be affected if members have a societal preference for industry; Cooper and Massell (1965) suggest that certain countries are willing to accept a degree of inefficiency associated with industrial protection. Under these circumstances, a customs union could serve to raise members' welfare by reducing excessive costs of inefficient industrial production while at the same time respecting the constraint of maintaining a desired level of industrial activity. This assumes, however, considerable room for industrial complementarity and for economies of scale within the union; it also assumes significant flexibility among member countries to reconfigure their industrial structure by "swapping" industries and specializing in lines that minimize costs. One conclusion from the Cooper-Massell model is that welfare might be raised even if trade diversion and suppression outweigh internal and external trade creation. Trade diversion and trade suppression would be a signal of success if a regional trading arrangement is established mainly to promote import-substituting industrialization through wider—but still protected—markets.

[6]From the point of view of the union as a whole, there are no net gains from rents associated with preferential access, except if such access allows union firms to realize efficiency gains from economies of scale that would not be captured otherwise (see next section on dynamic effects of customs unions).

These welfare gains, however, would evaporate over the medium to long run to the extent that accumulated inefficiencies render import substitution nonviable as a development model.

The concepts of trade creation and diversion continue to underpin the theory on customs unions. However, as these concepts emphasize the welfare of—and trade between—geographically defined nation states, their relevance is increasingly undermined by the globalization of investment and production. For example, the gains from trade creation would also accrue to firms of nonmember countries with a physical presence (branches or subsidiaries) in the region or with other forms of linkage to firms in the region (licensing agreements, cross-shareholding arrangements, strategic alliances, and so on). By the same token, the losses from trade diversion may also affect firms owned by the residents of the region located in nonmember countries, or firms located in the region but with strong linkages to firms in nonmember countries.

In principle, there are two different—but not incompatible—scenarios under which trade creation might be maximized. First, trade—predominantly inter-industry trade—may expand on the basis of differences in resource endowments (and thus in productive structures) across members, that is, through specialization guided by comparative advantage. Alternatively, where production structures and factor endowments are similar, trade creation based on an expansion of intra-industry trade, product differentiation, and economies of scale is most likely among countries with: (1) similar factor endowments and production structures; (2) overlapping demand structures and relatively high per capita incomes; and (3) a relatively large combined market size. In either case, the potential for trade diversion is less where countries are important trading partners prior to implementing regional integration schemes.

Dynamic Effects on Members

Regional integration arrangements may lead not only to a one-time increase in income owing to static efficiency gains, but also to a sustained increase in the rate of growth of income. These dynamic effects may arise through a number of channels, including economies of scale; spillover effects (such as transfers of know-how from producer to user industries); increased competition; an improved investment climate; and a stepped-up pace of technological change. (Another aspect of dynamic gains from trade integration is related to consumption smoothing. Unrestricted access to world markets enhances the ability of agents to smooth consumption during business cycles.) Clearly, the potential dynamic gains for members from a regional arrangement would be greater to the extent that the arrangement goes beyond the reduction in tariff barriers toward higher degrees of integration in other areas, including the removal of remaining obstacles to the free circulation of goods and services, free factor mobility, and the harmonization of macroeconomic and other relevant policies.

While economies of scale may also be considered a static gain—by assuming unchanged stocks of capital, labor, and technology—their potential for generating dynamic gains bears emphasizing. Economies of scale are made possible by larger regional markets. Gains from scale economies internal to the firm would come through lower costs and increased productivity, as companies previously operating at below minimum efficiency can now expand output and move down their cost curves (in static models) and their learning curves (in dynamic models). Larger regional markets may also widen opportunities to achieve economy-wide or industry-wide economies of scale, which are based on such externalities as spillover effects (for example, transfers of know-how from producer to user industries) and may be strongest in high-tech sectors. Regional cooperation and market broadening through regional integration could also help secure scale economies in infrastructure—such as transportation and communications networks—and in research and development.

Economies of scale and spillover effects may provide a rationale for regional trading arrangements based on temporarily high external barriers. By allowing firms to move down their cost curves, temporary protection would serve as a springboard for subsequent export expansion.[7] The argument hinges on regional markets being fairly large. But even then it is doubtful that a policy of "import protection for export promotion" would lead to sustainable gains. For one thing, trade policy instruments could not be shown to be optimal intervention tools in this context. For another, the policy carries serious risks. Under strong lobbying from vested interests, this policy could easily be turned into a defense of "sunset industries," thus postponing gains from needed structural adjustment. Also, monopolistic firms nurtured by the initial protection may subsequently offer formidable resistance to the lowering of regional external barriers. Moreover, protection in a large regional bloc,

[7]This is Krugman's (1984) "import protection as export promotion" argument applied to regional integration. Studies by Baldwin and Krugman (1986) and Venables and Smith (1986) suggest that this type of effect has been important for certain industries in industrial countries with large domestic markets.

even if temporary, would be likely to elicit retaliatory protection elsewhere. On balance, it would seem that outward-oriented regional trading groups would be much better suited than inward-oriented ones to generate sustained gains from economies of scale and spillover effects.

Significant dynamic gains may also stem from increased competition spurred by regional liberalization. Competition strengthens the reliability of relative prices as indicators of relative scarcities, which leads to more efficient and transparent markets and forces improvements in resource allocation. Even in the context of the oligopolistic and monopolistic market structures that tend to be associated with product differentiation and economies of scale, intensified competition within larger markets would limit social costs associated with collusion and other abuses of market power. Competition would also spur corporate restructuring and industry rationalization, as well as modernization through the adoption of superior technologies.

By providing larger markets through "binding" plurinational commitments, regional integration arrangements are likely to improve the investment climate. The attractiveness of investment in the region would increase for investors in member as well as nonmember countries, the latter also possibly reflecting defensive moves to avoid the adverse effects of trade diversion. Larger regional markets would increase investment opportunities in various ways, including by raising the profitability of innovation—as the fixed costs of research and development would be spread over a larger market—and facilitating the exploitation of economies of scale and scope. Also, the processes of corporate restructuring, rationalization, modernization, and technological change spurred by competition would further raise the level and efficiency of investment. Moreover, binding commitments supported by increasingly harmonized policies and regulations within the region would lead to reduced uncertainty; this would reduce the risk premia demanded by investors, lowering the value of postponing investment decisions, enlarging planning horizons, and so on.

Effects on Nonmembers

Regional groups, especially those that account for a sizable share of world trade, can have significant effects on nonmembers. The net impact is an empirical question and depends on net static and dynamic effects of trade creation and diversion. On the one hand, a large regional group may divert substantial amounts of trade from suppliers outside the region, shifting terms of trade against nonmembers, and possibly driving producers in nonmember countries out of markets where they may have a clear comparative advantage. Furthermore, if the union's external barriers are high, or if there is a perceived high risk that a "fortress mentality" may develop within the union, foreign direct investment that otherwise would have gone to nonmembers may now flow to the union. This latter adverse effect on nonmembers would be accentuated, with an erosion of confidence in the future viability of multilateralism.

On the other hand, nonmembers may reap gains to the extent that the discrimination inherent in the regional group is low (that is, there are minimal external barriers to trade and investment) and progressively reduced by liberalization. Through economies of scale and efficiency gains induced by intensified competition, a large union may be able to export at lower cost; this would imply a favorable move in the terms of trade for nonmembers, offsetting to an extent the deterioration in terms of trade that nonmembers may experience as a result of trade diversion. Other channels for these gains to nonmembers include, among other things, the spillover effects of increased demand for outside imports by the regional grouping and the reduced cost of access to a large market no longer segmented by differential regulations, technical standards, and customs formalities.

III Recent Initiatives

There is great potential for increases in the number of regional integration arrangements in Europe, the Western Hemisphere, Africa, Asia-Pacific, and the Middle East—and in their overlap in terms of membership. (Tables 1–4 list existing as well as prospective arrangements.)

In Europe, the completion of the single market program ("EC 1992") is scheduled for the end of 1992 (Table 1). The EC and the European Free Trade Association (EFTA) aim to form a European Economic Area (EEA) covering 19 countries and 380 million people, which will extend the provisions of EC 1992 to EFTA countries. The EC may also negotiate a similar agreement with Israel. Partly because the EEA will involve some loss of sovereignty for EFTA members without offering all of the advantages of the single market, Austria and Sweden have applied to become full members of the EC and other EFTA members may follow.[8] The EC and the Gulf Cooperation Council (GCC) are also discussing formation of a free trade area.

The Czech and Slovak Federal Republic, Hungary, and Poland have concluded Association Agreements with the EC, which, among other things, will involve free trade agreements between each of the countries and the EC. Further agreements are in prospect between the EC and other East European countries and the former Baltic republics of the Soviet Union.[9] Finally, the EFTA is negotiating free trade agreements with three East European countries (Czechoslovakia, Hungary, and Poland), and with Israel.

In the Western Hemisphere, recent initiatives involve North, Central, and South America, as well as the Caribbean (Table 2). In North America, the United States, Canada, and Mexico are negotiating to form a North American Free Trade Zone (NAFTA). The Enterprise for the Americas Initiative (EAI), which U.S. President George Bush launched in June 1990, envisages an eventual move to free trade in the hemisphere.[10] As an intermediate step, separate free trade areas between the United States on the one hand, and groups of countries and possibly single countries on the other appear likely. To date, 29 countries (including Bolivia and Mexico, which signed agreements prior to the EAI) have signed framework agreements with the United States.[11] To negotiate free trade agreements with the United States, countries in the region need to meet certain criteria.[12] Most countries in Latin America and the Caribbean are currently showing a renewed interest in regional integration. This is partly a response to the U.S. Enterprise for the Americas,[13] but it may also be a defensive reaction to EC 1992 and to the failure to conclude the Uruguay Round on schedule.

In Central America, in June 1990, members of the Central American Common Market (CACM) renewed their efforts to implement a free trade agreement by 1992 and, in December 1990, these countries began drafting a framework agreement for the establishment of a regional common market. In July 1991, the timetable for liberalizing trade among CACM members was formally approved.[14] Panama

[8]Cyprus and Turkey have also applied for EC membership.

[9]The former German Democratic Republic became a member of the EC as a result of German unification.

[10]The Enterprise for the Americas Initiative (EAI) aims to promote economic cooperation with Latin American nations in trade, investment, and debt relief.

[11]Formal negotiations are unlikely to begin until after the NAFTA negotiations are agreed.

[12]These criteria require that countries: eliminate tariff and nontariff barriers on trade between the negotiating parties according to a specified schedule; provide market access for trade in services; provide standards for treatment of investment, including the elimination of local content and performance requirements; take measures to protect intellectual property rights; and restrain government activities such as subsidies, state trading, and the use of foreign exchange restrictions and controls.

[13]Under the EAI, the United States has encouraged Latin American countries to integrate among themselves before seeking to form free trade areas with the United States.

[14]This involves a phased elimination of duties on intra-area trade for most agricultural products by December 31, 1991, with most remaining duties on agricultural products to be phased out by June 1992. Effective December 31, 1992, maximum tariffs on most nonagricultural products are to be reduced to 20 percent; these products will have a minimum tariff of 5 percent with intermediate tariff rates of 10 and 15 percent.

Table 1. Regional Trade Arrangements in Europe

	Existing Arrangements										Prospective arrangements								
	EC[2]	EFTA[3]	EC-Austria	EC-Finland	EC-Iceland	EC-Norway	EC-Sweden	EC-Switzerland	EC-Israel	EFTA-Turkey[4]	EEA[5]	EC-Israel[6]	EC-Bulgaria[7]	EC-Czechoslovakia[8]	EC-Hungary[8]	EC-Poland[8]	EFTA-East Europe[9]	EFTA-Israel[10]	EC-GCC[11]
Founded:	1957	1960	1972–73	1972–73	1972–73	1972–73	1972–73	1972–73	1976										
Objective:[1]	CM	FTA	FTA	FTA	FTA	FTA	FTA	FTA	FTA		CU		FTA	FTA	FTA	FTA	FTA	FTA	FTA
Western Europe																			
Belgium	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Denmark	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
France	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Greece	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Ireland	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Italy	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Luxembourg	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Netherlands	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Portugal	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Spain	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
United Kingdom	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Germany	•		•	•	•	•	•	•	•		•	•	•	•	•	•			•
Austria		•	•							•	•						•	•	
Finland		•		•						•	•						•	•	
Iceland		•			•					•	•						•	•	
Norway		•				•				•	•						•	•	
Sweden		•					•			•	•						•	•	
Switzerland		•						•		•	•						•	•	
Turkey										•									
Eastern Europe																			
Bulgaria													•						
Czechoslovakia														•			•		
Hungary															•		•		
Poland																•	•		
Romania																			
Yugoslavia																			
Israel									•			•						•	
GCC[11]																			•

[1]FTA: free trade area; CU: customs union; CM: common market.
[2] Years of accession to the EC: Denmark, Ireland, and the United Kingdom (1973); Greece (1981); and Portugal and Spain (1986). Austria and Sweden currently have membership pending. The single market program (EC 1992) is to be completed by the end of 1992.
[3]Finland was an associate member until its accession in 1986. Liechtenstein became a full EFTA member in 1991.
[4]The agreement was signed October 1991 and will enter into effect in April 1992.
[5]The European Economic Area (EEA) is currently being negotiated.
[6]The EC may negotiate an agreement with Israel similar to the agreement it is negotiating with EFTA countries to form an EEA.
[7]Bulgaria has requested preliminary discussions toward negotiation of an association agreement involving establishment of a free trade area.
[8]Association agreements, including the establishment of free trade areas between each of the countries and the EC, are being negotiated.
[9]The countries concerned have agreed to examine conditions for gradual establishment of free trade areas.
[10]Currently being negotiated.
[11]Gulf Cooperation Council (GCC) members include Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

Table 2. Regional Trade Arrangements in the Western Hemisphere[1]

	Existing Arrangements											Prospective arrangements						
	US-Canada	US-Israel	CACM[3]	El Salvador-Guatemala[4]	CARICOM[5]	OECS[6]	LAFTA/LAIA	MERCOSUR[7]	Argentina-Brazil	Andean Pact[8]	Chile-Mexico-	NAFTA	EAI (US)[9]	Mexico-Central America[10]	Chile-Colombia-Venezuela	Colombia-Mexico-Venezuela[11]	Venezuela-Central America[12]	RIO Group
Founded:	1988	1989	1961	1991	1973	1991	1960/80	1991	1990	1969	1991		1991					
Objective:[2]	FTA	FTA	FTA	FTA	CU	CU	FTA	FTA	FTA	FTA	FTA	FTA	FTA					
North America																		
Canada	•											•						
Mexico							•				•	•		•		•		•
United States	•	•										•	•					
Central America																		
Belize					•								•					
Costa Rica			•										•	•			•	
El Salvador			•	•									•	•			•	
Guatemala			•	•										•			•	
Honduras			•										•	•			•	
Nicaragua			•										•	•			•	
Panama[13]			•										•	•			•	
Caribbean																		
Antigua & Bermuda					•	•							•					
The Bahamas					•								•					
Barbados					•								•					
Dominica					•	•							•					
Grenada					•	•							•					
Jamaica					•								•					
Monserrat					•	•							•					
St. Kitts & Nevis					•	•							•					
St. Lucia					•	•							•					
St. Vincent					•	•							•					
Trinidad & Tobago					•								•					
South America																		
Argentina							•	•	•				•					•
Bolivia							•			•			•					
Brazil							•	•	•				•					
Chile							•			•	•		•		•			•
Colombia							•			•			•		•	•		•
Ecuador							•						•					
Guyana					•								•					
Paraguay							•	•					•					
Peru							•			•			•					•
Uruguay							•	•					•					•
Venezuela							•			•			•		•	•	•	•
Other Countries																		
Israel		•																

[1]Does not include unilateral trade preferences and exclusive countries with no arrangements.
[2]FTA: free trade area; CU: customs union.
[3]Revived in 1990; aims to establish a common market by 1992.
[4]Effective in October 1991.
[5]Aims to achieve a common external tariff by 1994.
[6]Organization of East Caribbean States.
[7]Aims to establish a common market by 1995.
[8]Efforts are under way to revive AP and create a common market by 1994.
[9]The Enterprise for the Americas Initiative aims to achieve hemisphere free trade zone. As of October 1991, the United States had signed framework agreements with 29 countries including the 13 CARICOM countries, the 4 MERCOSUR countries, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Honduras, Panama, Peru, Nicaragua, and Venezuela.
[10]These countries aim to form a Central American/Mexican free trade zone by 1996.
[11]Signature of the trade and investment agreement occurred in 1991, and trilateral limited free trade is expected by end-1993.
[12]The agreement aims to phase out tariffs on trade in the area.
[13]Panama participates in summits but is not ready to participate fully in regional integration.

participated in the July 1991 discussions as a full member of the CACM for the first time. In January 1991, Mexico and the Central American countries agreed to establish a free trade area by 1996. In September 1991, Chile and Mexico signed a free trade agreement.[15] Venezuela has also signed a trade agreement with Central American countries (see below).

In South America, the Latin American Integration Association (LAIA) announced new tariff reductions and trade liberalization measures in 1990. At its December 1989 summit, the Andean Group, a subgroup of the LAIA, targeted 1995 for the establishment of a free trade area, and 1997 for the establishment of a common market. At its November 1991 summit these deadlines were subsequently accelerated to 1992 and 1993, respectively. In July 1990, Argentina and Brazil agreed to establish a bilateral common market by the end of 1994. In March 1991, Argentina, Brazil, Paraguay, and Uruguay agreed to form a common market (MERCOSUR)[16] by 1995. These countries aim to share a common external tariff; to coordinate fiscal, foreign exchange, and customs policies; and to permit free movement of goods, services, capital, and labor throughout the region. (Bolivia and Chile may also join this group.) In December 1989, the Rio Group agreed to eliminate nontariff barriers to reciprocal trade and to improve the regional tariff preference system. In 1991, Colombia, Mexico, and Venezuela signed an agreement on trade and investment involving trilateral trade liberalization by the end of 1993. In January 1991, Venezuela signed an agreement with Central American countries to create a free trade area by 1996.

[15]The agreement between Chile and Mexico involves the phased elimination of tariffs on 90 percent of goods traded by 1995; the phased elimination of tariffs on petrochemicals, synthetic textiles, glass, meat, poultry, eggs, tobacco, and some timber products by 1998; the reduction of tariffs for motor vehicles from 1996; the creation of a list of exceptions, involving 46 Chilean products (including agricultural products receiving subsidies, such as sugar and wheat, as well as grapes and apples) and 59 Mexican products (including oil and oil derivatives); the immediate abolition of all nontariff barriers; the establishment of an "open skies" and "open seas" policy for the transport of goods and passengers; the introduction of new rules to avoid double taxation and to harmonize investment rules; and a safeguards provision allowing each country to increase tariffs temporarily for balance of payments reasons.

[16]These countries signed an EAI framework agreement with the United States in June 1991—the first such multilaterally negotiated agreement.

