

**THE POLITICAL ECONOMY OF CONTEMPORARY  
REGIONAL INTEGRATION: EVIDENCE AND  
INTERPRETATION**

**RICHARD JERRAM**

**PhD THESIS**

**LONDON SCHOOL OF ECONOMICS AND  
POLITICAL SCIENCE**

UMI Number: U148715

All rights reserved

INFORMATION TO ALL USERS

The quality of this reproduction is dependent upon the quality of the copy submitted.

In the unlikely event that the author did not send a complete manuscript and there are missing pages, these will be noted. Also, if material had to be removed, a note will indicate the deletion.



UMI U148715

Published by ProQuest LLC 2014. Copyright in the Dissertation held by the Author.  
Microform Edition © ProQuest LLC.

All rights reserved. This work is protected against  
unauthorized copying under Title 17, United States Code.



ProQuest LLC  
789 East Eisenhower Parkway  
P.O. Box 1346  
Ann Arbor, MI 48106-1346

735969

7792

F

THESES

THE POLITICAL ECONOMY OF COLLECTIVISM  
AND THE POLITICAL ECONOMY OF SOCIALISM

## ABSTRACT

This research takes a rigorous approach to examining available data for signs of regional integration and interprets the findings in terms of their illustration of the changing structure of the international political economy. A range of methodologies are examined and the inadequacies of various commonly-used approaches to measure regionalisation are discussed. Bearing this in mind, statistical measures of regional bias are developed, and time series of results are displayed to show trends in the three major economic areas over the past three decades in a way that has not been attempted in other studies. The findings suggest that regional integration has been advancing steadily in North America and Europe and there are suggestions that preferential trading arrangements have helped to promote closer regional integration. Surprisingly, the preferential bias between the founder members of the European Union is little changed in the past three decades. In the developed world the non-discriminatory qualities of some of the deeper aspects of regionalism have helped to blunt its preferential impact, as have corporate organisational strategies, which are also important in shaping regional production. The impact of preferential regional arrangements on internalisation of corporate transactions is ambiguous.

It is argued that multinational corporations are less concerned about whether liberalisation is regional or multilateral than is commonly assumed. This makes the "building block—stumbling block" debate less important than the question of whether barriers to cross-border business are declining. Taking the analysis down to the micro level highlights the complex relationship between trade and investment flows which is not captured in theoretical literature or the available statistics.

Although economics can explain the attractiveness of regional agreements, political economy explanations are useful to explain its growing popularity. One neglected issue is the benefit resulting from lower systemic risk.

A more accurate description of the structural change identified in this research is that of "regional globalisation", where the prime concern of multinational corporations is that of globalisation, but it is a trend which is currently manifested through regional organisation. This is not a fixed trend and could be superseded by sub-or supra-regional integration depending on technical change and political co-operation.

## TABLE OF CONTENTS

Abstract	2
Table of Contents	3
List of Figures	5
List of Tables	6
List of Abbreviations	7
Acknowledgements	9
<b>1. INTRODUCTION</b>	<b>10</b>
<b>2. REGIONALISM: THEORY AND POST-WAR DEVELOPMENTS</b>	
2.1 Introduction	16
2.2 Theoretical background	18
2.3 Typography of preferential agreements	22
2.4 Historical perspective	25
2.4.1 Post-World War II Experience	27
2.4.1.1 Reconstruction: 1947-1957	27
2.4.1.2 Lower Barriers: 1958-1973	29
2.4.1.3 Stalled Progress: 1974-1985	31
2.4.1.4 Renewed Liberalisation: 1986-1997	33
2.4.2 Numbers of Regional Trading Arrangements	35
2.5 Regionalism and Economic Cycles	39
2.6 Conclusion	41
<b>3. REGIONAL INTEGRATION: METHODOLOGY AND RECENT TRENDS</b>	
3.1 Introduction	42
3.2 Evidence of Regional Integration	43
3.3 Merchandise Trade Flows	44
3.3.1 Direction of Trade Flows	45
3.3.2 Bilateral Trade Intensities	48
3.3.3 Price Distortions	57
3.3.4 Regional Trade Intensities	59
3.3.4.1 Unadjusted denominator (Method 1)	61
3.3.4.2 Adjusted denominator A (Method 2)	63
3.3.4.3 Adjusted denominator B (Method 3)	65
3.3.4.4 Europe	67
3.3.4.5 North America	77
3.3.4.6 East Asia	82
3.3.4.7 Summary	88
3.3.5 Trade Intensities and National Income	88
3.3.6 Gravity Models	93
3.3.7 Summary of Findings from Trade Data	97
3.4 Foreign Direct Investment	98
3.5 Non-Equity Relationships	105
3.6 Investment Income Flows	106
3.7 Currency Flows	109
3.9 Conclusion: Is Regionalisation Increasing?	111
<b>4. REGIONAL INTEGRATION AND FOREIGN EXCHANGE RATES</b>	
4.1 Introduction	113
4.2 Exchange Rate Movements	114
4.3 Government Attitudes Towards the Exchange Rate	119
4.4 MNCs and the Exchange Rate	123
4.5 Controlling the Exchange Rate	131
4.5.1 A Capital Markets Regime?	135
4.6 Exchange Rate Volatility and Regional Integration	137
4.7 Regionalisation and Capital Flows	141
4.8 Single Market, Single Currency	142
4.9 Conclusion	148

