

# Is Regionalism a Threat to Trade Liberalization?

Written by Tom Moylan

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TOM MOYLAN, APR 10 2013

### Is Regionalism Really a Threat to Trade Liberalization?

#### Introduction

This essay will be looking at the issue of regional trade agreements and evaluating the effect they have on the prospects for multilateral trade liberalization. Mansfield and Milner briefly discuss the many different ways that regionalism can be defined. In this essay it will be defined as their description of Fishlow and Haggard's explanation of it, "a political process characterized by economic policy co-operation and co-ordination among countries" (Mansfield and Milner 1999, p.592). The essay will argue that regionalism is in fact a step forward on the road to multilateral trade liberalization. This point will be argued by dividing the essay into two main sections. The first will present the arguments supporting looking at regionalism as a stepping stone, defend them against their critics, and accept their limitations where necessary. The second section will consider the arguments that regard regionalism as a threat to multilateral trade and where possible undermine them. There are two main schools of thought within this debate. One is Summers' view that regionalization is trade liberalization. However, there is much variation within this school. Baldwin has his 'Domino effect' theory of regionalism, stating that as profits for one trading bloc grow, so does the outsiders' desire for membership. Bergsten propounds the idea that 'open regionalism' is not harmful to multilateral trade, while Ethier argues that it is in fact beneficial to the process. Also of the pro-liberalization school, Lamy suggests a 'multilateralism first' strategy. The opposing school of thought is Bhagwati's theory that discriminatory liberalization will only lead to problems in the future with trade discrimination. In this school we have writers such as Panagariya arguing that regional arrangements lead to division and build future problems. We will look at these, as well as studies from the World Trade Organization (WTO) and the US congress on the issue over the course of this essay.

#### Regionalism as a Stepping Stone to Multilateral Trade Liberalization

One of the major benefits that the process of regionalization offers is the sensitization of constituencies to liberalization.

"Both in Europe and North America, governments tend to espouse the views of pro-integrationist business leaders (and labor leaders as well in most of Europe), while the populace tends to be more wary" (Baldwin 1993, p.10).

People are afraid of liberalization due to a number of factors, including the possibility of unwanted competition in the local market, the outsourcing of work to other countries, and the loss of control over the market by the government. In this context it is possible that region-to-region arrangements, such as those between the EU and GCC or Mercosur, could be considered to be the next step along the path to multilateral liberalization (Lamy 2002, p.1407). The experience they have had in the past and the gains from liberalization within a region may dissipate fear and lend weight to the argument for further region-to-region liberalization.

The next argument that we will look at is the suggestion that regional trade agreements (RTAs) erode vested opposition to multilateral liberalization and reduce the value of preference, reducing their discriminatory impact over time (Best and Christiansen 2008, p.437). Sandholtz and Stone Sweet describe the neo-functional theory of

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regionalism (2010). Although this theory is used to describe how to effectively integrate regionally, we can see that through the processes of the “positive spillover effect”, the increased number of transactions, and the transfer of domestic allegiances predicted by the theory, that increased integration should lead to greater allegiance to a regional market. The question is then whether this action could be re-created on a multilateral level. It is possible to argue that it could, due to the fact that larger companies and those acclimatized to existing in a regional market are more likely to survive in a multilateral free trade situation, and therefore are more likely to push for it. In tandem they are more likely to gradually squeeze out or change those industries that would oppose it. In Mansfield and Milner’s paper they show how Oye purports this view (1999, p.603), though they also include a quote from Krueger that suggests that exporters’ desire for multilateral liberalization may be stunted by regionalism due to vested interests profiting from trade diversion increasing in size (p.603-604). This is a possible limitation to this point.

The next point we will look at purports the view that RTAs generally are not actually about trade within a region, but are used for other reasons. On NAFTA, Baldwin comments that

“the entire Mexican economy is smaller than that of the Los Angeles basin...It is highly unlikely that the US views this...as substituting in any way for global trade liberalization” (Baldwin 1993, p.2).

He attributes it instead to geopolitical reasons. We can see many examples of countries using RTAs as part of strategic or political alliances, such as the pooling of steel and coal production in the ECSC as a way of avoiding future wars (Lamy 2002, p.1405). This strengthens ties between states and builds trust. Where these kinds of agreements are not beneficial to trade liberalization, they generally do not harm it either. RTAs are also used to reinforce established trading links between countries, as Summers notes,

“Most seriously contemplated efforts at regional integration involving industrialized countries cement what are already large and disproportionately strong trading relationships. To this extent they are likely to be trade creating rather than trade diverting” (Summers 1991, p.298).