In the Caribbean area, the Caribbean Community (CARICOM) members, at their 1990 summit, outlined a new schedule for phasing in the common external tariff, beginning in January 1991 (this date has since been postponed), with completion targeted for January 1994. The summit also targeted July 1991 for the removal of remaining trade barriers. The seven members of the Organization of East Caribbean States (OECS), a subgroup of CARICOM, are undertaking subregional implementation of CARICOM's common external tariff ahead of schedule; in early 1991, they agreed to implement a phased removal of quantitative restrictions on all intraregional imports.[17]

In Africa, although no new arrangements are being formed, efforts continue to complete the Lagos Plan of Action. The Lagos Plan is intended to provide a unifying framework for existing arrangements and to create a common market in sub-Saharan Africa (Table 3).

In Asia and the Pacific, a number of proposals have been advanced to increase regional cooperation and, in some cases, to liberalize regional trade (Table 4). Following the suspension of the Uruguay Round negotiations in December 1990, Malaysia proposed an East Asian Economic Grouping (EAEG) to represent the views of Asian countries in multilateral negotiations.[18] The potential role that such a group might play has been evolving; at the recent meeting of the Association of South East Asian Nations (ASEAN), the name of the EAEG was changed to the East Asia Economic Caucus (EAEC), with its role defined as that of a "consultative" forum on global trade issues. Several other initiatives have been advanced within the ASEAN. For example, proposals by Thailand to create an ASEAN Free Trade Area (AFTA) within 15 years, and by Indonesia for common effective preferential tariffs on selected products, have been endorsed by ASEAN Ministers.[19]

No new arrangements are currently envisaged in the Middle East area (Table 4).

[17]Of the seven OECS members, only Dominica and St. Vincent have implemented the common external tariff; other members have experienced some reluctance to move ahead with full implementation of the agreement.

[18]This is similar to the role envisaged for the Asian-Pacific Economic (APEC) Forum, which also includes Australia, Canada, New Zealand, Japan, and the United States.

[19]The AFTA and the CEPT mechanism were endorsed by an ASEAN summit meeting in January 1992. Other proposals discussed by the ASEAN have not been formally adopted.

Table 3. Regional Trade Arrangements in Africa

	CEAO[2]	CEPGL	ECOWAS	MRU[2]	PTA[3]	SACU	UDEAC[4]	Lagos Plan of Action
Founded:	1972	1976	1975	1973	1981	1969	1964	1980
Objective:[1]	FTA	FTA	FTA	CU	FTA	CU	FTA	EU
Angola					•			•
Benin	•		•					•
Botswana					•	•		•
Burkina Faso	•		•					•
Burundi		•			•			•
Cameroon							•	•
C.A.R.							•	•
Chad							•	•
Comoros					•			•
Congo							•	•
Cote d'Ivoire	•		•					•
Djibouti					•			•
Equatorial Guinea							•	•
Ethiopia					•			•
Gabon			•				•	•
Gambia, The			•					•
Ghana			•					•
Guinea			•	•				•
Guinea-Bissau			•					•
Kenya					•			•
Lesotho					•	•		•
Liberia			•	•				•
Madagascar					•			•
Malawi					•			•
Mali	•		•					•
Mauritania	•		•					•
Mauritius					•			•
Mozambique					•			•
Namibia						•		•
Niger	•		•					•
Nigeria			•					•
Rwanda		•			•			•
Senegal	•		•					•
Seychelles								•
Sierra Leone			•	•				•
Somalia					•			•
South Africa						•		•
Sudan					•			•
Swaziland					•	•		•
Tanzania					•			•
Togo			•					•
Uganda					•			•
Zaïre		•						•
Zambia					•			•
Zimbabwe					•			•

[1]FTA: free trade area; CU: customs union; EU: economic union.
[2]In effect since 1974.
[3]In effect since 1984.
[4]In effect since 1966.

Table 4. Regional Trade Arrangements in Asia-Pacific and the Middle East

	Existing Arrangements					Prospective Arrangements		
	ANZCERTA	ASEAN	ACM[1]	ECO[2]	GCC	AFTA[3]	EAEC[4,5]	APEC[5]
Founded:	1983	1967	1964		1981			
Objective:[1]	FTA	FTA	CU	1985	CU			
Australia	•							•
Brunei		•				•	•	•
China							•	
Hong Kong							•	
Indonesia		•				•	•	•
Japan							•	•
Korea, Republic of							•	•
Malaysia		•				•	•	•
New Zealand	•							•
Philippines		•				•	•	•
Singapore		•				•	•	•
Taiwan Province of China							•	
Thailand		•				•	•	•
Middle East								
Bahrain					•			
Egypt			•					
Islamic Republic of Iran				•				
Iraq			•					
Jordan			•					
Kuwait					•			
Libya			•					
Oman					•			
Qatar					•			
Saudi Arabia					•			
Syria			•					
United Arab Emirates					•			
Yemen			•					
Other Countries								
Canada								•
Mauritania			•					
Pakistan				•				
Turkey				•				
United States								•

[1]FTA: free trade area; CU: customs union.
[2]The purpose of this group is bilateral trade promotion and cooperation in industrial planning.
[3]Thailand proposal endorsed by ASEAN Ministers in 1991.
[4]This grouping was initially proposed by Malaysia in 1990.
[5]Regional grouping to represent members' views in multilateral negotiating fora.

IV Experience with Regional Integration: Industrial Countries

Regional arrangements among the industrial countries generally aim to improve the welfare of participating countries by reducing or eliminating restrictions impeding closer integration of members' national markets. The arrangements under review have varied in terms of the model of integration adopted, their intermediate objectives, the integration instruments used, and the scope and depth of integration sought. (See Box 1 for information on the arrangements reviewed, and the Appendix for their membership.)

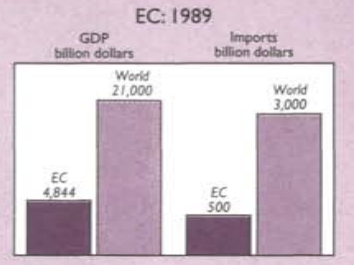
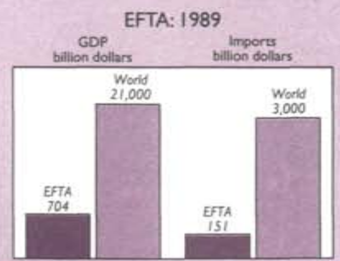
Differences among arrangements have existed at one point in time, and also within and among arrangements over time. Regional integration arrangements have been modified in response to experience, and to changes in the global economic environment and in the economic policy orientations of participant countries. These arrangements have covered trade in goods and, more recently, services. The treatment of "sensitive" sectors such as agriculture, where protection is relatively high, has differed between free trade areas and customs unions; in the former they are either not covered or subject to longer phase-in periods, while in the latter these sectors have been subject to common policies that have resulted in the harmonization of distortions. As tariffs and other border measures have been reduced—both multilaterally and within regional arrangements—increased attention has been given within regional arrangements among industrial countries to other policies that impede access to markets; these include subsidies, standards, customs procedures, government procurement, investment, and competition laws. Intra-area factor mobility has also been included, but commitments on capital mobility have generally exceeded those on labor mobility.

With regard to the models of economic integration, the EC from the outset emphasized the common market model, with the 1957 Treaty of Rome calling for the eventual achievement of unrestricted movement among members of goods, services, labor, and capital—the "four freedoms"—as well as the adoption of common commercial policies vis-à-vis the rest of the world. More recently, with the increased harmonization of policies, the EC has taken important steps in the direction of an economic union. Further policy harmonization is envisaged under the announced plans to establish a monetary union. By contrast, the other cases under review (Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), United States-Canada, and the EFTA) are free trade areas (FTAs), involving liberalization within the region without requiring a common commercial policy vis-à-vis nonmembers.

The instruments and institutional arrangements for integration have varied according to the model of integration. Within the EC, there is significant sharing of sovereignty among members through the establishment of a body of community law as well as supranational institutions and mechanisms for common decision making and enforcement. The EC's integration instruments have therefore emphasized common policies and coordination of national policies. Under the EC 1992 single market program, for example, the removal of remaining barriers to free circulation of goods, services, capital, and people procedurally involves the "transposition" into national legislation of "directives" proposed by the Commission—the EC's administrative and technical body—and adopted by the EC Council. By contrast, the FTAs under review are not supported by significant supranational institutions or elaborate mechanisms for common decision making, although in all cases special institutional arrangements for dispute settlement and for ongoing consultations on matters of common interest have been established.

The coverage of regional arrangements among industrial countries has been fairly broadly based; in most cases trade in both goods and services and investment issues have been covered. In the goods markets, the arrangements have called for an across-the-board removal of conventional barriers to trade (tariffs and quantitative restrictions), within specified time periods and, by and large, in an automatic manner. "Sensitive" sectors—those enjoying significant protection and needing considerable structural adjustment—have been handled

Box 1. Selected Regional Trade Arrangements in Industrial Countries[1]

Name	Objective/Instrument	Implementation Record	GDP and Extraregional Imports[2]
U.S.–Canada Free Trade Agreement Signed: January 1, 1988 Effective: January 1, 1989 Population: 275 million GDP: $6 trillion	Removal of all tariffs and most QRs, January 1989 – January 1999. Liberalization of trade in services, government procurement and investment.	Tariff reductions ahead of schedule.	
European Community (EC–92) Single European Act Effective: July 1, 1987 Population 326 million GDP $6 trillion	Free movement of goods, services, factors of production by 1992.	1968 removal of tariffs, QRs ahead of schedule; common external tariff ahead of schedule. New members acted on schedule. EC–92 on schedule so far.	
ANZCERTA Signed: 1983 Effective: 1983	Elimination of all tariffs by January 1, 1988, all QRs by July 1, 1995. Elimination of all direct export subsidies and incentives by 1987.		
Modified: 1988 Population: 20 million GDP: $340 billion	Elimination of all QRs by July 1, 1990. Liberalization of trade in services.	Broadly on schedule.	
European Free Trade Association (EFTA) Formed: 1960 Population 32 million GDP: $842 billion	Eliminate all tariffs on manufactures by mid-1967.	On schedule.	

Note: QRs = quantitative restrictions.
[1]See Appendix for membership.
[2]Data from World Bank, *World Development Report*, 1991; and IMF, *Direction of Trade Statistics*.

somewhat differently by FTAs and by the EC. Under FTAs, nontariff barriers on sensitive sectors (for example, agriculture, textiles and clothing, leather products, and steel) have often not been removed, while tariffs have been subject to reductions over relatively longer time periods. (In the case of the United States-Canada FTA, "cultural" industries have been excluded because they are considered sensitive by Canada.) In the EC, by contrast, sensitive sectors have tended to be subject to common policies, which have harmonized distortions, although efforts have recently been intensified to reform and liberalize these policies.

Agriculture is a prominent example of a sensitive sector that illustrates the differences in treatment between FTAs and the EC. The EFTA has not included agricultural products in its intra-area liberalization program, as this sector is heavily protected and subsidized at the national level by many EFTA countries. Although the United States-Canada FTA calls for the eventual reduction to zero of all tariffs on agricultural goods and for the elimination of a few nontariff barriers (for example, voluntary export restraint arrangements (VERs) on meat products), it does not cover the major protective farm policies in these countries. In the case of the ANZCERTA, agriculture is already substantially liberalized inside the FTA and also vis-à-vis the rest of the world, although a few areas of agriculture remain protected in Australia. By contrast, the EC has from the outset maintained a highly controlled common market for agricultural products under its Common Agricultural Policy (CAP), which includes a system of support prices, variable levies on imports, and subsidies for exports to compensate for differences between support prices and world market prices. (Other sensitive sectors subject to common policies in the EC include coal, steel, and shipbuilding.)

With most tariffs reduced to relatively low levels in industrial countries and conventional quantitative restrictions on manufactures eliminated in most industrial countries through successive rounds of GATT negotiations, other government-induced impediments to the integration of national markets—including those associated with different levels of subsidies, cumbersome customs formalities, technical and regulatory standards, and national preferences in government procurement practices—have become binding. Regional integration arrangements among industrial countries have increasingly incorporated provisions to reduce all or some of these barriers. In the area of subsidies, the ANZCERTA has gone the farthest among FTAs; effective July 1990 all subsidies and bounties on intra-area exports were eliminated. The EC, under its single market program, has stepped up efforts to reduce distortions in trade and investment arising from different subsidy practices across members by tightening the enforcement of its competition policy (Xafa and Kronenberg, forthcoming). The United States-Canada FTA includes a commitment to phase out subsidies affecting bilateral trade in the automotive sector; however, this FTA could not resolve any other key subsidy issue "because the political costs of removing the [subsidy] programs far outweighed the concessions that could be offered by the other country" (Schott, 1988, p. 31).

The areas of standards, customs formalities, and government procurement have received increasing attention in regional arrangements among industrial countries. Over half of all directives proposed in the context of EC 1992 concern technical and regulatory standards (OECD, 1990). The EC's general approach in this area has been to set "minimum" community-wide standards where necessary and to apply the principle of mutual recognition of national standards in the rest of the cases. As part of the program to create a European Economic Area, the EFTA and EC aim to harmonize technical standards through the European Committee for Standardization (CEN), the Committee for Electro-Technical Standardization (CENELEC), the European Telecommunications and Standardization Institute (ETSI), and through an organization for testing and certification (The European Organization for Testing and Certification, EOTC). The ANZCERTA includes explicit commitments to harmonize standards and other regulations that may impede trade. The United States-Canada FTA has no provisions in this area, although future negotiations are envisaged on technical standards, including testing and certification requirements. With regard to customs formalities, the EC as part of the single market program aims to abolish all such formalities, while the ANZCERTA includes commitments to harmonize customs processing procedures. All regional arrangements under review contain provisions to reduce discrimination in government procurement for member countries.

Recent regional arrangements among industrial countries have covered services and investment, areas hitherto not covered by GATT disciplines. Among FTAs, the United States-Canada agreement broke new ground by establishing firm contractual bilateral obligations to "level the playing field" in services, although the FTA was "better on rule making than on liberalization; almost all existing restrictions [were] grandfathered" (Schott, 1988, p. 31). The United States-Canada FTA includes a positive list of services to be liberalized, notably financial services (where the right of establishment for members' financial institutions and the

elimination of certain Canadian restrictions to access are considered particularly important), but also in computer-based services, tourism, architecture, and professional labor services. In the investment area, the FTA commits Canada and the United States to extend national treatment to each other in most cases. The ANZCERTA broke new ground by establishing a negative list of services specifically excluded by each member country;[20] capital movements between the two member countries are already relatively free. Both free trade in services and free movement of capital are key features of the single market program; directives have already been implemented covering air and road transport, telecommunications, audiovisual works, and financial services (OECD, 1990).

The EC has from the beginning been covered by a community-wide pro-competition policy, which is embedded in Articles 85–94 of the Treaty of Rome. Its enforcement has been significantly tightened under EC 1992 and a new Merger Control Regulation gives the Community authority to scrutinize all mergers and acquisitions that meet certain threshold requirements. Among FTAs, the ANZCERTA is unique in having incorporated (during the 1988 review of the agreement) a commitment to make business laws and regulatory practices of the two members compatible. This was facilitated by strong similarities in competition policies and legal systems, and by the high degree of pre-existing harmonization in areas such as restrictive business practices, intellectual property laws, and consumer affairs (OECD, 1990). Consistent with this agreement, the competition policies of each country apply to trans-Tasman trade rather than antidumping laws (but not countervailing laws). By contrast, in the absence of a commitment to harmonize competition policies, Canada and the United States continue to apply existing antidumping and countervailing laws to trade within the FTA. The FTA, however, established special procedures to deal with bilateral disputes arising in connection with antidumping and countervailing duty cases.

As noted above, FTAs among industrial countries have increasingly included undertakings to maintain and improve intra-area capital mobility, particularly through mutual concessions on financial services and investment. In this regard, FTAs have approached the philosophy of common markets. FTAs have not yet included, however, significant provisions to allow broad based intra-area labor mobility—a key feature of the EC common market. Nonetheless, in the case of the United States-Canada FTA, the provisions to liberalize trade in professional labor services implied a relaxation of temporary entry restrictions for professionals. Moreover, the ANZCERTA was signed against the background of relatively free labor mobility between the two partner countries (OECD, 1990). Provisions allowing free labor mobility within EFTA countries only exist within the Nordic countries (Abrams, and others, 1990).

Implementation Record

Regional integration agreements among industrial countries have been implemented on schedule and often ahead of schedule. The EC, for example, formally removed intra-union tariff and quota restrictions and established the common external tariff by July 1968, one and a half years ahead of the original deadline. Members that joined the EC subsequently (Denmark, Ireland, and the United Kingdom in 1973; Greece in 1981; and Portugal and Spain in 1986) have also adopted the common external tariff and removed tariffs and quota restrictions on intra-union trade in line with mutually agreed schedules. The EFTA also removed barriers to intra-area trade in manufactures in keeping with the original six and a half year timetable. A series of bilateral trade agreements between EFTA countries and the EC—most completed by 1973—have converted nearly all of Western Europe into an effective free trade area for most manufactured products.

The record of successful implementation by the EC of the Treaty of Rome during the 1960s and 1970s must be qualified. As was increasingly realized in the 1970s and 1980s, the formal removal of tariffs and conventional quota restrictions on intra-EC trade did not lead in all cases to the intended "free circulation" of goods. With intra-EC free trade established as a legal requirement in the Treaty of Rome, barriers to the free circulation of goods tended to involve less visible restrictions, including those associated with different subsidy practices among members and discriminatory public procurement practices, as well as those resting in the "nooks and crannies of administrative arrangements" (Holmes and Shepherd, 1983). Similarly, the formal adoption by the late 1960s of a common

[20]Upon adopting the 1988 Services Protocol, New Zealand's exemptions included international aviation, telecommunications, shipping, stevedoring, and postal services. Australia's exemptions included certain banking areas, airport services, construction, domestic and international aviation, telecommunications, coastal shipping, broadcasting and television, engineering and general consultancy, health insurance, and postal services (OECD, 1990). The review of the Services Protocol at the end of 1990 resulted in Australia eliminating the exemptions on construction, engineering, and general consultancy. New Zealand eliminated its inscriptions on stevedoring and telecommunications.

external tariff vis-à-vis the rest of the world did not effectively harmonize external protection for EC member countries. The degree of trade openness has continued to vary substantially among members owing to a significant number of sector-specific bilateral restraint arrangements maintained at the national level, including those maintained under Article 115 of the Treaty of Rome.[21] These restrictions—which typically have taken the form of "voluntary" export restraint arrangements (VERs), and "voluntary" undertakings by foreign suppliers to maintain a minimum price—have mainly affected such sensitive areas as agriculture, textiles and clothing, automobiles, and consumer electronics. In this regard, the EC has operated during most of its existence as an imperfect free trade area more than as a common market (El-Agraa, 1988). The single market program aims to remove the remaining obstacles to a truly unified EC market.

