# 11

# Conclusions and Recommendations

Regionalism adds an exciting dimension to the flat plane of unilateral versus multilateral trade policy. Countries are located at particular places on the globe, and their trade policies reflect this placement. The coming trade debates will be dominated, more so than in the first four postwar decades, by questions concerning the wisdom of having established free trade areas (FTAs) in Europe, the Americas, East Asia, and elsewhere; the prospects for expanding them, perhaps into continent-sized blocs; and the relationship between regionalism and multilateral liberalization.

The lesson from our empirical analysis in chapters 4 through 6 can be summarized succinctly: free trade area (FTAs) are indeed concentrating trade regionally. While many regional agreements have in the past been more show than substance, the new breed of FTA has real effects.

The lessons from our theoretical framework in chapters 7 through 9 can also be summarized succinctly. There is a strong case to be made in favor of regional trading arrangements. But that case cannot necessarily be made in terms of the static economic welfare effects of reducing barriers within each group while leaving those toward nonmembers unchanged. Rather, as explained in chapter 10, one must take into account the dynamic effects that intrabloc policies have on trade policies between the regions.

In traditional terms, if the level of trade barriers against outsiders is left unchanged, the harmful effects of trade diversion are likely to outweigh the beneficial effects of trade creation. In our terms, the degree of regionalization FTAs entail is likely to place the world in the supernatural zone, where the distortions in trade between blocs are so great as to leave the world worse off than it was under the nondiscriminatory status quo.



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These conclusions are only as good as the assumptions on which the model is based. There are ways of obtaining a more favorable verdict on regionalism. For example, some research goes beyond static effects on real income created by gains from trade and claims large, ongoing beneficial effects of trade on growth. Contrary to popular conceptions of competition among blocs, it may be that growth among the members of one bloc extends to countries elsewhere. Permanent effects are difficult to quantify, however.[1] Because our equation holds constant for income, these benefits have been omitted from the calculations in this book.

Even within the confines of our model, it is crucial to keep in mind the precise experiment to which these results pertain. That experiment is to compare a world of competing regional blocs with a world operating under most-favored nation (MFN) status. The question facing American policymakers is often a more immediate one: the decision whether or not to form an FTA among a given set of trading partners. Concerns about possible supernatural regionalization notwithstanding, such a move could very well be in the US interest when the policies of other country groups are taken as given. If one is indeed holding the trade policies of other countries constant, then a beneficial effect for the group of countries entering into a PTA is a shift in the terms of trade in their favor and against outsiders. This shift is particularly great if the countries involved are large ones. The point is thus relevant, for example, for the US decision to form or expand the North American Free Trade Agreement (NAFTA).

Large countries, however, are also the ones for which it does not make sense to take the global system as given. A large country's actions will influence those of other countries. They may respond in kind, whether the response is emulation or retaliation. Thus the hegemon must take some responsibility for the evolution of the system. It may have the power to determine the course that history takes. The choice is whether, on the one hand, to help move the world down a path of retaliatory formation of FTAs, ending in an equilibrium in which all are worse off or, on the other hand, to propose rules that will end in a superior outcome.

An ultimate verdict is possible only when one considers the political economy of the interactions of the regionalization process with the process determining trade policies between blocs. In other words, one cannot take the level of barriers toward nonmembers as given. Chapter 10 considered the political economy interactions. We saw that unfavorable outcomes and favorable outcomes are both possible. Regional trading arrangements can act either as stumbling blocks, undermining political support for more widespread dismantling of trade barriers, or as building blocks, helping

1. The idea behind one channel of transmission is that trade fosters the absorption into a national economy of the most advanced existing technologies and the most efficient production techniques. Frankel and Romer (1996) reference the empirical side of this literature and also present gravity-based evidence in support of the hypothesis.



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to build political momentum for global liberalization. There are many theoretical arguments, historical illustrations, and empirical results to bolster both sides.

Policymakers should seek to maximize the likelihood that regional arrangements will help global liberalization. The important question thus becomes what would be the best sort of rules to govern regional trading arrangements. Regionalism is a fact. How can it be harnessed for good rather than ill?