<b>5. CAUSES OF REGIONALISATION AND IMPLICATIONS FOR THE INTERNATIONAL POLITICAL ECONOMY</b>	
5.1 Introduction	150
5.2 Impact of Regionalism on Regionalisation	153
5.2.1 Impact of "Deep" Regionalism	154
5.3 A Microeconomic Perspective	166
5.4 Terms of Trade Effects	172
5.5 Offsetting Force of Globalisation	175
5.6 Impact of FDI	177
5.7 Regionalisation and Economic Welfare	179
5.8 Conclusion	184
<b>6. CAUSES OF REGIONALISM AND IMPLICATIONS FOR THE INTERNATIONAL POLITICAL ECONOMY</b>	
6.1 Introduction	185
6.2 Why is Regionalism on the Increase?	186
6.2.1 Economic Aspects	193
6.2.2 Political Co-operation	197
6.2.3 Structure and Behavioural Aspects	200
6.3 Is Multilateralism Fading?	201
6.4 The GATT and Regional Trading Arrangements	206
6.5 The WTO and Regional Trading Arrangements	210
6.6 Is GATT/WTO Multilateralism Still Regionalism?	213
6.7 RTAs, International Relations and International Business	216
6.8 FDI, Multilateralism and Protectionism	218
6.9 Regionalism and Protectionism	219
6.9.1 Institutional Bias of Regional Trade Agreements	223
6.9.2 Open Regionalism	228
6.9.3 MFN, Reciprocity and Free Riders	232
6.10 Conclusion	234
<b>7. REGIONAL TRENDS AND MULTINATIONAL CORPORATIONS</b>	
7.1 Introduction	237
7.2 Methodological Issues	239
7.3 Building Blocks and Stumbling Blocks	242
7.4 MNC Views on Regionalism	245
7.4.1 "Open" and "Closed" Regionalism	248
7.4.2 "Deep" and "Shallow" Regionalism	250
7.4.3 Internalisation	252
7.4.4 Systemic Risks	254
7.5 Impact of MNCs on Regionalism	256
7.6 Impact of Regionalism on MNCs	260
7.7 Conclusion	272
<b>8. CONCLUSION: THE POLITICAL ECONOMY OF CONTEMPORARY REGIONAL INTEGRATION</b>	
8.1 Introduction	274
8.2 Why is Regionalism a Growing Issue?	275
8.2.1 Regionalism and Intra-Regional Trade	277
8.2.2 Regionalism and Extra-Regional Trade	279
8.3 Regional Globalisation	280
8.4 Methodological and Theoretical Aspects	282
8.5 Conclusion	283
<b>APPENDICES</b>	
A1. Data for charts in Chapter 3	284
A2. Definitions of regional groupings used in calculations	308
<b>REFERENCES</b>	309