The implementation of more recent regional initiatives (ANZCERTA, EC 1992, and the United States-Canada FTA) has been broadly on schedule. In the case of the ANZCERTA, all tariffs, quantitative restrictions, and export subsidies on trans-Tasman trade in goods were fully phased out as of July 1990, five years ahead of the original deadline. In the case of the United States-Canada FTA, there have been two accelerated reductions in tariffs. In the case of EC 1992, about 70 percent of the 282 proposals submitted by the EC Commission had been approved by the EC Council by mid-1991. The transposition of EC directives approved by the EC Council into the national legislation of member countries has been slower than initially expected. There are, however, indications that the pace of transposition has been accelerating; as of mid-1991, about 70 percent of all approved directives had been transposed into national legislation. A few major difficulties remain in completing the single market program, including in the area of free movement of people (particularly nonprofessional workers and refugees), the harmonization of indirect taxation, and the treatment after 1992 of imports in some sensitive sectors currently subject to national restrictions.[22] In the case of Japanese vehicle imports, national restrictions previously applied by four member countries will be converted into an EC-wide restriction.[23]

Effects of Arrangements

Regional trading arrangements among industrial countries have undoubtedly been more successful than arrangements among developing countries in liberalizing intra-area trade, particularly in manufactures (see next section and Charts 1 and 2).

In sharp contrast to developing country cases (see next section), regional trading arrangements in the industrial world have typically involved countries that were previously highly integrated through trade. With the exception of the ANZCERTA, the regional arrangements under review have been established among countries that have previously been each other's major trading partners (Table 5).

The more recent regional initiatives among industrial countries—namely, EC 1992 and the United States-Canada FTA—have not existed long enough to determine their relative effects on intraregional and extraregional trade. In the cases of the EC and EFTA, which have been in effect for more than 30 years, the importance of intraregional trade increased substantially in the first 10–15 years following the establishment of these arrangements but tended to level off or even decrease in subsequent years. In the case of the ANZCERTA, which has been in effect for less than ten years, the relative importance of intra-area trade has not increased significantly (Tables 5 and 6).

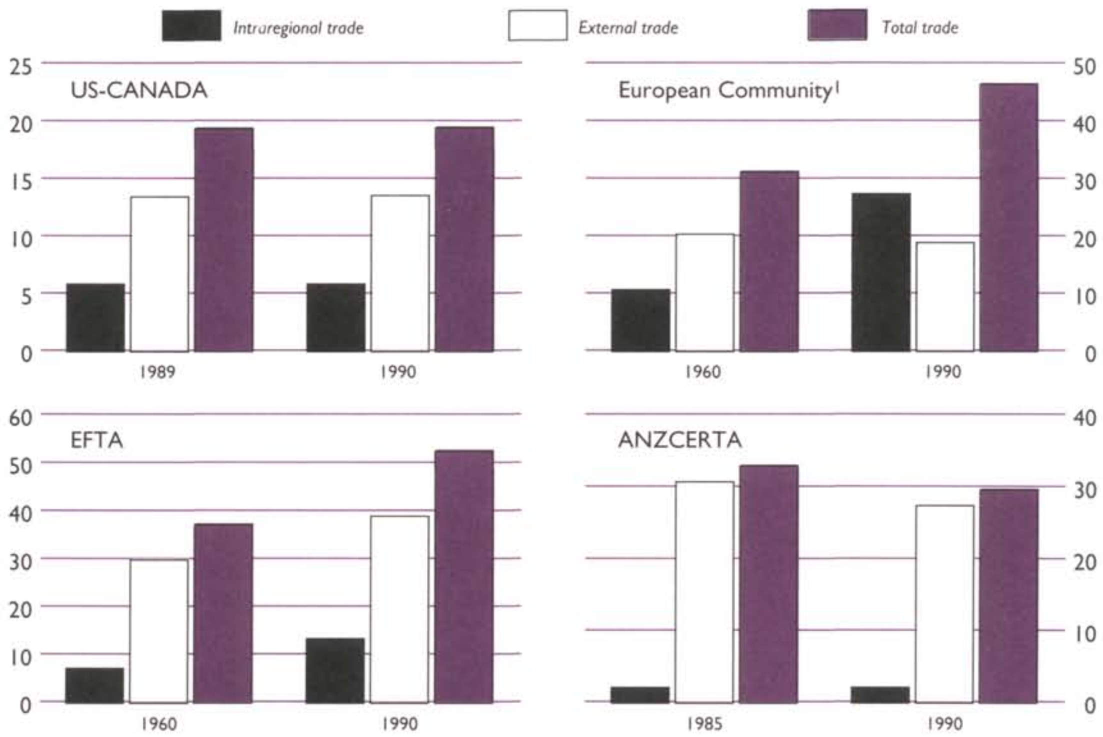
Chart 1 shows the rapid growth, particularly in intraregional trade, within the EC during the first two phases. Trade flows after the creation of the EFTA show relatively fast growth during the first decade, with stabilization at a lower rate after the United Kingdom joined the EC. Furthermore, EFTA exports to both the EFTA and EC have not increased relative to total exports. The trade openness ratios show, however, that international trade activities have gained importance in EFTA economies. For the ANZCERTA, while it is difficult to separate the impact of the trade agreements from those of privatization, deregulation, and unilateral trade liberalization, trade statistics show an acceleration of intra-area trade after the ANZCERTA signing, following the leveling off of intratrade in the latter years of the previous trade agreement. Between 1980 and 1990, intraregional trade as a percent of total trade increased to 7.4 percent from 6.4 percent. At the same time, Australia's traditional trade surplus with New Zealand remained

[21] Article 115 empowers the Commission to authorize member countries to apply protective measures against imports from third countries if such imports threaten domestic production of the product concerned and cause injury. These authorizations temporarily restrict free circulation of goods within the Community.

[22] National restrictions must be eliminated or replaced by EC-wide restrictions because the Commission signaled its intention not to give approval to member states' requests for Article 115 exemptions after 1992.

[23] IMF (forthcoming) discusses the difficulties raised by the agreement on Japanese vehicles from the point of view of trade and competition policies.

Chart 1. Trade Developments in Industrial Country Regional Arrangements
(As a percent of regional GDP)



Sources: World Bank, *World Development Report*, 1991; and IMF, *Direction of Trade Statistics*.
[1]The figures for 1960 are for the original six members, with a GDP of $190 billion. Figures for 1990 are for the EC 12, with a GDP of $6 trillion.

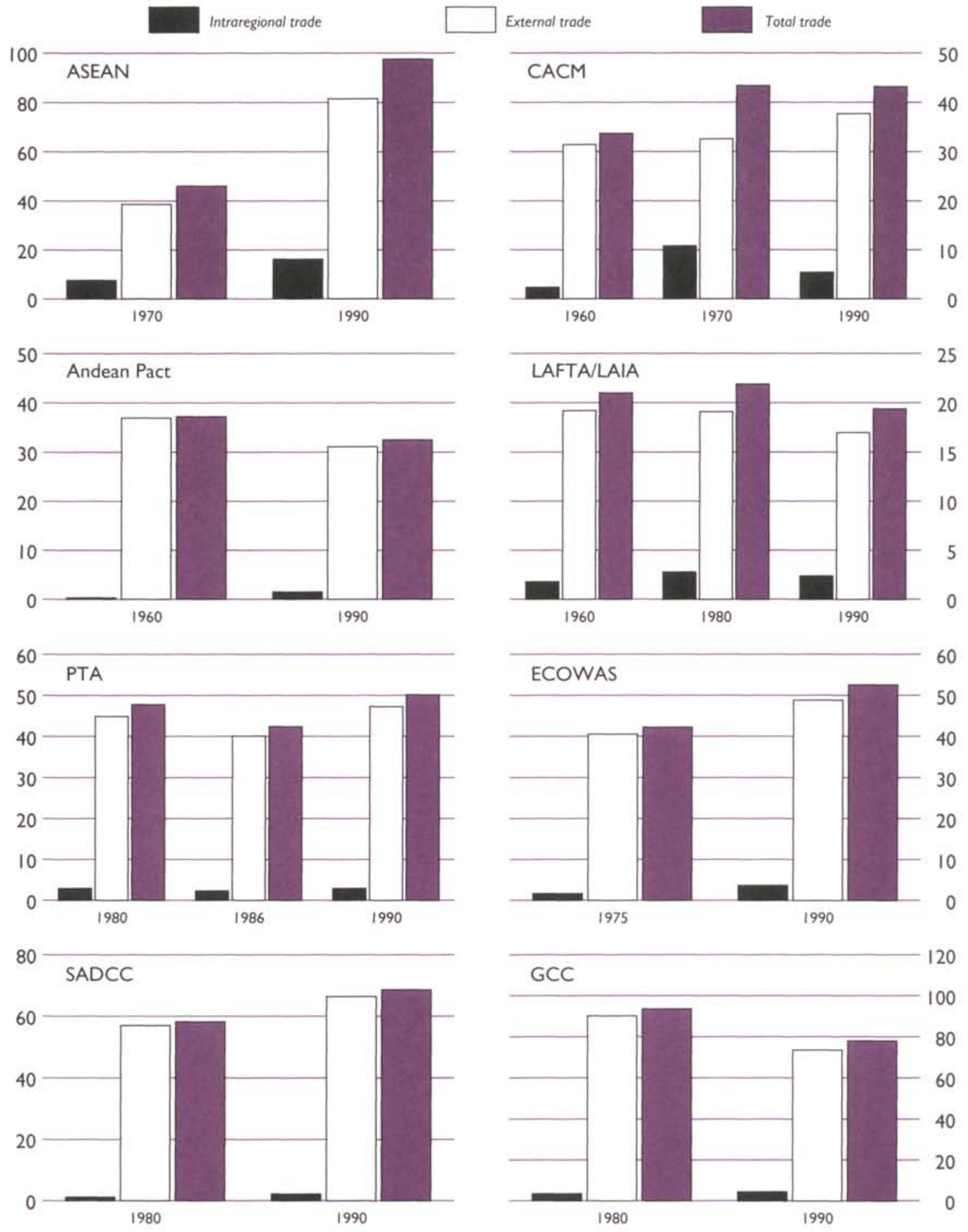
broadly unchanged in nominal terms. Although the trade openness of both countries decreased, this was due primarily to a substantial unit price decrease in both imports and exports. In fact, import volumes in New Zealand expanded considerably in the wake of the trade liberalization measures.

A number of elements explain relatively successful implementation and the greater impact of arrangements on trade within the industrial group. First, trade liberalization within industrial country regional arrangements has involved mainly intra-industry trade specialization (that is, trade in differentiated manufactures); such trade can be achieved without major shifts in factor proportions and entails relatively lower transitional adjustment costs, particularly in terms of labor dislocation.[24] Second, while structural adjustment costs attributable to resource shifts in line with inter-industry specialization have been incurred in certain areas (particularly with intra-area liberalization among the more developed and less developed regions of the EC), these have been easier to sustain in the presence of fairly steady growth—partly reflecting the dynamic effects of regional integration. In the case of the EC, localized structural adjustment costs have been partly alleviated by a system of compensatory transfers—the so-called "structural funds."[25] Third, as noted earlier, structural adjust-

[24]Krugman's (1981) model demonstrates that gains from trade are spread more evenly between capital and labor where similarity in factor proportions, and thus intra-industry trade, dominates. Ex post econometric evidence of links between intra-industry trade and regional integration in the EC and/or EFTA is found, among other things, in Havrylyshyn and Civan (1983), Balassa (1986), and Balassa and Bauwens (1987 and 1988). Greenaway (1989) discusses the general issue of the connection between regional trading arrangements and intra-industry trade.

[25]Gordon (1991, p. 22) argues that, for all their problems, EC transfers via structural funds appear to have been "carefully targeted toward meeting their objectives [of] . . . assisting less developed and declining regions and removing structural rigidities from labor markets."

Chart 2. Trade Developments in Developing Country Regional Arrangements
(As a percent of regional GDP)



Sources: World Bank, *World Development Report*, 1991; and IMF, *Direction of Trade Statistics*.

Table 5. Selected Industrial Country Regional Arrangements: Intraregional Exports
(In percent of region's total exports)

	1960	1970	1975	1980	1985	1986	1987	1988	1989	1990
ANZCERTA	5.7	6.1	6.2	6.4	7.0	6.9	7.8	7.6	7.8	7.6
EC-6	34.5	48.9	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
EC-10	. . .	51.1	50.1	53.5	52.1	. . .	. . .	. . .	. . .	. . .
EC-12	. . .	. . .	. . .	. . .	54.5	56.7	58.5	59.6	59.8	60.4
EFTA	21.1	28.0	35.2	32.6	31.2	30.2	30.0	29.7	29.5	28.2
United States-Canada	26.5	32.8	30.6	26.5	38.0	36.7	37.4	34.8	33.8	34.0
Memorandum items										
Total exports/world exports										
ANZCERTA	2.4	2.1	1.7	1.4	1.6	1.4	1.4	1.5	1.6	1.5
EC-6	24.9	30.5	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
EC-10	. . .	39.0	35.9	34.9	33.9	. . .	. . .	. . .	. . .	. . .
EC-12	. . .	. . .	. . .	. . .	35.6	39.7	40.7	39.5	39.1	41.4
EFTA	16.7	14.9	6.3	6.1	6.3	6.6	6.8	6.6	6.4	6.8
United States-Canada	21.9	20.5	16.8	15.1	16.7	15.3	14.9	16.2	16.7	15.8
Extraregional exports/world exports										
ANZCERTA	2.3	1.9	1.6	1.3	1.4	1.3	1.3	1.4	1.5	1.3
EC-6	16.3	15.6	. . .	. . .	. . .	. . .	. . .	. . .	. . .	. . .
EC-10	. . .	19.1	17.9	16.2	16.2	. . .	. . .	. . .	. . .	. . .
EC-12	. . .	. . .	. . .	. . .	16.2	17.2	16.9	16.0	15.7	16.4
EFTA	13.2	10.8	4.1	4.1	4.4	4.6	4.8	4.6	4.5	4.9
United States-Canada	16.1	13.8	11.6	11.1	10.4	9.7	9.3	10.6	11.0	10.5

Sources: IMF, *Direction of Trade; International Financial Statistics; World Economic Outlook*; and IMF staff estimates.

ment in key sensitive sectors has been postponed because these sectors have not been covered by FTAs or because distortions have been harmonized under common policies within the EC (for example, the CAP) and in some cases within the context of broader multilateral agreements (for example, the Multifibre Arrangement or MFA).

By definition, regional trading arrangements provide preferential treatment for members and inevitably entail some discrimination against nonmembers. Discrimination in industrial-country arrangements has been contained in the past in several ways, including the fact that they have mainly affected trade in manufactures on which members generally maintained low levels of protection vis-à-vis nonmembers. In some cases, restrictions against nonmembers were also reduced as regional arrangements were implemented (the EC, for example, reduced restrictions on manufactured products in the context of multilateral trade negotiations, and Australia and New Zealand have reduced restrictions on agricultural and manufactured products, as well as on services on a unilateral basis). In other cases, restrictions against third countries were relatively low at the time that the arrangements were formed (as were those on manufactured products covered by the United States-Canada FTA). Trade diversion in some cases was also limited by the similar economic structures of the countries forming the agreement (United States-Canada FTA). In addition, with the exception of the ANZCERTA, regional arrangements among industrial countries have involved countries that were important trading partners prior to forming a preferential trading arrangement.

This said, however, some arrangements that liberalized intraregional trade maintained high protection—and thereby, significant discrimination—vis-à-vis nonmembers. The extent and nature of discrimination against nonmembers has varied among regional arrangements. Here, the stance of policies in the EC and in the United States-Canada FTA are globally significant given their importance in world trade. Even if these arrangements increase global welfare, they involve large negative effects for countries whose production and exports are concentrated in sectors where discrimination has increased or remains high.

Bilateral liberalization under the ANZCERTA has not led to notable discrimination against nonmembers, even though the previously relatively minor importance of intra-area trade in the ANZCERTA's total trade (see below) might, in principle, have accentuated this risk. The absence of sizable discrimination reflects the fact that both Australia and New Zealand have been aggressively pursuing unilateral, nondiscriminatory trade liberalization—on goods and services, particularly financial services—simultaneously with the implementation of the ANZCERTA (OECD, 1990). Areas where discrimination is a concern include textiles and apparel, footwear, motor vehicles, and—in Australia—a few agricultural subsectors. Some quota restrictions and relatively high tariffs remain in these areas against third parties, even though tariffs and quota restrictions have already been fully phased out on virtually all trans-Tasman trade. The degree of discrimination in these cases, however, is being progressively reduced as Australia and New Zealand continue to implement their unilateral trade liberalization programs, which seek to eliminate all remaining quota restrictions and reduce all tariffs to low and fairly uniform levels. Other discriminatory elements in the ANZCERTA include mutual preferences in public procurement practices not extended to nonmembers, and in rules of origin. The latter are biased in favor of sourcing within the area, as products eligible for free trade within the region must have at least 50 percent of their value attributable to raw materials or value added from within the ANZCERTA. The discriminatory elements in the ANZCERTA are globally insignificant since this FTA accounts for only a minor share of world trade (about 1.5 percent in 1990).

The extent of discrimination against nonmembers of the United States-Canada FTA has been mitigated to a degree by the substantial integration of trade between the two countries prior to entering into the FTA (Chart 1); by relatively low average tariff rates on manufactures vis-à-vis nonmembers—although rates are somewhat higher in Canada than in the United States; and by the high proportion of bilateral trade already subject to zero tariffs prior to the agreement. The similar economic structures of the two countries also limit the scope for trade diversion while expanding scope for trade creation via intra-industry competition. (In the area of financial services, the FTA allows U.S. financial institutions a degree of preferential access to Canada. The ongoing liberalization and the opening up of the Canadian financial sector suggests, however, that this preferential access is unlikely to endure.) For example, in 1988, about 70 percent of U.S. exports to Canada, and nearly 80 percent of Canadian exports to the United States, entered the other country duty free; at the same time, Canada purchased nearly one fourth of U.S. exports and the United States was the destination of over three fifths of Canadian exports. However, some discrimination will persist as high tariffs or nontariff barriers remain for nonmembers for some products on which tariffs and nontariff measures on intra-area trade will be removed within ten years. These include textiles and clothing, footwear, some chemicals, soft plywood and furniture, steel, tires, and a few subsectors in agriculture and energy (OECD, 1990). Developing countries with a comparative advantage in these products would be most affected by this trade diversion. A multilateral agreement in the Uruguay Round to phase out the MFA and reduce tariff peaks on textiles and footwear would reduce the scope for trade diversion in these sectors. Discrimination against nonmembers is also likely to result from rules of origin, which are biased in favor of intra-area sourcing, and public procurement practices—which include bilateral concessions that go beyond the GATT Procurement Code—to which both countries are signatories.

In contrast to FTAs, the EC common market has by definition sought to maintain common trade policies vis-à-vis nonmembers. This approach has been a two-edged sword with regard to discrimination, depending on whether the creation of common external barriers—or their extension to new members—has resulted in higher or lower external protection. On balance, discrimination against third parties has been tempered by the reduction of

Table 6. Selected Industrial Country Regional Arrangements: Changes in Trade to GDP Ratios

		Total	Intra-regional	External
ANZCERTA	1980–90	–2.4	0.2	–2.6
EC-6	1960–70	11.6	10.1	1.5
EC-10	1970–85	12.0	6.8	5.2
EC-12	1985–90	–5.1	–0.2	–4.9
EFTA	1960–70	2.6	3.2	–0.6
	1970–75	8.4	4.6	3.8
	1975–85	10.7	1.3	9.4
U.S.-Canada	1985–90	2.1	0.3	1.9

Sources: IMF, *Direction of Trade; International Financial Statistics; World Economic Outlook*; and IMF staff estimates.

the common external tariff to low levels on most manufactures through successive rounds of GATT negotiations. A low common external tariff has influenced members that joined the EC after its foundation—particularly Greece, Spain, and Portugal—to liberalize in areas where these new members' prior protection exceeded the common external tariff. (For instance, Spain's average tariff on most-favored-nation (MFN) trade fell to 5 percent from about 13 percent as a result of joining the EC and adopting the EC's common external tariff.)