The phrase ''open regionalism'' has for some time been associated with the aspirations of the Asia Pacific Economic Cooperation (APEC) forum and its forerunners. The term was articulated in Canberra, Australia, at the first Pacific Economic Cooperation Conference (PECC) in 1980 and at the first APEC ministerial meeting in 1989.[2] Open regionalism can easily be derided as an oxymoron. A more constructive approach is to view it as a vessel into which to pour ideas as to how APEC and other still-evolving regional trading arrangements might best be molded so as to advance the cause of multilateral liberalization.

In this final chapter, we discuss possible policy prescriptions. Some of the recommendations could be pursued as agenda items for summit meetings of APEC, the European Union, or the Free Trade Area of the Americas (FTAA). Others would be best pursued at the multilateral level. This includes possible prescriptions regarding Article XXIV of the General Agreement on Tariffs and Trade (GATT) governing regional arrangements. Some of the analysis in this book is intended in an abstract sense. We will have to temper the theory of chapters 7 to 9 with some further practical considerations before seriously embarking on a revision of Article XXIV.

## Recommendations

**1. Facilitate trade through harmonization of customs procedures and liberalization of the shipping sector.**

We have treated transportation costs as given. The proxy that we have most often used, distance, is indeed exogenous. But transportation costs are not, in reality, exogenous. The construction of ports, rail lines, highways, and airports is usually undertaken directly by governments. Even when undertaken privately, these activities are strongly influenced by government policy. The airline industry is heavily regulated internationally, with an overabundance of national champions and a lack of competi-

2. Attempts at elaboration and definition include PECC (1992), Elek (1992), Garnaut (1993), Eminent Persons Group (1994), and Bergsten (1997) among many others. The definition of open regionalism mentioned as a possibility at the end of the preceding chapter, keeping membership open, is by no means a standard one.



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tion in fares. More ''open skies'' agreements would help. The shipping industry is even more highly regulated and cartelized, and unevenly so around the globe. ''Liner conferences'' operate as cartels. Shipping rates between South American and North America are artificially high, for example. This makes less appropriate the treatment of the two Americas as a single ''continent'' constituting a natural trade bloc (Amjadi, Winters, and Yeats 1995; Amjadi and Winters 1997).

It follows that groups of trading partners should reduce transport costs among their members. The shipping sector is a prime candidate for liberalization in any case, as it remains one of the most heavily protected industries. Its role as the necessary input into international trade makes it a doubly important candidate. WTO members should commit to abolishing protectionist habits in international shipping. This includes the practice of reserving a share of cargo for national companies. They should also liberalize port services: pilotage, cargo handling, and services associated with the transport of goods to and from ports.

In the airline industry, more ''open skies'' agreements would help. Liberalization is also needed in trucking. International deregulation and integration in trucking have been important components of the European Union and NAFTA. They should be pursued vigorously. Safety and environmental regulations and antismuggling measures should be enforced, but they should not be used as excuses for failing to implement agreements to allow truckers to cross national boundaries.

We learned in chapters 4 to 6 that physical shipping costs are not the only, nor even the largest, component of the cost to doing business at a distance. Ease of communication and cultural affinity are also important factors in international trade. We saw that, in general, two countries that speak the same language trade 55 percent more than two otherwise-similar countries. The effect of English may be even greater than other languages: English is rapidly becoming the lingua franca of Asia—and most of the world as well—thus helping to tie economically these countries to the United States.

Improving international communication and intercultural understanding are perhaps best left to private individuals. But government policy is important here, too. Global trade rules should be extended to telecommunications, for much the same reasons as they should be for transport. A 1997 global telecommunications agreement was a major step forward.

In addition, countries that heavily control freedom of expression, particularly freedom of the press, should recognize that they pay a price in impaired trade and financial links with the rest of the world and therefore in the growth of their economies.

The United States, for its part, should recognize that staying involved in the world is in its economic self-interest. To take one example, students from other countries should be encouraged to study in the United States; the ''export of education services'' over the last several decades has proba-



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bly done more to spread American values to Latin America and East Asia than anything other than conventional trade itself.