It is possible, however, that over time these relationships may become trade diverting as industries within the region strive to protect their interests. This is a potential weakness and will be examined more closely later. Finally, states use regional agreements to attract foreign capital, whether through commitment to reform, reduction of duties, or other methods, so that they have a better chance of success in the multilateral trading system (Ethier 1998, p.1157). In this situation, RTAs encourage enthusiasm for the multilateral trading system, and the development and stabilization of the economy of a country using these means will lead to their further participation in liberalization and the global economy.

Now we will consider how RTAs help developing countries learn to trade and test out liberalization in an environment protected from global competition (Best and Christiansen 2008, p.437). Lamy illustrates how RTAs can be used as a tool of development, by providing “closer and more stable economic relationships with immediately neighboring countries” “to underpin and lock in political reform” and to support a country’s economy through non-reciprocal trade agreements (Lamy 2002, p.1405). Baldwin states that one of the reasons that the US entered NAFTA was its desire to divert foreign investment to Mexico (due to its privileged access to US markets) that would have otherwise gone to third countries, therefore using it as a development tool (Baldwin 1993, p.2). Though indeed useful, the World Bank notes in its 2005 report that this could be creating future problems, with poorer countries being reluctant to let go of their comparative advantages (World Bank 2005, p.134). This is a glaring weakness in the advocacy of the use of non-reciprocal trade agreements as instruments of development. However, the other two uses for them seem sound enough. Ethier uses the example of the former Soviet countries and their entrance into high numbers of regional agreements to show how a country can use these agreements in order to highlight a commitment to reform and market openness, to attract investment and capital. Furthermore, the creation of dispute settlement mechanisms and procedures offer those committing the investment and capital some assurance that they can take action in the case of a “backslide” from commitments (Ethier 1998, p.1155). The trust built and experience earned from these agreements will provide solid ground upon which to build closer and more stable trade relationships.

The final point we will look at under this heading is that of the unwieldiness of the GATT/WTO. Baldwin, although not

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a proponent of the idea himself, notes the argument that the GATT/WTO is “outmoded and too cumbersome to deal with the complexities of contemporary trade issues” (Baldwin 1993, p.2). The idea behind this argument is that regions can advance liberalization in ways that the GATT/WTO cannot. As Ethier notes, “fewer participants presumably mean fewer conflicts of interest and fewer areas of disagreement” (Ethier 1998, p.1153). However, looking at RTAs in a different way, one may consider them to be a mechanism for larger and more powerful countries to hold on to their power. Mansfield and Reinhardt (2003) note that as WTO membership expands, larger membership reduces the ability of individual countries to influence the content and pace of MFN liberalization, and makes it more difficult to formulate coordinated positions.

As we can see from this section, there are strong arguments for the use of RTAs as means to act on needs that have less to do with trade than with development, politics and efficiency. It must be accepted, however, that there are legitimate concerns arising from some of these agreements, especially in the areas of non-reciprocal trade agreements, large countries using RTAs to protect their interests, and trade diversion.

## Regionalism as a Stumbling Block to Multilateral Trade Liberalization

One of the arguments against RTAs is that they are trade diverting. Summers claims that they are in fact the opposite:

“Most seriously contemplated efforts at regional integration involving industrialized countries cement what are already large and disproportionately strong trading relationships. To this extent they are likely to be trade creating rather than trade diverting” (Summers 1991, p.298).

Other scholars in the area have abandoned their attempts to make this argument, instead claiming that this is in fact irrelevant. Lamy states that in theory, multilateral liberalization is best because it avoids the risks of trade diversion, but goes on to make the point that if one removes the assumption that there is an environment of perfect competition, we begin to see a different picture regarding the benefits of competition and scale effects of RTAs on the participating economies (Lamy 2002, p.1401-1402). Looking at the situation through Lamy’s lens, we can see the other effects of RTAs in the areas of investment, growth, and the removal of non-tariff barriers; arguably, the strength of these factors in trade creation outweighs any possible trade diversion. Ethier states that there is a big difference between what he calls “new regionalism” and “old regionalism”, and blames the preoccupation with the trade diversion/trade creation argument in this area on a hangover from the discussion of “old regionalism” (Ethier 1998, p.1150).