Some areas (for example, agriculture, coal and steel, shipbuilding, and textiles and apparel) have enjoyed high levels of protection for decades, and maintenance of a common EC commercial policy vis-à-vis nonmembers appears to have raised average effective protection in those sectors for some EC members above levels in the absence of the common market.[26] This problem is most pronounced in the case of the CAP, which has introduced substantial discrimination against nonmembers in virtually the entire range of agricultural tradable products. In this regard, the EC differs from FTAs (other than the ANZCERTA), as the latter cover few agricultural subsectors. Protection and subsidization of farm products is high in many industrial countries participating in FTAs. By excluding agricultural products from intra-area liberalization, the FTAs neither help reduce this protection nor add to discrimination against nonmembers. The CAP sets intra-EC agricultural prices far above world prices, and generates structural oversupply—reflected in high stockbuilding and heavy subsidization of exports—and thus tends to depress world prices and to drive efficient producers out of business.[27] In the absence of a substantial reform of the CAP, discrimination against third countries in agriculture may widen to the extent that new members with relatively lower protection in this area are admitted to the EC. Spain and Portugal had to raise their external protection on agricultural products significantly when they joined the EC and embraced the CAP in 1986.[28] A similar situation may arise in the case of Sweden, which has recently applied for EC membership and currently plans to reduce protection substantially for agriculture over a three-year period that began at the end of 1991. The CAP is costly not only for foreign suppliers, but also for EC consumers, and it results in losses in productive efficiency within the EC owing to the misallocation of resources.

In addition to the areas mentioned above, there are concerns that other elements of the single market program may discriminate against nonmembers. These concerns are related to public procurement policies, the possibility that "reciprocal treatment" may be demanded from third countries whose firms seek access to the EC internal market, and the possible conversion of some national trade restrictions into EC-wide restrictions.

The extent of future discrimination would be affected by a number of factors. First, discrimination in regional arrangements in industrial countries tends to be concentrated in such sensitive areas as agriculture and textiles, currently subject to multilateral negotiations (see Chapter VI). A successful completion of the Uruguay Round could reduce discrimination against third countries associated with these arrangements and help ensure that they serve as building—rather than stumbling—blocks to global trade liberalization.

Second, the adverse static effects on nonmember countries attributable to trade diversion may be offset by dynamic gains generated by regional arrangements. As discussed in Chapter II, to the extent that these arrangements maintain an open external trade regime, nonmember countries may benefit from increased demand by member countries for outside imports; lower-cost exports originating in the regional grouping (achieved, for instance, through the exploitation of economies of scale); and access to a large regional market no longer segmented by administrative, technical, or regulatory barriers to trade. These benefits to nonmembers may, however, be dampened to the extent that regional groups achieve higher growth on the basis of "defensive" foreign direct investment—that is, investment diverted to member countries to enable foreign firms to "jump" existing trade barriers and hedge against the perceived risk that a regional grouping may adopt a

[26]Strictly speaking, textiles and apparel are not subject to an EC common policy to the same extent as agriculture, coal and steel, and shipbuilding. However, many import quotas on textiles and apparel under the MFA are negotiated for the EC as a whole and these seem appreciably higher than intra-EC barriers affecting this sector. Intra-EC trade in textiles, however, continues to be hampered by technical regulations and a complex scheme to distribute EC-wide quotas among members.

[27]The conditions of access to EC agricultural and other controlled markets have varied significantly for nonmembers because of a complex hierarchy of preferential arrangements maintained by the EC. These arrangements include FTAs with individual EFTA countries; trade and cooperation agreements with certain Mediterranean, African, Caribbean, and Pacific States (ACP), and Eastern European countries; and the EC's generalized system of preferences, which is granted unilaterally to developing countries. The reduction of discrimination against non-EC members participating in these preferential arrangements is, of course, at the expense of other non-EC countries.

[28]For instance, tariffs on corn and sorghum went from about 20 percent to a tariff-equivalent of over 100 percent when Spain joined the EC (Callahan, 1989). As discussed in Callahan (1989), however, the lowering of Spain's tariffs on manufactures to match the common external tariff of the EC was more important to nonmembers as a whole, and more than offset the adverse discriminatory effect of higher protection on agriculture.

"fortress mentality." (Such investment might be considered a "second best" solution, in that it results in a different pattern of investment than would occur in the absence of trade barriers.)

Third, the globalization of investment and production partially undermines the validity of basing the above analysis of discrimination on nation states as the main trading units. Foreign firms that have internationalized their operations and are already located within the geographic boundaries of the regional group may gain from discrimination. Profit repatriation and other less tangible returns (such as learning by doing in managerial and technical areas, market knowledge, and so on) could reduce, and perhaps reverse, the adverse effects of discrimination against third countries to which these firms belong. Lipsey (1990) and Peck (1989) have argued that non-EC multinational firms long since established in the EC have greater experience than many EC firms in treating the EC as a single market and are, therefore, relatively well positioned to take advantage of the unified market. A corollary is that third countries in the developing world that are not well integrated into the globalization process—largely as a result of their own domestic policies—stand to gain significantly less than other nonmembers from regional arrangements among industrial countries.

Quantifying Net Gains

Numerous studies have attempted to quantify the net gains and losses of regional integration arrangements among industrial countries. The impact of regional arrangements on third countries depends on whether trade diversion is outweighed by trade creation owing to both static and dynamic effects. This section summarizes the results of some such studies. It covers studies of arrangements where sufficient historical evidence provides the basis for an ex post analysis (the EC, EFTA, and ANZCERTA), and a number of studies on the prospective impact of the EC 1992 program and the United States-Canada FTA.

Ex Post Studies

Ex post studies have tended to focus on the static trade-diversion and trade-creation effects of regional trading arrangements. They have concluded that trade diversion exceeds trade creation for the EC and EFTA, with the reverse true for the ANZCERTA.

With regard to the EC, El-Agraa (1985a, 1985b, and 1988) argues that trade diversion exceeded trade creation in the first 10–15 years after the EC's establishment and that trade diversion was largely concentrated in agriculture, where—as noted earlier—highly distortive protection was harmonized under the CAP. Petith (1977) concludes that the formation of the EC led to an improvement in its terms of trade vis-à-vis the outside world—partly because of the lack of retaliation by the latter. Furthermore, until the mid-1980s, researchers found no significant evidence that the formation of the EC had led to higher-than-otherwise foreign direct investment, except perhaps from Japan (see Mayes, 1985; and El-Agraa, 1988).

A number of studies have attempted to measure the impact of the EFTA agreement on its member countries. Studies undertaken in the early 1970s focused on trade-creation and trade-diversion effects during the EFTA's first decade (EFTA, 1969, p. 24; Robertson, 1970, p. 91) and estimated trade creation to be higher than trade diversion (about \$0.5–\$2.0 billion, compared with \$0.4–\$0.9 billion in 1967). Later studies focusing on the period after the tariff cuts and the removal of quantitative restrictions did not find significant trade creation or diversion in EFTA countries. They showed, however, some trade diversion from trading regions outside the EC and EFTA (Utne, 1984; and EFTA, 1980).

Studies of the ANZCERTA show ambiguous results. Banks (1990), in a study of the effects on the Australian manufacturing sector, found the 1983 agreement provided more trade creation than trade diversion in Australia. The study also attempted to quantify the gains from increased specialization and economies of scale in both countries; it found that these sources of trade gains, as well as those provided by trade creation, were substantially higher for New Zealand than for Australia. Crocombe (1991), by contrast, focusing on the competitiveness of the New Zealand economy and based on a microeconomic approach, found few advantages of intra-area trade liberalization for the New Zealand economy.

Prospective Studies

In the case of EC 1992, the "Cecchini Report" (Cecchini, 1988) concludes that the single market program would lead to a once-off increase in the EC's real income of between 2.5 and 6.5 percent by improving resource allocation. Peck (1989) argues that the Cecchini Report overestimates the once-off gain from improved microeconomic efficiency by a factor of 2 to 3, partly on the grounds that it is doubtful that the single market program will be implemented in full. Baldwin (1989), by contrast, suggests that the Cecchini Report significantly underestimates the economic benefits because it ignores the indirect dynamic effects of EC 1992 over

the medium and long run. He estimates that the direct efficiency gain of the single market adds 0.9–2.8 percentage points to Cecchini's growth range in the medium term. The 1991 United Nations Conference on Trade and Development (UNCTAD) Trade and Development Report considers some of the spillover effects of EC 1992. Using a figure of 5 percent (in the middle of the Cecchini range) for EC income growth, UNCTAD estimates that this enhanced income could lead to $10 billion (7 percent of base-year exports) in increased exports from the developing countries to the EC.

Empirical estimates of the real income gains from trade within the United States-Canada FTA are highly sensitive to the underlying model used, whether macroeconomic or computable general equilibrium (CGE). Macroeconomic models typically allow for unemployment in factor markets and focus on the short- and medium-term impact of the FTA on such variables as output, investment, unemployment, and the trade balance. By contrast, CGE models usually assume full employment and allow for a detailed specification of complex microeconomic behavioral relationships and intersectoral and inter-country interactions. While macroeconometric models estimate the parameters, CGE models borrow the parameters from other studies or simply chose them on the basis of educated guesses. The numerical results of CGE models should be seen as simulations—rather than as forecasts—consistent with a given set of parametric and theoretical specifications.

Studies of the United States-Canada FTA based on macroeconomic models predict real income gains for Canada.[29] Studies based on computable general equilibrium models provide conflicting results and are highly sensitive to theoretical specifications (particularly market structure and pricing behavior) and elasticity and scale parameters. Some models that assume constant returns to scale and other studies reach the opposite conclusion, although the size of the gains and losses are relatively small. Studies incorporating increasing returns to scale tend to suggest larger gains for Canada, but within a wide range (1–9 percent of real income). The inconclusive results regarding the impact of the United States-Canada FTA on economic growth in the two countries implies that its likely impact on third countries is also inconclusive. To the extent that real income gains in both countries result from free trade, an increase in the demand for imports from the rest of the world can be expected, which would offset at least part of any losses incurred by third countries owing to trade diversion resulting from relative price changes.

Although there is yet no general theory on imperfect competition and the dynamic effects of liberalization are still poorly understood, scholars increasingly agree that economies of scale and investment effects are key to understanding and assessing the impact of the United States-Canada FTA and the EC 1992 single market program. This view appears to be corroborated by available data on investment and corporate restructuring. For instance, according to Howell and Cozzini (1990), international merger and acquisition activity targeting Western Europe rose sharply from $9 billion in 1986, to $31 billion in 1988, and to $52 billion in 1989. Most of this activity came from Western European countries themselves, as intra-European cross-border merger and acquisition deals increased from $5 billion in 1986 to $22 billion in 1988, and to nearly $28 billion in 1989. In the case of North America, international merger and acquisition deals targeting this area also increased markedly, from $29 billion in 1986, to $68 billion in 1988, before declining to $60 billion in 1989. The intra-North America component, although relatively less important than in the European case, has been significant: cross-border merger and acquisition activity within North America doubled from $5 billion in 1986 to about $10 billion annually in 1988–89.

[29]Macroeconomic studies include Canada, Department of Finance (1988); and Magun, and others (1988). General equilibrium models include Hamilton and Whalley (1985), Brown and Stern (1989), Andersson (1990), Harris and Cox (1985), and Wigle (1988).

V Experience with Regional Integration: Developing Countries

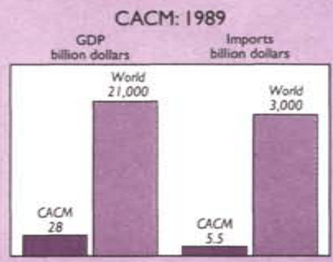
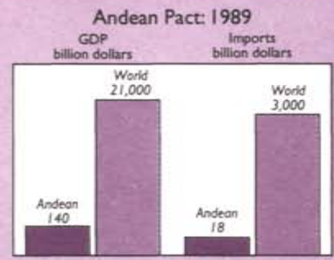
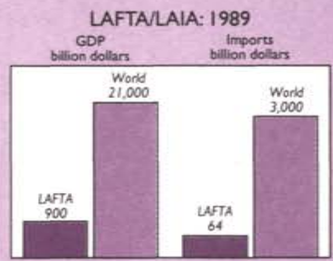
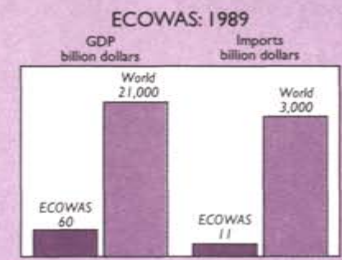
Regional integration schemes have featured highly in the policy agenda of developing country governments during the past three decades, although the strength of the commitment to such arrangements has fluctuated considerably. Developing countries have typically considered regional integration efforts to be, at a minimum, conducive to economic development and political stability in the region as well as to the bargaining position of developing countries in multilateral forums. At times and in some cases, regional integration has been considered essential for self-sustaining growth and development. Views on the role that regional integration might play in development have evolved in line with changing historical circumstances and economic and political philosophies.

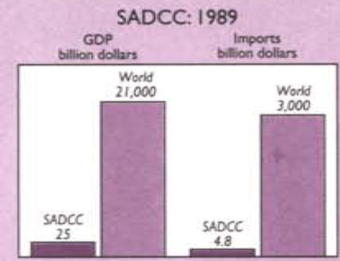
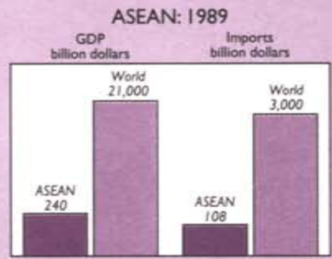
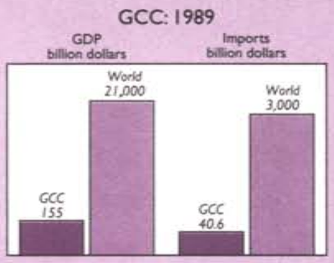
The great variety of regional integration arrangements among developing countries defies easy generalization. Box 2 provides general information and Table 7 more detail on the specific objectives of existing regional groupings, particularly those emphasizing preferential (reciprocal) trading arrangements, in the form of free trade areas or customs unions. (See also Appendix for the membership of these groups.)

A movement toward regional integration schemes in Latin America began in the 1950s, leading to the establishment of the Latin American Free Trade Association (LAFTA) and the Central American Common Market (CACM), both in 1960. Although stimulated in part by regional arrangements formed in Europe during the 1950s, the Latin American cases were based on an entirely different rationale. Reflecting the predominant economic philosophy of the times—promoted largely by the Economic Commission for Latin America (ECLA)—intraregional trade liberalization was seen mainly as a means to overcome the limits imposed by small domestic markets on an import-substitution development strategy. The expectation was that larger regional markets would engender economies of scale and provide firms with a "training ground" to gain the competitiveness needed for later success in world markets (Morawetz, 1974). This view permeated the design and choice of integration instruments in Latin American arrangements, most notably the CACM and the Andean Pact but also the Caribbean Community (CARICOM), where explicit means were devised to allocate import-substituting industries among members while attempting to ensure "balanced" industrial development. Interest in regional integration declined somewhat from the mid-1970s to the mid-1980s, against a background of disappointing results in the major Latin American group (the LAFTA) and the emergence of the debt crises in the 1980s. Under the current revival of regionalism on the continent (see Chapter III), the previous emphasis on import substitution appears to be giving way to a more outward-oriented and market-based approach, both in new regional arrangements and in old arrangements being revived.

The historical roots of regional integration schemes in sub-Saharan Africa may be traced to decolonization. Regional integration has been seen as a key means for cooperation in the midst of the often centrifugal forces stemming from the complex process of nation building. Against the background of fragile economic units, all regional integration arrangements in sub-Saharan Africa have emphasized collective economic self-reliance and security, with intraregional trade liberalization considered a key mechanism for achieving shared aspirations for growth and development. Sub-Saharan Africa has the largest number of regional groupings in the world, with considerable overlapping membership. It also has the largest number of ineffective or dormant arrangements. The Lagos Plan of Action, launched by the Organization of African Unity in 1980, provided a unifying framework for these arrangements. This plan envisages separate but convergent efforts toward integration in the three sub-Saharan African subregions: West Africa, East and Southern Africa, and Central Africa. The main arrangement in the first subregion is the Economic Community of West African States (ECOWAS)—established in 1975—which encompasses and broadens the memberships of the Economic Community of West Africa (CEAO) and

Box 2. Selected Regional Trade Arrangements in Developing Countries[1]

Name	Objective/Instrument	Implementation Record	GDP and Extraregional Imports[2]
Central American Common Market (CACM) Signed: 1960 Effective: June 1961 Revised: June 1991 Population: 25 million GDP: $25 billion	Customs union and joint industrial planning. Elimination of tariffs, QRs within region. Adoption of Common External Tariff (CET).	Initially on schedule; most restrictions lifted by early 1970s, but reintroduced 1980s. CET not effective in all members.	
Andean Pact (AP) Signed: 1969 Population: 88 million GDP: $140 billion	Customs union and joint industrial planning. CET by end–1980. Modified: 1988 Revived: 1989 Establish FTA by 1992, common market by 1993, phase out exceptions by 1995. Harmonize macroeconomic policies.	Postponed several times.	
Latin American Integration Association (LAFTA/LAIA) LAFTA signed: 1960 Effective: 1961 Replaced by LAIA: 1980 Population: 375 million GDP: $1,024 billion	Free trade association and industrial planning; common lists of products to be implemented by 1972. Facilitation of bilateral cooperation.	Partial implementation in 1960s. Common lists not liberalizated on schedule.	
Economic Community of West African States (ECOWAS) Founded: 1975 Population 180 million GDP: $80 billion	Free trade area and customs union, development and policy harmonization. Original targets for liberalization and CET by 1990. New target to eliminate NTBs by 1995. Enhance labor and capital mobility.	Progress negligible.	

Preferential Trade Area for Eastern and Southern Africa (PTA) Founded: 1981 Effective: 1984 Population: 220 million GDP: $70 billion	Free trade area: harmonization of policies. Elimination of tariffs on all goods traded in the PTA by 2000; reduction of NTBs.	Some progress on tariffs.	
Southern African Development Coordination Conference (SADCC) Founded: 1980 Population: 79 million GDP: $25 billion	1. Reduce economic dependence (on South Africa); 2. foster cooperation for balanced growth; and 3. coordinate and secure external support.	Successful in achieving 2 and 3.	
Association of South East Asian Nations (ASEAN) Founded: 1967 Population: 310 million GDP: $240 billion	Regional industrial cooperation; free trade area (trade policy subordinate to regional import substitution).	FTA repeatedly postponed; industrial cooperation scarcely implemented.	
Gulf Cooperation Council (GCC) Founded: 1981 Population: 22 million GDP: $155 billion	Political coordination and customs union; harmonization of policies. CET and Customs Union originally by 1986, now by March 1993.	1982 – Virtual elimination of customs tariffs. 1983 – Unification of tariff schedules, liberalization of trade in services.	