Harmonizing and expediting customs procedures, such as by standardizing customs forms and promoting the use of computer systems to process them, can also be useful in facilitating trade among a group of countries. This has been an early priority for APEC (Elek 1992; Eminent Persons Group 1994). APEC is working to promote uniform customs classifications and procedures and to establish common forms for manifest, travel documents, and the electronic transmission of business documents. Businesses can look forward to the day when a single customs form is accepted in all APEC countries. At the November 1996 summit in Subic Bay, Philippines, the leaders committed to develop measures to facilitate the cross-border movement of businesspeople. Measures include reciprocal agreements to extend 10-year multiple-entry visas and to facilitate movement through airports with electronically readable visas.

All these measures—liberalizing and promoting international transportation and communication, as well as harmonizing customs procedures—can help *create* natural trading areas that otherwise might not exist. They could, for example, make APEC into a more natural trading area than is suggested by the far-flung dimensions of the Pacific Rim. In the model of chapters 7 to 9, a reduction in transport costs among a group of countries not only in itself raises economic welfare, but also increases the odds that an FTA among that group will further boost welfare. In this sense, the criterion for the natural trading bloc could itself be endogenous—that is, subject to molding by policy.

**2. Enforce existing rules in the WTO.**

The GATT has not enforced its rules for regional trading arrangements. Many agreements have excluded particular sectors, such as agriculture, or have been phased in over interminable transition periods. These are clear violations of Article XXIV. Yet the GATT never rejected an FTA. The WTO is supposed to enforce such rules more seriously by imposing specific time limits on the transition period for example. It is important that member countries give this new institution the support it needs to enforce its rules (Bergsten 1996, 20; Lawrence 1995). The WTO has a Committee on Regional Trading Arrangements that will examine individual agreements and their conformity with multilateral rules. Some WTO members hope that the committee will also thoroughly reexamine the relationship between regional trading arrangements and the multilateral system, perhaps leading to strengthening Article XXIV and GATS Article V against abuse.

In some cases, member countries use the language of free trade as a justification for violating international rules. One example is using rules of origin to protect favored industries. Standardized rules should be internationally agreed upon for rules of origin—that is, we need ''rules about



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rules.'' One would be to prohibit an FTA from adopting different kinds of rules of origin for different sectors (Lawrence 1995). Another example of abuse that needs to be addressed by international agreement is antidumping duties. The establishment of supranational dispute settlement mechanisms to deal with such issues, as occurred in NAFTA, is an encouraging sign. But dispute settlement at the WTO would be better still. Given how firmly the bogeyman of dumping is embedded in the general consciousness, effective monitoring of antidumping policies at the multilateral level may have to await the day when there is broad international consensus on competition policy. Here, the Australia-New Zealand Closer Economic Relations (CER) pact, with its binational antitrust policy, may offer a better model than does NAFTA.

**3. Allow partial regional liberalization.**

Under the assumptions of chapters 7 and 8, we found that, so long as barriers between blocs remain, partial reduction of barriers within each bloc tends to give a better outcome than complete elimination of all internal barriers, as is technically called for under an FTA. Article XXIV, to the contrary, requires complete elimination of barriers.

Before presuming to pass judgment on this 50-year-old provision, let us consider several qualifications to our results. First, we must consider the point made above that, while distance itself is exogenous and immutable, the costs to doing business at a distance are partly endogenous. This means that whether two countries can be considered members of the same region is itself partly endogenous. To take an example, East Asia's treatment as a distinct region was not preordained, nor even predicted, as recently as 40 years ago. Nor was the fact that East Asia has closer economic and political ties to the United States, for example, than to South Asia. If, as this case suggests, regions cannot be considered to be fixed sets of countries, then the prescription deliberately to promote trade within one region to the exclusion of another makes less sense.

Second, it should be clarified that the results suggesting that complete liberalization within a region is suboptimal do not extend to the Article XXIV provision regarding liberalization of ''substantially all the trade between the constituent territories.'' They apply rather to ''elimination'' of barriers. The benefits of precluding distortions in relative prices across different goods, and of precluding wasteful lobbying and other rent-seeking behavior, argue in favor of the existing provision that preferences are to be applied uniformly to all sectors.