There are other kinds of diversions to worry about in the context of regionalism and its effect on multilateral trade liberalization: “Proliferating regional agreements absorb scarce negotiating resources (especially in poorer WTO members) and crowd out policymakers attention” (World Bank 2005, p.133). Attention diversion is a major concern. Panagariya discusses how options made available through regional agreements might distract countries from multilateral liberalization processes (Panagariya 2000). This concern could be challenged, because the current trend since the proliferation of new regionalism since the 1980s suggests that we have little to worry about, given the steadily rising membership of the WTO/GATT (WTO 2012). However, it is very difficult to accurately measure the concept of “attention”, with other arguments easily promoted by using other methods of measurement, such as the number and frequency of bilateral and regional trade agreements versus WTO/GATT multilateral agreements. Here a possible negative effect of RTAs on multilateral liberalization must be conceded.

Another potential ‘stumbling block’ is the possibility that competing RTAs may create incompatible regulatory structures (Best and Christiansen 2008, p.437). An excellent example of this is the conflict between the United States and the European Union over beef hormones. The US allowed more hormones to be used in their cattle than the EU; as a result, the EU blocked imports of US beef and the US responded in kind. The US congressional report on the situation states that,

“lost U.S. beef exports because of the EU’s ban were estimated at about \$100 million annually, and valued approximately equal to retaliatory trade sanctions against selected EU food product exports” (Hanrahan and Johnson

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2010, p.17).

Over ten years this was a serious loss to the trade between the US and EU. This situation is one of a possible litany. Nevertheless, we can see that both parties eventually came to a compromise, in that now "Cattle raised under control measures specified in USDA's NHTC Program is eligible for export to the EU" (Hanrahan and Johnson 2010, p.18-19), and furthermore, implementation has begun of a 3 phase plan to rebuild the beef trade between the countries (Hanrahan and Johnson 2010, p.14). Although this example shows that the 'stumbling block' does exist, it illustrates that it is very possible to surmount it, and undermines the argument that it is a major threat to multilateral liberalization.

In a similar vein to the last point, some are concerned that different legal frameworks and dispute settlement mechanisms may weaken discipline among countries (Best and Christiansen 2008, p.437). As Mansfield and Reinhardt note, enforcement of a GATT/WTO independent legal judgment is "is left to the complainant alone" (2003, p.840). This means that if a complainant or a defendant is powerful enough, a decision is more likely to be dictated by them. One could consider this alone to make the argument irrelevant, in that it would not matter which mechanism was used or if they contradicted each other, but rather the outcome of a dispute depends on the power of those involved. This point of view taken into account, the World Bank still included it in their 2005 report on trade, regionalism and development as something to be concerned about in the future (p.133). Perhaps an area of possible future study could be a comparison of the frequency of the use of GATT/WTO dispute settlement mechanisms and RTA mechanisms.

Finally, we will briefly look at the argument that the formation of RTAs may lead to the emergence of a trade bloc mentality:

"As [a] country accedes to the bloc, the potential economic benefits of entry for the next country on the outside margin rise and may offset the higher noneconomic costs of entry it faces" (Panagariya 2000, p.318).

This suggests a snowball effect, and the eventual existence of major competing trading blocs. This, it must be accepted, is a legitimate concern. The only way to battle the threat of a trade bloc situation arising is to continue momentum in the area of multilateral trade liberalization, to keep it relevant and to continue to monitor and control the possible negative effects of RTAs on the mentalities of the states involved.

In this section we can see that many of the arguments leveled to paint RTAs as negative factors in the drive for multilateral trade liberalization can, for the most part, be undermined or at the very least considered questionable. It is in the areas of trade bloc formation and attention diversion, especially among developing countries, that concern may lie. However, these concerns are not reasons to abandon RTAs.

## Conclusions

This essay has illustrated that, on balance, regionalism is not a negative thing in the context of multilateral trade liberalization, and that in some ways it is very helpful. Pervading the literature on the subject is the theme of promoting "appropriate RTAs". Much of the stress is on the importance of controlling and monitoring the development of RTAs, and the context in which they develop. Most of the weaknesses we have observed in this essay's argument can be remedied by this "responsible regionalism". Of the schools of thought, Bergsten's ideas about "open regionalism" and Lamy's emphasis on a "multilateralism first" approach, though not without their faults, seem to be on the right track regarding progressing this area of study to a practical level. One of the reasons this conclusion has been drawn is due to the wider context of regionalism being necessary in a new globalized world. Best and Christiansen state that production, exchange and consumption are escaping the regulation of the state, due to the new multinational nature of business (2008, p.437). Indeed, Lamy suggests that regionalism is important for the creation of rules for transactions involving capital, services, technology, and people (Lamy 2002, p.1408-1410). This exciting and dynamic area is a possible area of future study, which tries to reconcile Lamy's and Bergsten's theories with the modern globalized world.

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