[1]See Appendix for membership.
[2]Data from World Bank, *World Development Report*, 1991; and IMF, *Direction of Trade Statistics*.

Table 7. Selected Regional Trade Arrangements in Developing Countries: Main Objectives

	CACM	ASEAN	LAFTA/LAIA	Andean Pact	ECOWAS	PTA	GCC
Tariff elimination	o	o	o	o	o	o	o
Nontariff elimination	o	o		o	o	o	
Positive list		o			o	o	
Negative list				o			
Rules of origin		o			o	o	o
Common external tariff	o			o	o		o
Specified timetable for liberalization	o			o	o	o	o
Free trade in services							o
Free movement of labor					o		o
Free movement of capital					o		o
Promotion of industrialization	o	o	o	o	o	o	o
Compensation fund					o		
Promotion of other trade objectives		o		o	o	o	o
Accompanying payments arrangement	o		o			o	

the Manu River Union (MRU). The Preferential Trade Area (PTA), in operation since 1984, was established for Eastern and Southern Africa. With regard to Central Africa, the Economic Community of Central African States (CEEAC) has been under negotiation for some time; it would encompass and broaden the memberships of existing arrangements in the subregion, namely, the Customs and Economic Union of Central Africa (UDEAC) and the Economic Community of the Great Lakes Countries (CEPGL). Approaches to regional economic cooperation not emphasizing preferential trading agreements have also emerged, illustrated in particular by the Southern African Development Coordination Conference (SADCC), established in 1980. The SADCC is excluded from this analysis, since it did not aim to increase intraregional trade; however, it made significant progress in other areas (see Box 3).

Broadly speaking, the enthusiasm for regional integration arrangements in Asia and the Middle East has not been to date as pronounced as in sub-Saharan Africa and Latin America. Sharp ideological differences, political instability, frequent military hostilities, and substantial economic heterogeneity (in terms of market size, resource endowments, and per capita income level) among countries explain why regional integration schemes involving intraregional trade liberalization have not been numerous in these areas (Langhammer and Hiemenz, 1990). The same reasons, however, seem to have favored a variety of political and economic cooperation agreements. For example, the success of the Association for South East Asian Nations (ASEAN), established in 1964, stems not from intraregional trade but mainly from it having become an effective interlocutor for cooperation in economic matters and foreign affairs with OECD countries. Ambitious plans for integration contained in the design of the Arab Common Market (ACM) and the Maghreb Customs Union, both established in the 1960s, have remained largely unimplemented. By contrast, cooperation efforts have achieved considerable success in a number of cases, including, among other things, an earlier agreement on Regional Cooperation for Development among the Islamic Republic of Iran, Pakistan, and Turkey—replaced in 1985 by the Economic Cooperation Organization (ECO)—and the Gulf Cooperation Council (GCC), established in 1981.

Intraregional Trade

The following analysis is based on regional arrangements in which intraregional trade liberalization had been expected to play a central role. (The assessment does not focus on noneconomic objectives of regional integration arrangements. Nor does it apply to agreements geared exclusively toward economic cooperation or to the economic cooperation aspects of integration arrangements.) In general, regional arrangements among developing countries have not led to a large or sustained rise in intraregional trade (Tables 8 and 9, and Chart 2), but they have been more successful in other areas of economic cooperation. Further scope may therefore exist for enhancing such cooperation in the joint production of "software" public goods, such

Box 3. Southern African Development Coordination Conference (SADCC)

This paper focuses on regional arrangements aimed mainly at trade liberalization. Trade liberalization is not a major goal of the Southern African Development Coordination Conference (SADCC), and its strong performance has, therefore, not been discussed. Its effectiveness as a regional organization may, however, have lessons for others, while its focus on establishing cooperation in other areas has been important in facilitating trade (Chart 2).

The SADCC, founded in 1980, comprises ten member states.[1] Its main objectives are to reduce economic dependence, particularly on South Africa, foster cooperation among members on projects to promote a balanced regional development, and coordinate and secure support from "cooperating partners" (that is, foreign donors).[2] The SADCC's pragmatic approach emphasizes flexible and feasible cooperation on specific projects rather than detailed and highly formalized multicountry agreements. The SADCC does envisage expanding trade among members, but mainly along the narrow lines of production covered by SADCC-sponsored industrial programs. Although more recently, the SADCC has shown interest in liberalizing internal trade, it continues to adhere to the motto: "let production push trade rather than trade pull production."

Consistent with its pragmatic approach, the SADCC has a small secretariat (in Gaborone, Botswana), which performs limited coordination, conducts research on regional issues, and takes the lead in certain regional policy discussions. The main responsibility for coordinating sectoral programs is assigned to individual members (for example, food security to Zimbabwe, and energy conservation and development to Angola). SADCC policy is set annually at a summit meeting of heads of state, where priorities are established and decisions on which projects to include as official SADCC projects are made. Decisions on individual sectors are made by the relevant ministries. Eligible projects must have substantial regional content. The annual Consultative Conference, which includes open meetings with "cooperating partners" (that is, foreign donors), is equally important because it provides funding to SADCC projects.

The SADCC as a whole is relatively small in economic size. Its GDP of about $25 billion compares to that of Chile or Morocco, while its population of 79 million is comparable to that of Mexico, yielding a low per capita income (about $315). A number of SADCC countries, however, are relatively rich in such mineral resources as copper, cobalt, chrome, diamonds, gold, silver, and uranium. Nearly all members are heavily dependent on South Africa, which supplies about one third of SADCC imports. Intra-Conference trade has remained below 5 percent of total SADCC trade since the 1970s (Chart 2), and nearly half involves semi-manufactured and manufactured goods, compared to 10 percent for total SADCC trade, which suggests some potential for regional trade creation. However, about 80 percent of intra-Conference trade is accounted for by Zimbabwe, which is the most industrialized member of the SADCC, deriving about 30 percent of its GDP from manufacturing. Six of the ten member countries are landlocked. Transport and communication networks—particularly rail links to Mozambique ports—have been often and severely disrupted by guerilla attacks, causing certain landlocked members to shift to substantially longer and costlier routes to South African ports.

The SADCC has been rather successful in achieving some of its objectives, although its economic dependence on South Africa has not been appreciably reduced. The SADCC's focus on specific projects has helped mobilize foreign donor support and the delegation of responsibilities has enhanced efficiency in project implementation. Attention has appropriately centered on projects with substantial positive externalities for the region, with transport and communications at the top of the SADCC priority list during most of the 1980s. Despite military activity around transport corridors, by 1990 60 percent of transit traffic from the six landlocked states moved through SADCC ports, compared with only 20 percent in 1980, and national power grids in six member states had been interconnected. Progress was also made in the 1980s in other priority areas, particularly food security. By the late 1980s, the SADCC could point to visible achievements: firms were increasingly shipping and receiving cargo through ports and railways improved under SADCC auspices (which was particularly beneficial for landlocked countries); air links had also improved, including cooperation between national carriers; the intra-Conference share in the SADCC total international telecommunication traffic had risen to about 15 percent (compared to 8 percent in 1980), and new crop strains from the SADCC research center were being used. In terms of value, transport and communications accounted for over 75 percent of SADCC-sponsored projects followed by food and agriculture (12 percent), and energy (8 percent). Mining, industry and trade, manpower, and tourism accounted for the remainder (Hanlon, 1989).

This has entailed a shift in favor of what the SADCC calls the "enterprise sector" (private firms and parastatals), including through greater efforts at cooperating with the private sector and improving the environment for foreign and domestic investment in regional industrial enterprises. The SADCC has also stepped up efforts to improve the investment climate and to address the problem of human resource development, especially the shortage of well trained manpower and low productivity.

[1] Angola, Botswana, Lesotho, Malawi, Mozambique, Namibia (joined in 1990), Swaziland, Tanzania, Zambia, and Zimbabwe.

[2] All SADCC members are eligible for membership in the Preferential Trade Area for Eastern and Southern Africa (PTA) and eight SADCC members (Angola, Lesotho, Malawi, Mozambique, Swaziland, Tanzania, Zambia, and Zimbabwe) have joined it. Four SADCC members (Botswana, Lesotho, Namibia, and Swaziland) belong with South Africa to the Southern African Customs Union (SACU).

Table 8. Selected Developing Country Regional Arrangements: Intraregional Exports
(In percent of region's total exports)

	1960	1970	1975	1980	1985	1986	1987	1988	1989	1990
Andean Pact	0.7	2.0	3.7	3.8	3.4	3.2	4.1	4.8	4.8	4.6
ASEAN	4.4	20.7	15.9	16.9	18.4	16.5	17.6	17.5	17.8	18.6
CACM	7.0	25.7	23.3	24.1	14.7	10.2	13.4	13.4	14.4	14.8
CEAO	. . .	6.3	11.6	9.4	8.2	8.3	8.7	10.2	10.8	11.3
CPGL	. . .	0.4	0.3	0.1	0.8	0.6	0.5	0.7	0.5	0.6
ECOWAS	. . .	3.0	4.2	3.5	5.3	6.7	6.4	7.8	7.8	6.0
GCC	. . .	3.0	2.6	2.8	4.6	5.1	5.0	5.3	5.5	4.4
LAFTA/LAIA	7.9	9.9	13.6	13.7	8.3	10.8	9.9	10.2	10.8	10.6
MRU	. . .	0.2	0.4	0.8	0.4	0.3	0.3	0.3	0.3	0.3
PTA	. . .	8.4	9.4	8.9	7.0	7.4	8.7	8.3	7.8	8.5
SADCC	. . .	2.4	2.3	2.7	2.4	2.8	3.2	3.7	3.7	3.9
UDEAC	1.5	5.0	2.7	1.7	2.1	3.3	3.6	4.3	4.7	4.6
Memorandum items										
Total exports/world exports										
Andean Pact	2.9	1.6	1.6	1.6	1.2	1.0	0.8	0.8	0.9	0.9
ASEAN	2.6	2.1	2.6	3.7	3.9	3.4	3.5	3.9	4.2	4.3
CACM	0.4	0.4	0.3	0.3	0.2	0.2	0.2	0.1	0.1	0.1
CEAO	. . .	0.3	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2
CPGL	. . .	0.3	0.1	0.1	0.1	0.1	—	0.1	—	—
ECOWAS	. . .	1.0	1.4	1.7	1.1	0.6	0.6	0.5	0.5	0.6
GCC	. . .	1.7	6.0	8.6	3.4	2.5	2.5	2.2	2.4	2.7
LAFTA/LAIA	6.0	4.4	3.5	4.2	4.7	3.5	3.4	3.5	3.5	3.4
MRU	. . .	0.1	0.1	—	—	0.1	—	—	—	—
PTA	. . .	1.1	0.6	0.4	0.3	0.3	0.3	0.3	0.3	0.2
SADCC	. . .	0.3	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
UDEAC	0.3	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1
Extraregional exports/world exports										
Andean Pact	2.8	1.6	1.5	1.5	1.2	1.0	0.7	0.7	0.8	0.8
ASEAN	2.5	1.7	2.2	3.1	3.2	2.8	2.9	3.2	3.4	3.5
CACM	0.3	0.3	0.2	0.2	0.2	0.2	0.1	0.1	0.1	0.1
CEAO	. . .	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.1
CPGL	. . .	0.3	0.1	0.1	0.1	0.1	—	0.1	—	—
ECOWAS	. . .	1.0	1.3	1.7	1.0	0.6	0.6	0.5	0.5	0.6
GCC	. . .	1.7	5.9	8.4	3.3	2.4	2.4	2.1	2.3	2.5
LAFTA/LAIA	5.5	4.0	3.1	3.6	4.3	3.1	3.1	3.1	3.2	3.0
MRU	. . .	0.1	0.1	—	—	0.1	—	—	—	—
PTA	. . .	1.0	0.5	0.4	0.3	0.3	0.3	0.3	0.2	0.2
SADCC	. . .	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1
UDEAC	—	0.1	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1

Sources: IMF, *Direction of Trade; International Financial Statistics; World Economic Outlook*; and IMF staff estimates.

as education and training; research and development, particularly in agriculture; joint management and control facilities; and coordination of investment incentives.

The performance of regional integration arrangements may be assessed by comparing actual results to initial objectives. Two measures of performance are useful in this regard. The first examines whether the arrangements have succeeded in achieving their fundamental goal of raising intraregional trade. The second looks at the extent to which the arrangements have succeeded in implementing initially agreed liberalization timetables. Given that an increase in the share of intraregional trade is not, in itself, an indication of welfare gains for member countries (trade-diversion effects may predominate), an alternative approach would be to assess, ex post, the net gains associated with the

Table 9. Selected Developing Country Regional Arrangements: Changes in Trade to GDP Ratios

		Total	External	Intra-Regional
Andean Pact	1970–80	9.7	8.8	0.9
	1980–85	–11.0	–10.5	–0.4
	1985–90	3.2	2.9	0.3
ASEAN	1960–70	9.4	3.6	5.8
	1970–80	27.6	23.6	4.0
	1980–90	23.9	19.3	4.5
CACM	1960–70	9.7	8.5	1.2
	1970–80	10.3	0.7	9.6
	1980–90	–10.6	–6.1	–4.4
CEAO	1970–80	9.5	2.0	7.4
	1980–90	–12.9	—	–12.9
CPGL	1975–90	0.4	0.2	0.3
ECOWAS	1975–80	2.1	—	2.1
	1980–85	–12.2	0.1	–12.3
GCC	1980–90	–15.6	1.0	–16.6
LAFTA/LAIA	1960–70	–3.3	—	–3.4
	1970–80	4.2	0.9	3.2
	1980–90	–2.5	–0.4	–2.1
MRU	1970–80	13.1	0.2	12.8
	1980–90	–27.4	–0.2	–27.2
PTA	1980–85	–9.8	–0.9	–8.9
	1985–90	12.2	0.9	11.3
SADCC	1980–85	–19.1	–0.4	–18.7
	1985–90	29.6	1.4	28.2
UDEAC	1965–75	–0.3	1.0	–1.3
	1975–90	–12.7	–0.1	–12.6

Sources: IMF, *Direction of Trade; International Financial Statistics; World Economic Outlook*; and IMF staff estimates.

arrangements, in terms of static trade-creation versus trade-diversion effects and in terms of dynamic effects on growth and development. The latter assessment is inherently difficult because it presupposes an ability to guess correctly what would have happened in the absence of the regional integration and under alternative policy scenarios.

The main exception to the general rule that the formation of these arrangements did not increase trade among members is the CACM during its first decade of existence; its share of intraregional exports rose sharply between 1960 and 1970 but stagnated in the 1970s and declined in the 1980s (Table 8). The LAFTA also experienced an appreciable increase in intraregional exports during 1960–80. In the case of the ASEAN, while the share of intraregional trade is not insignificant (18.6 percent in 1990), it declined in the 1970s and has remained fairly stable since then. Moreover, the ASEAN's relatively high share of intraregional trade can be explained by transshipment trade. The remaining arrangements that have operated for over a decade have recorded only small increases, at best, in the share of intraregional trade, which in many cases has been subject to fluctuations and reversals.

The relative importance of intraregional trade remains low for most groupings, although the variance is significant. In 1990, the share of intraregional exports ranged from a high of 18.6 percent in the case of the ASEAN, to regional groups in Africa with shares typically below 5 percent. The share of intraregional trade in developing country regional groupings is not any greater—and, in most

cases, considerably less—than the share of South-South trade in the total trade of the South, even after excluding trade of the oil exporting developing countries and of the dynamic Asian economies; South-South trade excluding the major oil exporters and the four most dynamic Asian economies—Hong Kong, Korea, Singapore, and Taiwan Province of China—was about 17 percent in 1988–90. (Including the oil exporting developing countries and the four most dynamic Asian economies, the 1988–90 share of South-South trade in the total trade of the South was about 34 percent.)

Total trade shares may not, however, always be the best measure of the importance of intraregional trade. For example, in the Andean Pact, where large oil exports heavily influence aggregate statistics, non-oil intraregional trade more than tripled to 10 percent during the 1970s—the first decade of the Andean Pact—with most of the increase accounted for by manufactured exports (although a narrow range). Similarly, the bulk of the higher share of intraregional trade in the LAFTA during 1960–80 was due to increased manufactured exports. Despite its weak implementation, it appears that the LAFTA did provide a wider market for the expansion of manufactured exports within the region and contributed to general export diversification, particularly for Argentina, Brazil, and Mexico. In a number of sub-Saharan African groups, the low shares of intraregional trade conceal the fact that such trade is important (ranging between 10–50 percent) for some of the individual countries in regional groups, particularly those that are landlocked. Such considerations do not appreciably alter the basic conclusion, however, that regional arrangements have fallen short of their goal of fostering substantial intraregional trade.

Implementation Record

The failure of regional integration schemes to increase trade among members was due partly to structural elements limiting the scope for potential gains, and partly to the low degree of implementation. Implementation delays generally reflected a basic incompatibility between the inward-oriented development strategies of most members and regional liberalization. While there are differences among developing country arrangements, significant difficulties have generally been encountered in implementing trade and other integration measures on schedule. This has been particularly evident in four areas: the removal of barriers to intraregional trade, an important target in all arrangements; the establishment of a common external tariff; the implementation of nonmarket mechanisms to allocate new industries among participating countries; and the removal of constraints on intra-area factor mobility (particularly on labor mobility). (The last three were operational targets in only a subset of arrangements.)

In most cases, initial deadlines for the removal of barriers to intraregional trade were postponed, often several times. Normally a reduction in quantitative restrictions and import tariffs was contemplated. In a number of cases (for example, the LAFTA/LAIA and PTA), delays in liberalizing intraregional trade reflected a lack of automaticity in implementation timetables, with reciprocal tariff reductions made subject to periodic negotiating rounds and consensus, either on a product-by-product basis or on a request-and-offer basis. In addition, in many cases (for example, the ASEAN, Andean Pact, CEAO, LAFTA/LAIA, and PTA), reductions in trade barriers were not based on across-the-board reductions in tariff and nontariff barriers but on a system of positive "lists," that gave participating countries considerable latitude to exclude sensitive products from the set of items subject to reciprocal trade concessions, and biased the selection of products in favor of those with limited potential for intraregional trade. In a number of cases (for example, the ASEAN, ECOWAS, and PTA) that aimed to create a free trade area—permanently or as a precursor to a customs union—the coverage of intra-area trade liberalization was also limited by fairly restrictive rules of origin; these narrowed the range of goods eligible for tariff preferences on the basis of value-added criteria, and in some cases (for example, the ECOWAS and PTA) also on the basis of enterprise ownership criteria.