Third, the restriction does, as often claimed, provide a useful hurdle to entering into FTAs frivolously. If a hurdle is wanted, however, one wonders why it cannot be one of intrinsic merit. Within the theoretical framework of chapter 8, a condition that FTAs should be geographically proximate would be of this sort. Proposals 4 and 5 below are also hurdles



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of intrinsic merit and are not as dependent on a particular theoretical framework as chapter 8 may be.

Fourth, theoretical models treat trade between members of an FTA as if it takes place as freely as do economic transactions within a country. Yet we know from gravity studies, including those of the Canadian federation that were discussed in chapter 6, that the barriers to trade across political boundaries, even in the absence of trade barriers, are much greater than the barriers to trade across FTAs. Typical FTAs promote intraregional trade by a factor of two, relative to what it would otherwise be. Political boundaries appear to have a large negative effect on trade, even independent of trade policies. Some estimates say that the elimination of a political border increases trade between two regions in the neighborhood of a factor of two. (These estimates are based on the dissolution of the Austro-Hungarian Empire, the breakup of Czechoslovakia, German reunification, and the average home bias in all countries' trade). Another estimate of the effect, for the case of Canadian provinces, suggests that the effect of the US-Canada border may be as large as a factor of 20. If these cross-border barriers are regarded analytically as similar to tariffs and other trade barriers, then an FTA should properly be interpreted in our theoretical framework as an arrangement in which barriers to trade have been only partially eliminated. In other words, the elimination of all trade policy barriers within an FTA may double internal trade, and yet this may be only 10 to 50 percent of the effect of an elimination of national boundaries within the region. In that case, the analysis of chapters 7 to 9 makes FTAs look good. The political barriers, which still remain after formal trade barriers have been eliminated, limit the amount of trade diversion.

The alternative is that the cross-border barriers are to be regarded analytically as similar to transportation costs. The key distinction thus is whether the costs borne by exporters in crossing boundaries are payments that accrue to the importing country (tariff revenue) or are deadweight losses (transport costs). Recall some of the reasons that have been suggested for the intranational bias: the ease of doing business within the same legal system, the existence of nationwide store chains, transportation patterns (e.g., East-West railroad networks, in the Canadian case), nationally integrated media and advertising sectors and other aspects of communication patterns, and patterns of migration and family ties based in part on national education systems and portability of health care and pension rights. These costs to cross-border transactions have some of the characteristics of trade barriers and some of the characteristics of transport costs. A definitive conclusion is not possible.

Fifth, the point about invisible trade barriers is strengthened by the observation that FTAs in practice seldom eliminate even all the visible trade barriers. The theoretical notion of a group of countries that literally



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removes all internal barriers has no counterpart in the real world. In this light, the danger of going too far is less than it might otherwise appear.

Considering these qualifications, it would be rash to recommend eliminating the Article XXIV stipulation that FTAs result in the complete elimination of intragroup barriers, let alone revising it so as to prohibit complete elimination. On the other hand, as the WTO seeks to tighten enforcement that has hitherto been exceedingly lax, our theoretical results suggest that the 100 percent provision is one that may not need such enforcement.

**4. Require that barriers against outsiders be lowered sufficiently to prevent the loss of exports.**

Many observers have long envisioned a felicitous scenario in which customs unions serve as steppingstones to global free trade, expanding so as to benefit both members and nonmembers at each stage. The game plan calls for tariffs against nonmembers to be lowered each time the membership of a customs union is expanded, in such a way as to prevent the terms of trade from shifting against them. More specifically, the plan calls for external tariffs to be cut in such a way that the nonmembers do not lose any exports.[3]

A practical problem with enacting a rule along these lines is that scientific knowledge is not sufficiently advanced to be able to tell countries in advance how big a tariff reduction would be needed to leave trade quantities unaffected. To make the criterion operational, one has to be able, in the aftermath of a new regional trading arrangement, to estimate what trade with nonmembers would have been otherwise. Our gravity equation does this. Our estimates suggest that in the case of many existing FTAs, there has been a positive effect on trade with outsiders. The effect may be attributed either to new liberalization vis-a-vis the outsiders or to economic growth resulting from the union. Examples include the European Union, Mercosur, and the Association of Southeast Asian Nations (ASEAN). Other examples, however, show that liberalization vis-a-vis outsiders has either not taken place or else has been small enough to be outweighed by the trade diversion resulting from the preferences themselves. The European Free Trade Association (EFTA) is one such example.

3. McMillan (1993), in the tradition of Kemp and Wan (1976). Winters (1997a, 1997b) argues that a better criterion for judging the effect of a customs union on nonmembers, rather than looking at the effect on their *exports* to members, is to look at their imports and their terms of trade. Measuring the terms of trade effect, however, seems even more difficult than estimating the effect on the trade quantities. Bhagwati (1992, 546-48) points out the practical difficulties with predicting quantitative trade effects as a criterion for judging prospective FTAs. Nonetheless, he supports the McMillan proposal as consistent with his own idea that some sort of requirement to bring down the average level of external tariffs should be added to Article XXIV.



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Perhaps the rules should be rewritten to require external liberalization as a condition for WTO approval. Statistical tests could be applied to the trade data after the FTA goes into effect. The members could be required to compensate any nonmembers that lose exports due to the failure to cut external tariffs sufficiently, much as customs unions currently face nonmembers' demands for compensation when tariffs are raised against them.

Simulations with our model suggest that the required degree of external liberalization is quite different depending on the precise experiment that one is considering (Wei and Frankel 1995b). To ensure that the formation of a given FTA does not harm nonmembers, the required degree of external liberalization might have to be almost as great as the degree of internal liberalization. It seems unlikely that this would be politically feasible. But we have seen that there is an incentive for all regional groups to form PTAs simultaneously if each is allowed to do so. If one is writing rules for a new system to guide the simultaneous formation of regional arrangements in many parts of the world, then the problem changes. It turns out that the degree of external liberalization required for each FTA need not be large.

It would be foolish to take literally a numerical estimate from our model, or any other model and to write it into a revised Article XXIV. The model and the estimates are far too uncertain for that.

The line of reasoning that undergirds the model, however, offers some support for a simple, even crude, proposal that others have made (e.g., Bhagwati 1990, 1992): that members of a customs union set the common external tariff at the level of the lowest of the members' preunion tariffs.[4] In many cases, this would offer the degree of liberalization necessary to make sure that all benefited from the customs union.

In some cases, the result would be to foreclose a particular regional trading arrangement. There is not necessarily anything wrong with that. In other words, this provision would create the sort of obstacle to frivolous FTAs called for under recommendation 3 above, a hurdle that would serve a useful screening purpose in its own right.

Perhaps a requirement that each member reduce its tariffs on trade in all goods with all nonmembers, to the lowest among them, would be too high a hurdle. It would, for example, have precluded Mercosur. One alternative is for each member to reduce its *average* tariff on trade with nonmembers to the lowest among them. On the other hand, the proposed requirement that each member reduce its tariffs in all goods to the lowest

4. Bhagwati points out that ruling out FTAs with varying tariffs, and thus permitting only customs unions with common external tariffs, would for the most part have the effect of reducing tariffs to the lowest level among them because countries' tariffs have been "bound" in GATT negotiations. Unfortunately, in the Uruguay Round, many developing countries bound their tariffs at rates far above their recent actual applied levels.



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among them might be too *low* a hurdle. It would not prevent trade diversion from EU policy in agriculture, for example. An intriguing possibility is the Wonnacotts' proposal: adopt a common external tariff on some goods but keep FTA rules for other goods (Wonnacott and Wonnacott 1995; Paul Wonnacott 1996).

**5. Keep membership open.**

An obvious way to give some meaning to the phrase ''open regionalism'' is to make the membership of regional trading arrangements open to newcomers by means of accession clauses. This property has also been called ''inclusivity.'' NAFTA has explicit provisions for adding new members, with Chile presumed first in line. The European Union has expanded steadily up to now and anticipates admitting more members from the east. ASEAN has now expanded to the north. The Eminent Persons Group recommended that APEC be prepared to extend any preferences negotiated among its members to other countries, on a reciprocal basis, which makes it sound almost like an expandable PTA.[5]

When a bloc proclaims that it anticipates eventual expansion or that it welcomes applicants, this can send a reassuring signal to outsiders who might otherwise feel threatened by it. The situation is different from that before World War I or before World War II, when expansion of a bloc was automatically viewed as threatening to others. More important, a willingness to expand is the way to enact the aforementioned Kemp-Wan game plan, under which a sequence of customs unions is the pathway to worldwide free trade.