The degree of implementation of intraregional liberalization programs also varied widely. Implementation was fairly successful in the CACM, which broadly adhered to the original liberalization timetable, and maintained a substantially unrestricted intraregional trading environment throughout most of the 1960s and 1970s; this record was subsequently undermined, however, particularly by nontariff barriers, in the face of recurrent balance of payments crises during the 1980s. The GCC also appears to have removed tariff barriers to intra-area trade broadly on schedule, although with special reservations granted to Oman. At the other extreme are some sub-Saharan African groupings (for example, the ECOWAS and UDEAC), that are characterized by an almost complete nonimplementation of intra-area liberalization. In most other cases, implementation has been partial, and initial liberalization has often been followed by impasses, delays, and sometimes reversals—the latter frequently taking the form of

erosion of previously granted trade preferences because of exchange and trade restrictions introduced in response to balance of payments difficulties.

Where the establishment of a customs union has been an operational target (and not only a statement of intent), the implementation of a common external tariff has proven elusive. The initial deadlines were in most cases not met. The extent of partial implementation has varied, however, among cases. For example, the CACM agreed in principle to a common external tariff but the common tariff was rendered largely ineffective—mainly because of exemptions from external tariffs granted by some member countries for "necessary" imports from outside the region—over most of the period since the CACM was formed. The GCC adopted a minimum common external tariff in principle—albeit with some delays—but exceptions have been applied for certain members, significant variations among countries remain, and noncompliance has persisted in some areas—particularly concerning luxury items. In most other cases, nonimplementation of the envisaged common external tariff has been the rule.

The implementation of nonmarket mechanisms to allocate new manufacturing industries among members[30] has also fallen substantially short of initial targets. For instance, the Andean Pact had originally intended to include in its Sectoral Programs of Industrial Development (PSDIs) about one third of all manufactured items in the tariff code; in the event, only 4 PSDIs were approved and most were only partially implemented. In the case of the ASEAN, only 2 out of the originally envisaged 5 ASEAN Industrial Projects (AIPs)—and only 1 out of the originally proposed 32 ASEAN industrial complementation projects (AICs)—were implemented. In the CACM, only 2 firms were created under the Regime for Central American Integration Industries, and the scheme became inoperative in the late 1960s. In the MRU, no "union industry" has gone beyond feasibility status.

The ECOWAS, CEAO, and the GCC are among the few regional groups that have included operational commitments to allow freer intra-union factor (labor) mobility. The implementation record in these cases is mixed. The ECOWAS signed a protocol on labor mobility in 1979, but it has not been implemented. The GCC took action to permit skilled professionals in member countries to register and practice in any other member country of their choice. The CEAO adopted and implemented a community convention recognizing the right of residence of migrant workers within the region.

Factors Influencing Low Implementation

Implementation problems do not, however, fully explain the failure of developing country regional integration schemes to raise intraregional trade in line with initial expectations. For one thing, the share of intraregional trade increased in some cases, as has been noted, even as the implementation of the regional liberalization program came to a standstill. For another, the implementation problems themselves need to be explained. The explanation seems to lie in a number of political and structural features—an incompatibility between members' national pursuit of inward-oriented development policies and the goal of intraregional trade liberalization, combined with strong vested interests in import-competing industries and a weakening external environment.

The deterioration in the external environment in the 1970s—and particularly in the early 1980s—exposed the underlying weaknesses of import-substituting development strategies and further reduced the scope for trade liberalization. Fundamental questions about the role of integration were underscored by other considerations, including differences in economic philosophies and strategies among members of some regional arrangements (such as the ASEAN); the role of powerful vested interests in highly protected sectors; constraints imposed on liberalization in many cases by inappropriate macroeconomic policies; and political problems that sometimes led to military conflict. At the operational level, these economic and political elements led to implementation delays because the underlying lack of commitment was not offset by a strict timetable for reforms. The timetables lacked automaticity, included "positive" lists rather than across-the-board liberalization of tariff and nontariff barriers, and entailed restrictive rules of origin. This made it easier for members to backtrack in the face of balance of payments difficulties or not to implement reforms owing to the lack of supporting policies. In the case of arrangements that aimed to allocate industries among members, their failure to do so reflected administrative problems and conflicts of interest arising from the difficulty of determining industrial location in the absence of market criteria and clear comparative

[30]Nonmarket mechanisms to allocate manufacturing industries must be distinguished from regional cooperation on infrastructure projects of mutual advantage. In the latter case, successes in regional cooperation are not difficult to find, as illustrated, for instance, by the experience of SADCC (see Box 3).

advantages. In addition, while many arrangements were ostensibly modeled on the EC, most lacked the necessary institutional mechanisms to achieve their objectives; this was evident in inconsistencies between national legislation and integration commitments, the absence of strong enforcement mechanisms and ineffective dispute settlement procedures, and lack of compensation mechanisms to address distributional concerns. (The latter was important in schemes that grouped members with widely differing stages of development.)

An inward orientation tended to lead to high levels of effective protection in the form of tariff structures characterized by high and highly dispersed rates and complex systems of nontariff barriers. Firms established behind such high protective walls have often enjoyed strong lobbying power. Most developing country governments signing regional integration pacts during the 1960s, 1970s, and 1980s typically did not intend to alter fundamentally their inward-oriented policies; on the contrary, they often saw regional integration as an extension of import-substituting industrialization, as a means to enlarge the markets for their protected firms. In the absence of a wholehearted commitment to shift toward outward-oriented policies, governments were unwilling to sacrifice the demands of their influential national import-competing sectors to the goal of free trade within regional groupings. The political economy of vested interests in import-competing sectors, as noted above, in turn limited the scope for governments to shift the orientation of their policies.

Under these circumstances, governments engaged in regional integration schemes often preferred to avoid automaticity in the implementation of intraregional liberalization programs and timetables. The tendency in many regional arrangements was rather to choose an implementation approach based on negotiation and consensus, often on a product-by-product basis, which in most cases led to negotiating fatigue and excessive selectivity of offers. The "lists" of products eligible for trade preferences within the region were relatively easy to construct as long as the products in question were subject to trade within the region prior to the arrangement or were not produced in the region at all. However, heavy resistance and negotiating impasses tended to be encountered when it came to the "hard core" products of highly protected firms. The significant differences in efficiency of import-competing industries across member countries only worsened this problem. Even in the case of the ASEAN, differences in economic philosophies and strategies among members constituted a major stumbling block to intraregional trade liberalization—with Singapore, at one extreme, pursuing a decidedly outward-oriented strategy, and Indonesia, at the other, espousing import-substituting industrialization.

Implementation difficulties in intraregional liberalization did not, therefore, stem from inward orientation in economic policies alone, but rather from the combination of these policies with strong vested interests in import-competing industries. Thus, as Edwards and Savastano (1989) note, the relative success of the regional liberalization process in the CACM was made possible by the initially weak position of import-competing sectors in member countries, even if the CACM itself was seen as—and in fact became—a means to foster import-substitution industrialization within the region. By contrast, powerful vested interests in highly protected import-competing sectors existed before the establishment of the LAFTA; these explain to a significant extent the major impasses in the liberalization program that relied on a product-by-product negotiation of reciprocal trade concessions, rather than on a more automatic process.

Developing country regional groups typically did not, therefore, intend to implement a "classical" model of integration involving an across-the-board removal of barriers to intraregional trade followed by market-based resource reallocation. Instead, many regional pacts tended to engage in limited and highly selective intraregional trade concessions, so as to maintain protection for many existing industries. Moreover, in a number of cases, regional pacts also set up mechanisms to allocate—on a nonmarket basis and often through negotiation—new industries among member countries. The failure to implement these latter mechanisms reflected not only huge administrative problems (as in the case of the Andean Pact, which also faced severe geographical limits on integration) but also, and perhaps more fundamentally, sharp conflicts of interests arising from the inherent indeterminacy of industrial location in the absence of market criteria and clear comparative advantage.

The scope for liberalization within regional groups was in many developing country cases constrained by inappropriate macroeconomic policies. Against a background of external and internal imbalances—often reflecting expansionary fiscal and monetary policies—country authorities unwilling to allow a substantial devaluation of their overvalued currencies also tended to resist meaningful reductions in trade barriers. This resistance reflected an unwillingness to release foreign exchange reserves and fiscal revenues from import tariffs. In part, the adoption of realistic exchange rates was resisted because of concerns regarding the potentially contractionary short-term effects of devaluation, particularly where import-substitution

policies had led to a heavy reliance of manufacturing output on artificially cheap imports of intermediate and capital goods. Thus, import substitution tended not only to be inconsistent with far-reaching intraregional liberalization, it also introduced structural rigidities in macroeconomic management. These conditions could be sustained only to the extent that commodity export prices remained buoyant and no major constraints arose in terms of access to foreign capital inflows.

The CACM in the early 1980s provides an example of a successfully implemented regional arrangement with a relatively high level of intraregional trade (in a developing country context) that was undermined by unsupportive national policies. While political and military conflicts in the area contributed to the decline of intraregional trade in the 1980s, the main reasons for this development were economic. With the onset of the debt crisis in the 1980s, external imbalances gave rise to severe foreign exchange shortages; these were initially addressed through the imposition of trade and exchange restrictions, including on intraregional trade. Inadequate macroeconomic policies contributed to higher inflation rates in all member countries, while official exchange rates remained pegged or closely linked to the U.S. dollar. The resulting overvaluation of the CACM currencies was worsened by the concurrent appreciation of the dollar relative to other major currencies. The competitiveness of CACM exports consequently declined, which reduced recorded intra-area trade. At the same time, cross-country differences in the degree of overvaluation gave rise to informal border trade as imports from third countries were channeled through the countries with the most overvalued currencies.

Commodity price shocks in the 1970s and the broader and deeper deterioration of the external environment in the early 1980s (including those owing to terms-of-trade losses, sharp increases in real international interest rates, and a severe curtailment of access to foreign credit), exposed the underlying weakness of macroeconomic policies under import-substituting development strategies and further reduced the scope for trade liberalization within regional arrangements. Although developing countries pursuing export-oriented industrialization were generally better able to adjust to the difficult external environment, those emphasizing import substitution encountered relatively more severe constraints on their ability to implement appropriate adjustment policies. As a result, liberalization in many regional groups tended to be reversed, particularly in the early 1980s, as country authorities, faced with mounting macroeconomic imbalances, reintroduced or increased nontariff barriers and exchange restrictions, including on intraregional trade.

With chronic shortages of foreign exchange, the functioning of some clearing and payments systems attached to regional integration arrangements also tended to falter. This often reflected an accumulation of arrears and the growing unwillingness of net creditor partners to maintain large amounts of nonconvertible currencies in their asset portfolios. The existence of monetary unions in some of the African regional groups, although ensuring the convertibility of the common currency (through the willingness of a major industrial country to defend the peg), could not prevent inappropriate fiscal policies from causing inflation. The resulting overvaluation of these unions' common currency, in turn, reduced the scope for intraregional trade.

Political and institutional factors also constrained integration. Implementation of integration schemes requires a degree of shared sovereignty—reflected in binding commitments and possibly in a body of community law and supranational institutions—commensurate with the degree of integration sought. Many of the regional integration arrangements among developing countries, although ostensibly modeled on the EC, were unable to endow their integration agreements with the institutional effectiveness needed to achieve their often ambitious objectives. This has been evidenced by, among other things, inconsistencies between national legislation and integration commitments, the absence of strong enforcement mechanisms, and ineffective dispute settlement procedures. The difficulties encountered in subordinating nationalistic goals to supranational structures were in a number of cases compounded by contradicting political philosophies among members of the same regional group; political instability in national systems (for example, frequent changes of government and military coups); and at times also bilateral (military) border conflicts within regions.

In many cases, important distributional questions were not addressed. Issues of uneven distribution of the benefits and costs of integration have been high on the agendas of regional integration arrangements among developing countries. Such concerns have focused not only on the potentially uneven distribution of short-run costs of economic dislocation (transitional unemployment and idle capacity) and losses of fiscal revenues, but also on economic polarization over the medium term—that is, the possibility that the dynamics of integration would favor development in the more developed member countries. Regional arrangements among developing countries have attempted to address these concerns in several ways, including

special treatment for lesser developed member countries (for example, through relatively less demanding liberalization schedules and special access to regional credit facilities); "balanced growth" criteria in the allocation of new industries among members; and explicit compensation funds. However, compensation funds intended under several arrangements were never established—owing to design problems and budgetary constraints in member countries. And other mechanisms tended to be perceived as insufficient by the smaller, less developed members. As a result, distributional concerns added to the resistance against deeper and broader liberalization within regional groups.

The ECOWAS' failure to enhance intra-Community trade, for example, partly reflected the economic diversity of members. (The ECOWAS includes Côte d'Ivoire, with a per capita income of $770, and Burkina Faso, with a per capita income of $210.) Less developed partners tended to resist a faster reduction of intra-Community tariff and nontariff barriers. They feared that large revenue losses and the transitional costs of economic restructuring would be insufficiently compensated by access to the Community's compensation fund. Initial deadlines for even minor liberalization measures—such as a freeze on all intra-Community tariffs and initial moves toward selective, modest tariff cuts—were therefore repeatedly postponed. This contrasts with the experience of regional groups in industrial countries—particularly the EC—where "structural funds," although limited, have been carefully targeted to assist depressed regions and remove structural rigidities in labor markets, thus facilitating adjustment following liberalization (Gordon, 1991).

Even if intraregional trade liberalization programs had been successfully implemented, some structural elements would still have limited the scope for potential gains. A first constraint has been the point of departure of regional trading arrangements among developing countries. Typically the trade systems of member countries were characterized by high and highly dispersed effective protection, with little intraregional trade occurring prior to integration. This contrasts with the starting position of regional arrangements among industrial countries, where the countries involved tended to be each other's best customers. A second—and fundamental—constraint has been that regional pacts among developing countries with similar factor endowments have offered, by their nature, limited scope for trade creation along the lines of comparative advantage (for which different factor proportions in technology are key); at the same time, their small markets and low per capita incomes have not been conducive to significant trade based on scale economies and product differentiation. Finally, underdeveloped capital markets, barriers to entry, differential tax and regulatory environments among member countries, and restrictions on intraregional factor mobility have seriously constrained the capacity to reallocate resources and rationalize production in response to the removal of barriers to intraregional trade.

Quantifying Net Gains

A number of studies have attempted to estimate the net static gains and losses of developing country regional arrangements. These produce mixed results for Latin American arrangements, while studies of sub-Saharan African regional arrangements generally indicate that they resulted in negligible trade diversion. The results have been highly sensitive to, among other things, the choice of time period and the technique used to determine the path for trade and other economic variables that would have obtained in the absence of the arrangement. The results of a sample of these studies are given below.[31]

Studies of the CACM—the most intensively examined developing country regional group—have shown inconclusive results. Wilford (1970) and Aitken and Lowry (1973), focusing on the eleven- to twelve-year period ending in 1967, concluded that trade creation predominated in the years following the formation of the union. Willmore (1976), on the other hand, using 1958–68 data and a more disaggregated approach, found that the CACM had predominantly trade-diversion effects in nondurable consumer goods but led to significant external trade creation in intermediate goods, while results for durable goods were inconclusive. Cline (1978) expanded the measurement of net static gains for the CACM beyond trade creation and diversion to include the effects of extraregional trade creation, trade suppression (replacement of imports by domestic production), increases in domestic production at wage rates above the social opportunity cost of labor, economies of scale, foreign exchange savings, and industry intermediate-input effects (reflecting output and import requirements via input-output relationships). According to Cline, although trade diversion exceeded trade creation in the CACM, the effects of the other factors more than compensated for this, leading to substantial net static gains—albeit unequally dis-

[31]El-Agraa (1989, Chapter 15) discusses some of the approaches used in measuring the effects of economic integration among developing countries.

tributed among member countries—on the order of 2 percent of the region's 1972 GDP.[32]

With regard to the LAFTA, George and others (1977), using 1952–69 data, and Langhammer and Spinanger (1984) using 1962–79 data, conclude that trade diversion accounted for most of the expansion of intraregional trade in the LAFTA. By contrast, Aitken and Lowry (1973), focusing on the 1955–67 period, find no evidence of significant trade diversion.

In the case of the Andean Pact, Khazeh and Clark (1990), using 1968–77 data, estimate static gains to be sizable—about 9 percent of the region's 1977 GDP—in part because of substantial extraregional trade creation. (Khazeh and Clark's results are, however, difficult to accept at face value. The measured gains appear disproportionate, exceeding most estimates of static gains for the EC; they also incorporate a substantial upward bias by using the counterfactual, which assumed that the trade of Andean Pact countries would have unfolded, in the absence of the arrangement, in step with the trade of certain comparator countries.)

As regards sub-Saharan African groups, Langhammer (1978) found that the CEAO led to negligible trade creation and that extraregional imports were replaced more by domestic production (trade suppression) than by intraregional imports (trade diversion). A World Bank (1989a) study suggests that negligible trade creation has been the rule, rather than the exception, in the case of sub-Saharan Africa, as indicated by only marginal increases in the ratio of intraregional trade to GDP during 1965–83. Most of these groups displayed a significant increase in the ratio of extraregional trade to GDP over the same period, but this can hardly be attributed to the regional integration schemes themselves, especially since most have not been implemented to an appreciable extent. These conclusions are corroborated in Table 9, which decomposes the changes in the trade openness ratio (trade to GDP) over relevant periods into intraregional and extraregional trade components—that is, crude measures of trade creation and trade diversion, respectively.

Few studies have attempted to quantify the trade impact of the trade liberalization measures undertaken by the GCC. Cain and Al-Badri (1989) have identified the industries responsible for the relative increase in intra-area trade as those of textiles, nonmetallic products, and other manufacturing. Metwally and Daghistani (1987) attribute the weakness of the industrial base in these countries, and therefore marginal intraregional trade, to the oil boom experienced by GCC members since 1973, which has transformed these economies into major importers.

Reflecting the inherent methodological difficulties involved, few studies have attempted to quantify, ex post, the dynamic gains or losses of regional integration arrangements among developing countries. One of the few studies available is of the CACM (Cline, 1978); it attempted to gauge the impact of integration on structural change—assuming that this would raise welfare of risk-averse nations—and on foreign capital inflows. The study concludes that these types of dynamic effects in the CACM led to additional gains, equivalent to about 1 percent of the region's 1972 GDP.

Contrary to the expectations of many developing countries, empirical studies typically have found that regional arrangements have not yielded significant economies of scale (see Carnoy, 1970, for Latin America; and Pearson and Ingram, 1980, for Ghana and Côte d'Ivoire). In the case of the CACM, while Cline (1978) estimates positive gains from economies of scale, Willmore (1979) finds that the common market has tended to support oligopolistic behavior (for example, market sharing arrangements) more than specialization and economies of scale.

Views on the Role of Regional Integration

The past experience with regional integration arrangements among developing countries raises questions about the future role of these in developing country trade policies. These questions are all the more relevant in view of the recent resurgence of interest in regionalism.

Views among economists on this matter vary widely. Some authors focusing on Latin America—for example, Dornbusch (1989)—argue that, given the often prohibitive protection systems and the political resistance to a substantial dismantling of these systems, intraregional liberalization behind (presumably transitory) high external barriers offers little risk of trade diversion and potentially substantial gains; these gains include those derived from industrial complementarity, economies of scale, rents associated with preferential market access, greater product variety for consumers, and competition-induced improvements in efficiency.