Will blocs in fact be willing to expand? There is some reason to fear that the economic incentive for a bloc to expand its membership disappears long before it has expanded to include the entire world. We saw in the preceding chapter that terms of trade benefits to the bloc, which exist at early stages, diminish as the number of members grows large. Moreover, there is always a trade-off between deepening an existing

5. Internal liberalization among APEC members is not expected to take place in a formal negotiated manner. This makes it hard to know what offer is being made to nonmembers. It also makes it hard to classify the APEC plan as either (1) an FTA as envisioned in Article XXIV, (2) a preferential trade arrangement that violates Article XXIV, or (3) a club of countries that encourage each other to undertake unilateral, nondiscriminatory liberalization, which would be consistent with the most-favored nation (MFN) principle. Page (1995, 22) distinguishes the murky ''Asian'' brand of open regionalism from the ECLAC (1994) brand of open regionalism in Latin America, in which a group takes in any country willing to accept the agreements already reached. The Eminent Persons Group (1994, 30) recommends that APEC remove barriers along four lines simultaneously: ''the maximum possible extent of unilateral liberalization; a commitment to continue reducing its barriers to nonmember countries while it liberalizes internally on an MFN basis; a willingness to extend its regional liberalization to nonmembers on a mutually reciprocal basis; and recognition that any individual APEC member can unilaterally extend its APEC liberalization to nonmembers on a conditional or unconditional basis.''



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agreement and expanding the membership. As the countries that are admitted become increasingly dissimilar from the core of the bloc, the trade-off may dictate closing the membership rolls. (Expansion of the European Union, for example, may soon reach a limit for this reason, as well as due to difficult related budgetary issues.) We saw in the models of chapter 10 that the ultimate outcome if blocs do not have reason to expand, whether in a world of roughly equal-sized, competing blocs or of one large bloc, is not a happy equilibrium. Competitive regionalization results in distorted trade all around. In a system of one or more large blocs, the harm is particularly great for any countries that are left out altogether.

A potentially attractive solution to this difficulty, in theory, is the one proposed by Yi (1996): add a clause to Article XXIV specifying that FTAs must let in any country that wants to join. Unfortunately, it would be difficult to enforce a formal open-membership requirement. Expansion entails negotiation over many details of the terms of accession. The existing members can always make the terms sufficiently onerous to discourage applicants. Nevertheless, it might be beneficial to build a presumption of inclusivity into a code of good behavior for FTAs.

**6. Make FTAs ultimately compatible.**

This book has focused on those trade barriers, often represented as tariffs, that can be unambiguously ranked on a scale of liberalization or protection. Joining up two PTAs or FTAs is in this case a simple matter of reducing or eliminating the trade barriers between them in the same manner that each has already done internally.

In reality, regional arrangements increasingly deal with issues of a different nature: the environment, direct investment, intellectual property rights protection, competition policy, and dispute settlement mechanisms. In many of these areas, integration among countries consists primarily of harmonization on a common standard. As with the choice between Betamax and VHS or between driving on the right-hand side of the road and driving on the left, it does not matter so much what the standard is, so long as everyone can harmonize compatibly. Examples in the area of intellectual property rights protection include agreeing on whether patents should be awarded to the first to invent or the first to file and setting a uniform time span for patent protection. Other examples include environmental, sanitary, and phytosanitary standards.[6]

6. To the extent that standards are used as a wall to keep out foreign products, they are a form of trade protection analogous to tariffs. But to the extent that firms waste resources in the effort to satisfy local standards—for example, when a product that has already been tested and accepted in the producer country must be tested over again in the importing country—the loss is analogous to transport costs. The distinction is that in the former case the cost is transferred to the protected firms, while in the latter case it is a deadweight loss. Eliminating such costs—for example, by agreeing that tests in one country's laboratories will be accepted elsewhere—is another way to facilitate the creation of natural trading blocs.