The above reasoning is based, in part, on considerations of political feasibility and seems to assume

[32]Cline's conclusion, however, hinges largely on the sizable measured "gains" from foreign exchange savings, which are based on a rather questionable method (Bulmer-Thomas, 1988). According to this method, trade suppression and diversion evaluated at the shadow exchange rate are deemed to constitute a gross saving of foreign exchange. Net savings are then arrived at by subtracting the domestic resources used, but these are valued at the official or market (rather than shadow) exchange rate.

that political resistance to far-reaching unilateral liberalization would be significantly greater than to more limited liberalization within regional groups. Intraregional liberalization is, furthermore, assumed to be easier to "sell" domestically in view of the reciprocal nature of regional trade concessions. Experience suggests, however, that the political resistance to liberalization is not necessarily a continuous, upward sloping function of the degree of liberalization; rather, there appears to be a "threshold" to resistance, associated with shifts in economic philosophies. Thus, as long as policies have been firmly committed to protecting import-substituting industries, little progress has been made toward meaningful intraregional liberalization, reciprocity in regional trade concessions notwithstanding. By contrast, once sufficient political consensus has been mobilized in favor of a shift in policies toward outward orientation and greater reliance on market forces, developing countries have tended to opt for comprehensive trade reforms on a unilateral basis, regardless of the actions of regional and nonregional trading partners.

Intraregional liberalization behind (temporarily) high external barriers is often also proposed as a means to provide a "training ground" for firms to gain experience and reap economies of scale, before they are exposed to import competition or are ready to move toward export markets outside the region. Experience suggests, however, that this approach has inherent dangers. First, most regional groups among developing countries are not likely to offer sufficient market size for exploiting economies of scale. High protection against third countries in these cases would tend to foster excess capacity and inefficient and monopolistic market structures, in which rents would not constitute a net income gain for society—but mainly a transfer of income from consumers to firms and a net loss of welfare relative to free trade. This would tend to create vested interests that would resist subsequent liberalization, thereby perpetuating high external barriers initially envisaged as transitory.

Second, even where economies of scale might be reaped through regional pacts—and, thus, where rents might represent a net increase in member countries' income that could not be obtained without temporary protection of regional markets—the prolonged maintenance of high external barriers would tend to lead to excessive entry, as new firms try to capture monopoly rents. This would in turn drive incumbent firms up their average cost curves, with excess profits eventually absorbed by reduced efficiency owing to operation at below the optimal scale (Eastman and Stykolt, 1962; and Horstmann and Markusen, 1986). A frequently cited example in this connection is the automobile industry in Latin America, where—perhaps with the exception of Brazil—most plants have average production runs well below what is generally considered to be the minimum efficient scale (Rodrik, 1988).[33] Thus, to realize the gains from economies of scale, external protection would have to be lifted relatively soon—not an easy thing to do. In sum, as Krugman (1989, p. 359) notes, protectionism has extra costs when domestic market structures are concentrated and "import substituting industrialization looks even worse in the new theory [which models trade under imperfect competition and economies of scale] than in standard theory [based on models that assume perfect competition and constant returns to scale]."[34]

In contrast to Dornbusch, other authors contend that the case for preferential trading agreements among developing countries is not convincing. This view is based partly on their disappointing past experience, including the fact that no developing country case can be cited where a regional integration scheme was, in itself, a significant contributor to development (Langhammer and Hiemenz, 1990). More fundamentally, it is argued that there is a "fallacy of transposition" in the expectation that the success of regional integration among industrial countries could be replicated in arrangements among developing countries. In particular, many developing country regional groupings include members with small markets, low per capita incomes, and similar factor endowments—leading to similar productive structures. The similarity of economies in these cases does not serve as a basis for trade expansion based on intra-industry specialization and product differentiation—which contrasts with industrial country cases, where intra-industry trade expansion is made possible by large markets, product differentiation, and high per capita incomes. Developing countries would thus be better off exploiting gains from trade based on differences in resource endowment and productive structure—seizing comparative advantages dynamically at every point in time as they build their human, capital, and technological stocks. This strategy would be best pursued in the context of

[33]In the Andean Pact, excessive entry in the automobile industry was administratively decided from the outset, as various types of models were allocated via political negotiation among member countries, in the context of implementing the Pact's joint industrial planning program.

[34]Rodrik (1988) similarly argues that import-substitution policies in developing countries "look doubly bad" in the presence of imperfect competition and increasing returns to scale. He concludes (p. 132) that "the levels of protection observed in the manufacturing sectors of most developing countries vastly exceed any that could be justified by the presence of imperfect competition."

unilateral and multilateral liberalization (Greenaway and Milner, 1990).

While the above conclusion is compelling, it tends to discount excessively the potential for intraregional trade and thus needs qualification. As Greenaway and Milner (1990) note, similarities among developing countries should not be exaggerated. Some regional groups display differences in per capita incomes—although typically within relatively low levels—and in productive structures among members, suggesting the existence of complementarities and the potential for a degree of intraregional trade expansion based on inter-industry specialization (and perhaps even intra-industry specialization in the larger groups).[35] Even in sub-Saharan Africa, where per capita incomes and market sizes are lowest among developing countries, the World Bank (1989b) estimates that some \$4–5 billion of this region's imports from the rest of the world could be potentially supplied by other sub-Saharan African countries already exporting similar products to the rest of the world. Should this potential be realized, the share of intraregional trade in sub-Saharan Africa would treble to 18 percent. Although subject to qualification, this result could be seen as evidence of the possibility of efficient trade switching, provided that countries are willing to remove barriers to trade on a fairly comprehensive basis—which has not been the case to date. The thrust of this argument would apply, *a fortiori*, to regional trading arrangements among middle-income developing countries.

Regardless of the economic case for regional trading arrangements among developing countries, these arrangements can be expected to continue to be a feature of the international trading system—indeed, they may become increasingly important given the perceived noneconomic benefits and other factors discussed earlier. Hence, it is important to identify conditions under which the potential gains of such arrangements can be maximized while the losses—to members and nonmembers—are minimized. The review of experience suggests that the potential gains of regional arrangements can be maximized if at least two key conditions are met: (1) maintenance of an outward orientation; and (2) provision for across-the-board intraregional liberalization with automatic timetabling. These two conditions broadly correspond to the provisos in Article XXIV of the GATT (see Chapter IV).

Outward orientation in development strategies would be reflected, among other things, in relatively low and uniform levels of protection vis-à-vis third countries and in open and transparent foreign direct investment regimes. These conditions are crucial not only for minimizing the trade-diversion effects of regional trade preferences, but also for ensuring that developing countries are part of the process of globalization of investment and production, the main channel of access to technology transfer. The process of dynamically seizing comparative advantages in a multilateral context would allow developing countries to achieve stronger growth while diversifying their productive structures. As per capita incomes and capital stocks rise, so would the opportunities for trade expansion based on similarities among developing countries. South-South trade is more likely to grow if developing countries are integrated into the multilateral system of trade and investment than if they are not (Greenaway and Milner, 1990).

The need to achieve outward orientation in developing country regional arrangements would appear to favor free trade areas rather than customs unions, particularly where little shared sovereignty through supranational structures for common decision making is envisaged. A free trade area allows importing member countries to avoid undue costs from trade diversion by unilaterally reducing trade barriers, thus shifting the source of supply back to lower-cost outside producers. Also, member countries already maintaining more liberal trading regimes or wishing to liberalize their trade policies would not be constrained by free trade areas. Under a customs union, protectionist pressures could end up forcing the more liberal members of the union to adopt higher levels of external protection vis-à-vis nonmembers. Free trade agreements would, by contrast, allow the more liberal members to proceed unilaterally with the ongoing nondiscriminatory removal of trade barriers; this would, in turn, impose a salutary—and noncoercive—liberalizing pressure on external trade policies of the rest of the members.

Experiences with regional trading arrangements among developing countries clearly illustrate the drawbacks of undue selectivity in trade concessions and nonautomatic timetables. These features have generally reflected deep-seated unwillingness to liberalize intraregional trade in a meaningful way. They have also tended to bias the negotiations in favor of trade concessions on products not yet produced in the region—thereby widening the scope for trade diversion or suppression, especially where external tariffs are high—or on products already

[35]Ex post econometric evidence of a possible link between the CACM and/or LAFTA and intra-industry trade is found in Balassa (1979), Havrylyshyn and Civan (1983), Balassa (1986), and Balassa and Bauwens (1987 and 1988). As Greenaway (1989, p. 35) notes, however, "all of this documentary work suffers from the classic *antimonde* problem. Would the growth in [intra-industry trade] have been as rapid in the absence of integration?"

traded relatively freely within the region—thus adding little trade-creation potential. An approach to regional integration based on automatic time-tabling and—as required by Article XXIV of the GATT—an across-the-board reduction of trade barriers would help avoid these drawbacks. It would ensure participation in regional trading agreements only where the liberalization commitment is serious. It would therefore also enhance the probability that such arrangements would be outward oriented, thus reducing the risk that they might be used as a substitute for—or an excuse for not engaging in—nondiscriminatory liberalization.

The full benefits from trade liberalization in developing countries will not be reaped, however, unless industrial countries remove their high protective barriers on products where developing countries possess clear comparative advantages—for example, agricultural products, textiles and clothing, and leather products. As emphasized earlier, the Uruguay Round of GATT negotiations offers the best forum for developing countries to secure from industrial countries the removal of these barriers.

Finally, economic cooperation is also relevant. While the experience with the trade liberalization aspects of regional integration arrangements has been disappointing, considerable success with economic cooperation has been achieved in a number of such arrangements. Potentially vast mutual gains may be secured through regional economic cooperation among developing countries in areas where significant externalities and public goods exist and, therefore, where market mechanisms tend to fail. As Langhammer and Hiemenz (1990) note, experience indicates that success in economic cooperation among developing countries is likely to be greater where the joint production of "software" public goods (for example, education and training; research and development, particularly on agriculture; joint management and control facilities; coordination of investment incentives; and so on) is given sufficient weight in comparison to the joint production of "hardware" public goods (for example, infrastructure). This type of economic cooperation has the advantage of minimizing the risk of "white elephants" and their associated—often unsurmountable—management difficulties.

VI Implications of Regional Integration for the Multilateral System

Regional trading arrangements—bilateral as well as plurilateral—have been a fairly constant feature of the world trading system. The recent trend toward regionalism, however, may be qualitatively different from past efforts and may carry greater risks of becoming a substitute for, rather than a complement to, multilateralism. Apart from the potentially distorting effects of these arrangements on the allocation of world resources (see Chapter II), a number of important elements unique to current regionalism seem to pose a greater threat to multilateralism.

Regional arrangements in industrial countries have not appeared—until now—to have been obstacles to efforts to achieve multilateral liberalization; trade barriers against third countries have been low and trade diversion has generally been minimized. Moreover, in some cases it has been easier to negotiate regional, rather than multilateral, liberalization. For the current trend to continue to support multilateralism three conditions are necessary: (1) steady progress with multilateral liberalization; (2) an outward orientation in regional arrangements; and (3) across-the-board intraregional liberalization. These conditions have implications for the form of arrangement chosen, and its membership. Outward orientation, for instance, may be easier to achieve in a free trading area rather than a customs union because it is less restrictive. Similarly, developing countries are likely to exploit gains from trade more readily in arrangements with industrial countries on the basis of differences in resources and productive capacity.

Finally, the globalization of investment and production is likely to lessen the risk of regional arrangements becoming closed blocs. Global investment—carried on by multinational enterprises with global, rather than national, strategies—has exposed the limitations of nationally based policies; it increasingly confronts governments with the need to liberalize and harmonize policies, standards, and regulations with other countries, including in—but not limited to—trade and trade-related areas. Harmonization and liberalization in response to the challenges posed by globalization is in some instances being conducted in the context of regional arrangements. Increasingly, however, globalization calls for multilateral solutions.

Aspects of the New Trend

The first unique aspect of the renewed interest in regionalism is that it has taken place in a weakening multilateral trading system. Substantial difficulties were encountered in launching the Uruguay Round in 1986; it took four years of arduous work—from 1982 to 1986—to break the resistance to a new Round. And progress in completing the Round has been slow. The GATT's inability to curb rising protectionist pressures since the end of the Tokyo Round has created frustration with the slowness of the GATT process and raised concerns about its effectiveness and its ability to adapt to the emerging trade issues of the 1990s (which include problems posed by high-technology industries and by firms engaged in trade and investment in goods and services on a global scale). Thus, doubts have arisen about the political will of the major players to strengthen the GATT's credibility through the Uruguay Round. In this context, regionalism has been advocated as an alternative to multilateralism; indeed, regional approaches to liberalization might be seen as a response to the regional and global integration of investment and production with which an unwieldy and slow multilateral approach has been unable to keep pace.

The second novel element is that far-reaching and successful regional initiatives by major industrial countries have created the perception that preferential trading arrangements are here to stay. In part, this reflects the demonstration effects of the extraordinary, albeit fortuitous, conjunction of EC 1992 and the United States-Canada FTA. Some have interpreted this conjunction of events as a confirmation of a trend toward a fragmentation of the multilateral trading order into a tripolar system of trade blocs—centered around the United States, the EC, and Japan (although the latter does not form part of a trade bloc). The accord between the

EC and EFTA to form a European Economic Area (EEA) and the prospect of a North American Free Trade Area (NAFTA)—involving Canada, Mexico, and the United States—have heightened this perception.

The above concerns have been reinforced by the shift in the trade policy stance of the United States—the main architect of the GATT system—from a virtually one-track approach emphasizing nondiscrimination to a multitrack approach encompassing unilateralism, regionalism, and multilateralism.[36] To be sure, the United States has sought to use regional initiatives as complements to multilateralism, both substantively (for example, to build useful precedents for broader liberalization in areas not yet covered by the GATT) and tactically (for example, to goad other countries into participating more seriously in the Uruguay Round (Schott, 1989)). However, this has been accompanied by the perception that, if GATT negotiations fail, the United States would be prepared to use bilateral or plurilateral arrangements as an alternative course of action.[37] In all, there is an increased concern that the big players in the multilateral trading system may be giving greater priority to regionalism in their trade policy agendas at the expense of multilateralism.

Finally, the recent trend toward regionalism involves preferential trading arrangements among industrial and developing countries involving *reciprocal* trade concessions. (Reciprocity in concessions has, of course, been a standard feature of the numerous regional arrangements among developing countries.) This is illustrated by the ongoing United States' Enterprise for the Americas Initiative (EAI) and the negotiations between Canada, Mexico, and the United States on a NAFTA, as well as the association agreements between the EC and Czechoslovakia, Hungary, and Poland. Previous arrangements with developing countries generally took the form of one-way trade preferences granted by industrial countries in favor of selected developing countries (examples include the U.S. Caribbean Basin Initiative and EC preferences extended to certain developing countries under the Lomé Convention).[38]

Clearly, the main intention of industrial countries in offering opportunities for (reciprocal) preferential trading arrangements to developing countries has been to encourage further economic and political reform, particularly at a time when budgetary constraints in industrial countries have placed limits on foreign aid. Nonetheless, there is a risk that developing countries may interpret such moves as a further sign that the major players have doubts about the viability of the GATT and are offering preferential trading arrangements as an alternative. Such an interpretation may in turn induce developing countries to divert scarce resources away from multilateral negotiations so as to concentrate efforts on securing a place in the queue for preferential trading arrangements with the major players.

While the above concerns may be overblown, they raise the important question of whether the recent revival of regionalism is likely to retard, rather than promote, multilateralism. This issue is addressed below by examining the compatibility of regional arrangements with the GATT and by focusing on some of the risks and limitations of regionalism.

Compatibility of Regional Arrangements with the GATT

The principle of nondiscrimination is a cornerstone of the GATT. It is embedded in Article I,

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[36]During most of the post-World War II era the United States took on the leadership role in building the GATT-based trading order, typically remaining suspicious of regionalism (Bhagwati, 1990a). A key exception was its support for the EC in 1958—largely because of political and military considerations (Patterson, 1966). Until the mid-1980s, the United States had not made use of Article XXIV of the GATT—which sets out provisions under which preferential trading arrangements involving GATT members may qualify for a derogation of the most-favored-nation (MFN) obligation (see below). Since 1985, beginning with its free trade agreement with Israel, the United States has been participating in reciprocal and preferential trading arrangements. A discussion of the relevance of, and reasons for, the U.S. "conversion to Article XXIV" is found, among other things, in Bhagwati (1990a) and Schott (1989).

[37]For instance, George Schultz, former U.S. Secretary of State, noted in a speech in 1985 that ". . . bilateral arrangements . . . can strengthen the multilateral system. Our hope . . . is that the example of greater liberalization [under these arrangements]—*and the recognition that the United States can pursue another course*—will motivate a larger group of nations to tackle the job of expanding trade on a global basis." (Quoted in Patterson, 1989; emphasis added.) A similar point has been made by James Baker III, former U.S. Treasury Secretary (Baker, 1988): "If possible, we hope . . . liberalization will occur in the Uruguay Round. *If not, we might be willing to explore a 'market liberalization club' approach, through minilateral arrangements or a series of bilateral arrangements*" (emphasis added).

[38]The proliferation of preferential arrangements built by the EC after 1958 with its former colonies and Mediterranean neighbors was subject to strong criticism, led by the United States, in the GATT, and resulted in a standoff in the early 1970s. The reciprocal nature of such arrangements was a key point of contention because the EC was perceived as using these arrangements to secure preferential access to developing country markets. According to Luyten (1989), the impasse was broken through an informal understanding (the "Casey-Soames understanding") through which the EC obtained "armistice" on the legal issue in the GATT by committing itself not to insist on reverse trade preferences from developing countries.

which commits the contracting parties to grant most-favored-nation (MFN) treatment with respect to trade concessions to all other GATT members. Regional trading arrangements (bilateral or plurilateral) are, by definition, discriminatory: trade concessions are granted only to members whose preferential access to other members' markets may enable them to displace exporters from nonmember countries.

Although discrimination in regional arrangements runs counter to the principle of non-discrimination, the GATT permits regional arrangements under certain conditions. The architects of the GATT recognized that such arrangements could provide a complementary, practical route to universal free trade—where politics permitted a faster and deeper degree of liberalization. Thus, Article XXIV of the GATT permits departures from the MFN obligation for preferential trading arrangements (free trade areas, customs unions, or interim arrangements leading to either of the former) provided that: (1) other GATT members are notified of the details; (2) such arrangements do not raise trade barriers on the whole against other Contracting Parties to the GATT; and (3) such arrangements cover "substantially all trade" between partners and commit them to reduce barriers to intraregional trade, possibly by means of a schedule and within a "reasonable length of time." (As indicated below, less strict conditions apply to developing countries.) The first condition was intended to enable other GATT members to scrutinize such arrangements to ensure their consistency with Article XXIV. The second condition sought to minimize the adverse effects of trade diversion on third countries and on members of preferential trading arrangements. The third condition, as further explained below, aimed to limit the number of preferential arrangements.