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If two blocs of countries each harmonize on different standards, then it will be more difficult to bring the two blocs together in the future. One attribute of open regionalism, then, is for blocs to set standards with an eye to what other blocs are doing. This is a possible agenda item for the broader clubs—APEC and FTAA—assuming they are to flourish. APEC, for example, could monitor ASEAN, NAFTA, and the Australia-New Zealand CER and point out when they are in danger of adopting incompatible standards or procedures. In this regard, it would also be a good idea for the broader regional groups to be reviewed biannually through the WTO's Trade Policy Review Mechanism (TPRM), along with the smaller, more formal, trading arrangements.

**7. Lead the way in future multilateral rounds.**

One of the items on chapter 10's list of respects in which FTAs could help advance regionalism was the point that negotiations are sometimes more easily carried out among larger units rather than among a large number of individual countries. Starting up a new round of multilateral negotiations always required someone to do the proposing and the organizing. The United States most often played that role. It seems increasingly reluctant or unable to do so, however. The theory of international political economy can explain this.

The most telling statistic is that the United States now constitutes less than one-quarter of gross world product. Thus the United States can expect to reap something like one-quarter of the expected long-run global gains from public goods, such as maintaining an open trading system. It may be that this is no longer large enough, from the American viewpoint, to outweigh the short-run incentive to protect its industries. Or, even if the true balance of economic gains and losses favors the multilateral process, the difference may no longer be large enough for some American voters to appreciate.

The European Union is somewhat larger than the United States economically. So, of course, is NAFTA, when taken as a whole. APEC as a unit is much larger still. It may be that in the future no single country will find it in its interest to take the lead in multilateral negotiations. This responsibility could conceivably then fall to a supranational group such as the European Union or even APEC.

The day when the European Union can function effectively as a political unit is not yet here, but it may come. The member countries need not have identical views. After all, there is always a great deal of disagreement on trade policy within the United States, to the point where Congress considers rejecting international trade agreements that the US government has proposed and successfully negotiated at great length. But just as internal disagreements do not preclude US trade officials from initiating negotiations with countries, after having been authorized to do so, the same principle might apply at the bloc level.



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Even a collection of countries as disparate as APEC, which harbors none of the EU's ambitions to evolve into a single decision-making unit, has a role to play in this regard. Leaders at a summit meeting of APEC could agree to propose a multilateral round and could then take their proposal to the WTO (Bergsten 1995b; 1996, 114). For the rest of the world to take the proposal seriously, it would help if the governments in question had already agreed to take new steps among themselves. These steps could be unilateral removal of tariffs or quotas, adoption of codes for investment or government procurement, or the introduction of new topics such as competition policy or the environment. Not only could the group in question help maintain momentum in the multilateral process, it could also shape the direction of that movement to its taste. An example was President Clinton's success at Subic Bay in November 1996 in persuading other APEC members to support an Information Technology Agreement (ITA). This consensus then encouraged the membership of the WTO to accept the ITA proposal at the first ministerial meeting in Singapore a few weeks later.

**8. Don't fall for the line that the American bloc is in geopolitical competition with a yen bloc and an EU bloc.**

This book has focused on the question of whether the regionalization of trade raises or lowers economic welfare—the question of most interest to economists. Even where we have considered the politics of regionalization, it has only been to see whether regionalization is politically compatible with more general liberalization, or how the rules governing regional arrangements should be written so that the political process is most likely to produce general liberalization. The ultimate criterion has been economic welfare.

We conclude by noting the existence of other possible criteria. Political motivations have often been dominant in the origins of regional trading arrangements. The overriding motivation behind the foundation of the European Economic Community was to bind Germany to France so that there would never be a repeat of the three wars that they had fought over the preceding century. The overriding motivation behind the expansion of the European Community to include Greece, Spain, and Portugal was to cement the transition from dictatorship to democracy that all three Mediterranean countries were undergoing in the 1970s. The overriding motivation behind prospective plans to admit Central European countries to the European Union is to solidify their transition from communism.

In other parts of the world as well, regional trading arrangements are determined by political considerations as much as by economics. The US decision to form NAFTA was prompted by a desire, not only to cement economic reforms in Mexico, but also to boost democracy and stability in its southern neighbor. Reluctance among many East Asian countries to join a bloc that might be dominated by Japan arises, not from fears of



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economic domination, but from lingering historical resentments. By the same token, their interest in APEC stems not just from contemplation of possible economic gains, but also from a desire to keep the United States politically and militarily engaged in the region, as a counterweight to Japan, China, or any other country that might grow assertive.

A popular view among American geopoliticians is that the US stake in the development of blocs in other parts of the world is completely different from what it used to be. During the Cold War, this view goes, it might have been in the US interest to promote economic and political development in noncommunist regions. Sometimes this meant promoting regional associations. The most prominent example is the European Economic Community (EEC), but it is worth recalling that ASEAN was simply an anticommunist organization during the first 10 years of its existence, without a major economic component.

While US interests have undoubtedly changed, it is questionable to view the rise in economic size or income per capita of certain countries (especially in Asia) as the new preeminent threat to US interests. The logic behind this view is that economic competition has replaced political-military competition and that economic competition among the three rival blocs is a zero-sum game. Whatever is good for the East Asian bloc or European bloc must therefore be bad for the United States. Those who hold this view assume that past US support for removing trade barriers contains an element of charity that the United States can no longer afford. This assumption not only has been invoked in prospective trade liberalization talks within groups abroad, it has even been advanced when the prospective liberalization was to take place within North America (prompting the marginally more enlightened geopoliticians to explain to others that building a NAFTA bloc was necessary in order to compete with the yen bloc and the Eurobloc). The unifying theme appears to be that if something is good for foreign countries, then it must be bad for the United States.

This logic is vulnerable on several points. Most fundamentally, the flourishing of market economics has always been one of the most potent means of advancing American values around the world and continues to be so. Economic growth tends to have a liberalizing effect politically, and trade-led growth all the more so. The maximal spread of stable, democratic, market-oriented systems should be the main goal of US foreign policy.

It is true that economic competition was a key element of the Cold War. As the US economic system gradually proved its superiority to the Soviet system, third countries watched and drew the appropriate lessons. It is a non sequitur, however, to claim that the Soviet Union's demise implies that US foreign policy should now be driven by economic competition with other challengers. This ignores that the economic and political



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system of the supposed challengers, Japan and the European Union, is similar to our own. If all countries were to become as stable, democratic, and market-oriented as those two, the goals of American foreign policy will have been fulfilled. It should not be worrisome, in that case, if East Asian countries concentrate their trade somewhat with Japan or European countries within the European Union.

The other point in which the conventional wisdom is vulnerable is the three-bloc delineation. The world does not in fact seem to be evolving toward the three-bloc world that has been so widely discussed. Most of the simulations in the theoretical framework of chapters 7 to 9 chose three as the number of continental blocs. Yet the three popular continental groups of the Americas, Europe, and East Asia do not correspond to explicit existing trading arrangements, particularly in the case of East Asia.

We have considered broad informal groups because of the popular view that Japan, for example, is establishing a yen bloc in Asia through means that are implicit, indirect, and invisible. Our empirical results in the gravity framework, however, suggest that the strongest of the broad groups, besides Europe, is the APEC bloc rather than East Asia alone. This finding suggests a possible two-bloc world, consisting of Europe and a trans-Pacific bloc, rather than the standard three-bloc world. It is consistent with the observation that no Asia-only institutions rival the APEC forum.

The finding holds equally when one considers monetary aspects, which, after all, are implicit in the appellation ''yen bloc,'' instead of trade. Econometric tests indicate that East Asian countries remain tied far more closely to the dollar and to New York financial markets than to the yen and Tokyo financial markets (Frankel and Wei 1994a, 1995b; Chinn and Frankel 1995, and other references cited therein). The United States has so far succeeded, through initiatives such as its support for APEC, in heading off the three-bloc world.

The United States is fortunate in belonging to both the prospective FTAA bloc and the prospective APEC bloc and, indeed, to be the key member of both. US initiatives in both regions were largely responsible for the new regionalist trend. It remains true that the United States, alone in the world, is large enough to exercise leadership. In the case of regional trading arrangements, this means doing everything possible to make sure that they evolve in a manner consistent with global liberalization.



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# APPENDICES