At first glance, the third condition appears somewhat paradoxical, especially considering Meade's (1955) conclusion that, other things being equal, a movement in the direction of 100 percent tariff cuts within a union would be associated with an increase in the probability of losses from trade diversion. This condition was central in the view of the GATT architects, however, in that it aimed at limiting the number of preferential trading arrangements to those where the intensity of the political commitment was commensurate with the liberalization and structural adjustment effort required (Bhagwati, 1990a). The underlying intent was to minimize the risk of the world trading system fragmenting into the discriminatory and sectoral bilateral arrangements that dominated the 1930s. At the same time, the "substantially-all-trade" clause recognized that full integration of trade among members of a preferential trading arrangement would create "an important element of single-national [sic] characteristics among [these members] . . . the resulting quasi-national status following from such integration in trade [would legitimate] the exception to MFN obligation towards other GATT members" (Bhagwati, 1990a, p. 1308). The latter argument takes on more force with higher degrees of economic and political integration among members: after all, each nation state is a customs union, and no one would consider the removal of barriers among states and provinces of a nation state as a threat to multilateralism.

The implementation of the provisions of Article XXIV was further weakened by the 1979 Enabling Clause. Under this clause, arrangements that are exclusively among developing countries can bypass Article XXIV altogether, unless the arrangements contemplate the selective removal of nontariff barriers, in which case approval by other GATT members is required. The Enabling Clause is thus substantially less demanding than Article XXIV in terms of notification and consultation, substantially-all-trade requirements, ex ante and ex post protection vis-à-vis third countries, and the timeframe for implementation of intraregional trade liberalization.

In practice, the provisions of Article XXIV have not been strictly observed partly because of ambiguities in the language that have permitted different interpretations. The notification and examination of the European Community was an important watershed for the subsequent fate of Article XXIV. For political reasons, GATT Contracting Parties decided not to issue a formal ruling on whether the Treaty of Rome was compatible with GATT provisions (Patterson, 1966; and Patterson, 1989). A precedent for inaction was thus set and has not subsequently been reversed (Schott, 1989). Of the 70 regional trading arrangements (including amendments to existing arrangements) notified during 1948–90 and examined by GATT working parties, only 4 were deemed by consensus to be compatible with Article XXIV.[39] No arrangement, however, has been formally declared to be incompatible with Article XXIV.

With most GATT members involved in some form of preferential trading arrangement, members have tended to refrain from forcefully criticizing preferential trading arrangements involving other GATT members, particularly since the United

[39]The four cases are: (1) the South Africa-Rhodesia Customs Union (1948); (2) the Nicaragua-El Salvador Free Trade Agreement (1951); (3) Nicaragua's participation in the Central American Common Market (1958); and (4) the Caribbean Common Market (1973).

States—previously the major critic of discriminatory arrangements—has become a user of Article XXIV.

The concerns with the lax implementation of Article XXIV are nevertheless not trivial. As stated in a report commissioned by the GATT (Leutwiler, and others, 1985; p. 41): ". . . exceptions and ambiguities have been permitted . . . [which] have set a dangerous precedent for further special deals, fragmentation of the trading system, and damage to the trade interest of non-participants." And a former Deputy Director General of the GATT has lamented that "of all GATT articles, [Article XXIV] is one of the most abused, and those abuses are among the least noted" (Patterson, 1989, p. 36).

Notwithstanding the lax implementation of Article XXIV, there is broad agreement that these arrangements have not, in themselves, hindered multilateral liberalization, at least until now. Part of the reason is the maintenance of low trade barriers vis-à-vis third countries in most areas of trade (see Chapter IV). Through successive rounds of GATT negotiations, industrial countries have eliminated formal quantitative restrictions on most manufactured goods and drastically reduced import tariffs. Moreover, unilateral liberalization by some countries participating in regional arrangements have helped minimize trade diversion that might otherwise have occurred. The obvious exception to these developments is the EC's adoption of the Common Agricultural Policy (CAP), which has sheltered the agricultural sector and stifled the views of the more liberal EC members that could have, in the absence of the CAP, joined forces with the advocates of liberalization. Regional arrangements cannot justifiably be blamed for the proliferation over the past fifteen years of nontariff measures (such as voluntary export restraint arrangements, countervailing and antidumping measures, and orderly market arrangements). These reflect a resistance in industrial countries to structural adjustment required by changes in comparative advantage and have not been confined to members of regional arrangements.

In addition, liberalization under regional arrangements can serve as a useful precedent that could be subsequently multilateralized through GATT negotiations. In effect, regional negotiations may be less hampered than GATT negotiations by problems of "free riding" (members enjoying MFN benefits while escaping obligations), "foot dragging" (members taking advantage of consensus rules to block progress until their demands are met), and "convoy effects" (the least willing participant determining the pace of negotiations). This, together with similarity in economic philosophies and a high degree of pre-existing integration, may allow certain countries to liberalize faster and more deeply within regional groups than multilaterally—including in areas previously not subject to GATT rules and disciplines. This has been illustrated, for example, by the liberalization of services and investment under the United States-Canada FTA, and by the liberalization of capital and financial services in the context of EC 1992. As noted below, however, there are limits to regional liberalization in those areas where protection is most ingrained.

The multilateralization of liberalization gains under regional arrangements presupposes, of course, that a credible and well functioning multilateral system is in place. Thus, steady progress with multilateral liberalization is essential to subsume preferential trading arrangements into a broader and more open trading system; to hold in check—and indeed to erode—the inherent discrimination of such arrangements; to convert their regionally circumscribed liberalization into building blocks for freer trade on a global basis; and to prevent regionalism from fragmenting the world trade system.

Risks and Limitations of Regionalism

As suggested above, concerns that the recent revival of regionalism may undermine the GATT-based trading system are related to a perception that the major players in the system may have shifted their priorities away from multilateralism. At one extreme, pessimistic scenarios based on a faltering of the Uruguay Round envisage a fragmentation of the trading system into large blocs with a "fortress mentality" and a proliferation of bilateral and minilateral preferential trading arrangements. Absent the restraint of multilateral disciplines, regionalism could, in effect, become divisive. Nevertheless, a more widely held view in recent years has been that a vigorous pursuit of regionalism, including by the major players, is consistent with a strengthened multilateral trading system. Undue emphasis on regionalism, however, would necessarily undercut multilateralism and render it inoperative; proponents of this view tend to overestimate the virtues of regionalism and underestimate its risks.[40]

The risks of regionalism include the possible diversion of scarce skills from multilateral to regional negotiations, the increased potential for friction among regional groups, and possible adverse effects on countries excluded from such arrangements.

Regional and multilateral negotiations are time-consuming and skill-intensive; they both compete

[40]Schott (1989) discusses the weaknesses in arguments advanced by the proponents of regionalism.

for scarce—and often the same—human and administrative resources. The obvious concern is that the current proliferation of regional trading arrangements that have high priority in governments' agendas may be diverting these scarce resources away from multilateral negotiations, precisely when concentrated negotiating energy and political commitment are required to complete the Uruguay Round successfully. Diversion of resources may occur even where governments would rather focus on multilateral talks, if they feel a need for defensive actions in response to moves toward regionalism by other trading partners.

An excessive number of preferential trading arrangements would lead to significant frictions, political pressures, and practical problems. Each new arrangement would inevitably undermine the value of the preferential access granted to some countries under existing arrangements, and lead to increased tension.[41] The trade-diversion effects of regional arrangements may also lead nonparticipants to retaliate with preferential arrangements of their own, possibly triggering a damaging chain reaction. A proliferation of preferential trading arrangements would give rise to a host of technical problems, including mismatches in the phasing of tariff reductions under overlapping arrangements, inconsistency of rulings under different dispute settlement mechanisms, and confusion and conflicts in implementing and enforcing different rules of origin under separate FTAs. As Schott (1989) suggests, negotiation and maintenance of the GATT system appears "simple and straightforward compared with the maze of problems" that would result from an expanding network of preferential trading arrangements. These problems would be reduced, however, if preferential trading arrangements were open to new members, as this would help to convert these arrangements into building—rather than stumbling—blocks to universal liberalization (Bhagwati, 1990b).[42]

Smaller countries would be the most hurt by a drift toward regionalism that undermines the principle of MFN nondiscrimination. As Bhagwati (1990a, p. 1304) puts it, the GATT system is intended, among other things, to shield "the weak against the strong who would otherwise, in bilateral one-to-one confrontations, have an advantage constrained only by altruism and conscience." An open multilateral trading system is particularly important to developing countries undertaking structural adjustment programs including the liberalization of their exchange, trade, and foreign direct investment regimes. Partly reflecting the high stakes they have in a strong system of multilateral disciplines, developing countries have been engaged in the Uruguay Round much more intensively than in previous GATT rounds, including through their participation in coalitions (for example, the Cairns Group of agricultural exporting countries and the de la Paix Group of middle-sized countries) that have served as catalysts for compromise proposals.

In view of the importance of the multilateral system for developing countries, it is not clear why they are interested in forming preferential and reciprocal trading arrangements with industrial countries. Several reasons have been advanced to explain this interest. First, these types of arrangements may have important elements of economic and political cooperation and may extend to areas (for example, foreign direct investment) hitherto not covered by the GATT. Second, for developing countries that have already liberalized trade substantially on a unilateral basis, these arrangements might serve to "lock in" liberalization and protect it from domestic protectionist pressures at home. (Of course, this objective can also be achieved by "binding" such liberalization in the GATT.) Third, developing countries might enter these arrangements defensively to hedge against the risk of rising protectionism in industrial countries. In this context, the reciprocity of trade preferences is puzzling. Industrial countries with whom developing countries might wish to enter into preferential trading arrangements are likely to account for a major share of the latter's trade, which implies that an FTA that is comprehensive (as required by Article XXIV of GATT) would be tantamount, from the developing country point of view, to broadly based unilateral liberalization. In these circumstances, there would seem no reason for a developing country to circumscribe its reciprocal concessions by making them available only to the industrial partner in the FTA, rather than extending them on an MFN basis. As Fritsch (1989, p. 343) succinctly puts it:

> . . . on the one hand, if [developing countries] tend to favor the maintenance of a restrictive trade regime, the proposal of an FTA [with a major industrialized trading partner] is by definition a non-starter, whereas on the other hand, if they are willing to liberalize, they should in fact do so on an MFN basis to avoid the negative trade diversion effects of the formation of an FTA.

[41] Schott (1989) notes that this type of problem has already occurred in the case of the United States-Israel FTA, with Israel considering that Canada obtained better terms in its FTA with the United States, particularly regarding the provisions on trade in services and the dispute settlement mechanism.

[42] Schott (1989, p. 23) notes in this connection that the U.S. Congress has not favored open-ended FTAs, "because of the uncertainty about which countries would join and thus what the anticipated adjustment pressures and trade effects would be. In fact, under U.S. law only self-contained FTAs may qualify for 'fast-track' implementing provisions."

As noted earlier, regional arrangements can forge—and have forged—liberalization in areas not yet covered by the GATT. It is doubtful, however, that these arrangements can deliver, on their own, substantial trade reform in areas where protectionism has proven to be most resilient. The latter include agriculture—which is subject to heavy protection and subsidization in most industrial countries, including in the EC, EFTA, Japan, and the United States—and textiles and apparel, where a highly restrictive regime of bilateral quotas under the Multifibre Arrangement (MFA) has been in effect for more than twenty five years. Regional arrangements involving industrial countries have done nothing to dislodge protection in these fields.

By contrast, it is widely believed that the Uruguay Round offers the best avenue—perhaps the only one—for achieving meaningful liberalization in these areas. This reflects the fact that the GATT forum—unlike negotiations toward regional arrangements—allows for "overall reciprocity" (Patterson, 1989), where the give-and-take in negotiations and trade-offs are not limited to country-by-country or sector-by-sector concessions. The success of the Uruguay Round hinges, to a significant extent, on whether a bargain can be struck in which industrial countries accept substantial liberalization in such key fields as agriculture and textiles in return for liberalization by developing countries in the "new" areas of services, investment, and intellectual property (Schott, 1990; Bhagwati, 1990b).

Finally, the ongoing process of globalization of investment and production is likely to lessen the risks of regionalism. The globalization process—carried on by multinational enterprises with global, rather than national, strategies—has exposed the limitations of nationally based policies and increasingly confronts governments with the need to liberalize and harmonize policies, standards, and regulations with other countries, including in—but not limited to—trade and trade-related areas. Harmonization and liberalization in response to the challenges posed by globalization is in some instances being conducted in the context of regional arrangements. Increasingly, however, the process of globalization calls for multilateral solutions; this fact will likely limit the risk that regional arrangements will turn into closed blocs.

Appendix. Membership of Selected Regional Trade Arrangements

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Membership of Selected Regional Trade Arrangements

Africa		
CEAO	Communaute Economique de l'Afrique de l'Ouest Members (7):	Benin, Burkina Faso, Côte d'Ivoire, Mali, Mauritania, Niger, and Senegal
CEPGL	Communaute Economique des Pays des Grands Lacs Members (3):	Burundi, Rwanda, and Zaïre
ECOWAS	Economic Community of West African States Members (16):	Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, The Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, and Togo (Integrates the members of the CEAO and MRU, and Gabon, The Gambia, Ghana, Guinea-Bissau, Nigeria, and Togo.)
IOC	Indian Ocean Commission Members (5):	Comoros, France, Madagascar, Mauritius, and Seychelles
MRU	Mano River Union Members (3):	Guinea (1980), Liberia, and Sierra Leone
PTA	Preferential Trade Area for Eastern and Southern Africa Members (18):	Angola, Burundi, Comoros, Djibouti, Ethiopia, Kenya, Lesotho, Malawi, Mauritius, Mozambique, Rwanda, Somalia, Sudan, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe
SACU	Southern African Customs Union Members (4):	Botswana, Lesotho, South Africa, and Swaziland
SADCC	Southern African Development Coordination Conference Members (10):	Angola, Botswana, Lesotho, Malawi, Mozambique, Namibia (1990), Swaziland, Tanzania, Zambia, and Zimbabwe
UDEAC	Union Douaniere et Economique de l'Afrique Centrale Members (6):	Cameroon, Central African Republic, Congo, Gabon, Chad, and Equatorial Guinea
Asia and the Pacific		
ANZCERTA	Australia-New Zealand Closer Economic Relations Trade Agreement Members (2):	Australia and New Zealand
ASEAN	Association of South East Asian Nations Members (5):	Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand
Europe		
BENELUX	Belgium-Netherlands-Luxembourg Economic Union Members (3):	Belgium, the Netherlands, and Luxembourg
EC	The European Communities Members (12):	Belgium, Denmark (1973), France, Germany, Greece (1981), Ireland (1973), Italy, Luxembourg, the Netherlands, Portugal (1986), Spain (1986), and the United Kingdom (1973)
EFTA	European Free Trade Association Members (7):	Austria, Finland (1961), Iceland (1970), Liechtenstein (1991), Norway, Sweden, and Switzerland
Middle East		
ACM	The Arab Common Market Members (7):	Egypt, Iraq, Jordan, Libya, Mauritania, Syria, and Yemen
ECO	Economic Cooperation Organization (formerly the Regional Cooperation for Development) Members (3):	Islamic Republic of Iran, Pakistan, and Turkey
GCC	Cooperation Council for the Arab States of the Gulf; also known as Gulf Cooperation Council Members (6):	Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates
Western Hemisphere		
ANDEAN PACT	Andean Subregional Integration Agreement Members (5):	Bolivia, Ecuador, Colombia, Peru, and Venezuela (Chile withdrew in 1976)
CACM	Central American Common Market Members (5):	Costa Rica (1962), El Salvador, Guatemala, Honduras, and Nicaragua
CARICOM	Caribbean Community Members (13):	Antigua and Barbuda, Bahamas (1983), Barbados, Belize (1974), Dominica (1974), Grenada (1974), Guyana, Jamaica, Montserrat (1974), St. Kitts and Nevis, St. Lucia (1974), St. Vincent and the Grenadines (1974), and Trinidad and Tobago
LAFTA/LAIA	Latin American Integration Association Members (11):	Mexico and all South American countries, except Guyana, French Guiana, and Suriname
U.S.-CANADA FTA	United States-Canada Free Trade Agreement Members (2):	The United States and Canada
U.S.-ISRAEL	United States-Israel Free Trade Area Agreement Members (2):	The United States and Israel

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Regional Trade Arrangements

Corrigendum: This page replaces page 9 of the published version

Table 2. Regional Trade Arrangements in the Western Hemisphere[1]

	Existing Arrangements											Prospective arrangements						
	US-Canada	US-Israel	CACM[3]	El Salvador-Guatemala[4]	CARICOM[5]	OECS[6]	LAFTA/LAIA	MERCOSUR[7]	Argentina-Brazil	Andean Pact[8]	Chile-Mexico-	NAFTA	EAI (US)[9]	Mexico-Central America[10]	Chile-Colombia-Venezuela	Colombia-Mexico-Venezuela[11]	Venezuela-Central America[12]	RIO Group
Founded:	1988	1989	1961	1991	1973	1991	1960/80	1991	1990	1969	1991		1991					
Objective:[2]	FTA	FTA	CU	FTA	CU	CU	FTA	FTA	FTA	FTA	FTA	FTA	FTA					
North America																		
Canada	•											•						
Mexico							•				•	•		•		•		•
United States	•	•										•	•					
Central America																		
Belize					•								•					
Costa Rica			•										•	•			•	
El Salvador			•	•									•	•			•	
Guatemala			•	•										•			•	
Honduras			•										•	•			•	
Nicaragua			•										•	•			•	
Panama													•	•			•	
Caribbean																		
Antigua & Bermuda					•	•							•					
The Bahamas					•								•					
Barbados					•								•					
Dominica					•	•							•					
Grenada					•	•							•					
Jamaica					•								•					
Monserrat					•	•							•					
St. Kitts & Nevis					•	•							•					
St. Lucia					•	•							•					
St. Vincent					•	•							•					
Trinidad & Tobago					•								•					
South America																		
Argentina							•	•	•				•					•
Bolivia							•			•			•					•
Brazil							•	•	•				•					•
Chile							•				•		•		•			•
Colombia							•			•			•		•	•		•
Ecuador							•			•			•					•
Guyana					•								•					•
Paraguay							•	•					•					•
Peru							•			•			•					•
Uruguay							•	•					•					•
Venezuela							•			•			•		•	•	•	•
Other Countries																		
Israel		•																

[1]Does not include unilateral trade preferences and exclusive countries with no arrangements.
[2]FTA: free trade area; CU: customs union.
[3]Revived in 1990; aims to establish a common market by 1992.
[4]Effective in October 1991.
[5]Aims to achieve a common external tariff by 1994.
[6]Organization of East Caribbean States.
[7]Aims to establish a common market by 1995.
[8]Efforts are under way to revive AP and create a common market by 1994.
[9]The Enterprise for the Americas Initiative aims to achieve hemisphere free trade zone. As of October 1991, the United States had signed framework agreements with 29 countries including the 13 CARICOM countries, the 4 MERCOSUR countries, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Honduras, Panama, Peru, Nicaragua, and Venezuela.
[10]These countries aim to form a Central American/Mexican free trade zone by 1996.
[11]Signature of the trade and investment agreement occurred in 1991, and trilateral limited free trade is expected by end-1993.
[12]The agreement aims to phase out tariffs on trade in the area.