## LIST OF FIGURES

<b>2.1</b>	<b>Number of Regional Integration Agreements Notified to GATT, 1948-1994</b>	<b>36</b>
<b>2.2</b>	<b>Number of Non-EC/EFTA Related Regional Integration Agreements Notified to GATT, 1948-1994</b>	<b>38</b>
<b>3.1</b>	<b>Intra-European Trade Shares</b>	<b>67</b>
<b>3.2</b>	<b>European Union 6 Trade Intensity Index</b>	<b>69</b>
<b>3.3</b>	<b>Trade Intensity Index Between EU6</b>	<b>70</b>
<b>3.4</b>	<b>European Union 15 Trade Intensity Index</b>	<b>71</b>
<b>3.5</b>	<b>Trade Intensity Index Towards EU6 'Founders'</b>	<b>73</b>
<b>3.6</b>	<b>Trade Intensity Index Towards Stage 1 Enlargement</b>	<b>74</b>
<b>3.7</b>	<b>Trade Intensity Index Towards Stage 2 Enlargement</b>	<b>75</b>
<b>3.8</b>	<b>Trade Intensity Index Towards Stage 3 Enlargement</b>	<b>76</b>
<b>3.9</b>	<b>North American Intra-Regional Trade Shares</b>	<b>78</b>
<b>3.10</b>	<b>Canada-US Trade Intensity Index</b>	<b>80</b>
<b>3.11</b>	<b>Mexico &amp; Canada Export Intensity Index with USA</b>	<b>81</b>
<b>3.12</b>	<b>Asian Intra-Regional Trade Shares</b>	<b>83</b>
<b>3.13</b>	<b>East Asian Trade Intensity Index</b>	<b>84</b>
<b>3.14</b>	<b>APEC 15 Trade Intensity Index</b>	<b>86</b>
<b>3.15</b>	<b>Trade to GDP Ratios</b>	<b>90</b>
<b>3.16</b>	<b>Intra-Regional Trade Propensities</b>	<b>91</b>
<b>3.17</b>	<b>Extra-Regional Trade Propensities</b>	<b>92</b>
<b>3.18</b>	<b>North American FDI Intensity Index</b>	<b>103</b>
<b>3.19</b>	<b>European FDI Intensities</b>	<b>104</b>
<b>3.20</b>	<b>Japan's Interest, Profits and Dividends Intensity Index</b>	<b>108</b>
<b>4.1</b>	<b>Exchange Rate Arrangements</b>	<b>121</b>

## LIST OF TABLES

<b>2.1. GATT Rounds</b>	<b>28</b>
<b>3.1. Intra-Regional Trade as a Percentage of Total Trade</b>	<b>46</b>
<b>3.2. Share of World Exports</b>	<b>54</b>
<b>3.3. Intra-Regional Trade Intensities (Frankel, Wei and Stein)</b>	<b>62</b>
<b>3.4. Intra-Regional Trade Intensities (Anderson and Norheim)</b>	<b>64</b>
<b>3.5. Investment Intensity Index for East Asia</b>	<b>101</b>
<b>3.6. Japan's Trade and IPD intensities</b>	<b>109</b>
<b>4.1. Pass Through Rate of Yen Appreciation</b>	<b>130</b>
<b>4.2. Trade Intensities and Relative Volatility of Exchange Rate Movements of the US Dollar With the Japanese Yen and Canadian Dollar</b>	<b>138</b>
<b>4.3. Trade Intensities and Relative Volatility of Exchange Rate Movements of the Deutschmark With the French Franc and British Pound</b>	<b>140</b>
<b>7.1. Matrix of Impact of Regionalism on MNCs</b>	<b>270</b>



## LIST OF ABBREVIATIONS

ACP	Africa, Caribbean and Pacific group
AFTA	ASEAN Free Trade Area
ANZCERTA	Australia-New Zealand Closer Economic Relations Trade Agreement
APEC	Asia Pacific Economic Co-operation forum
APIC	Asia Pacific Investment Code
ASEAN	Association of South East Asian Nations
CACM	Central American Common Market
CAP	Common Agricultural Policy
CARICOM	Caribbean Community and Common Market
CERTA	Closer Economic Relations Trade Agreement
CET	Common External Tariff
CM	Common Market
CMEA	Council for Mutual Economic Assistance
CU	Customs Union
CUSFTA	Canada-United States Free Trade Agreement
DSM	Dispute Settlement Mechanism
EAEG	East Asia Economic Group
EAI	Enterprise for the Americas Initiative
EC	European Community
ECSC	European Coal and Steel Community
EEA	European Economic Area
EEC	European Economic Community
EFTA	European Free Trade Association
EMS	European Monetary System
EU	European Union
FDI	Foreign Direct Investment
FTA	Free Trade Area
FTAA	Free Trade Area of the Americas
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GSP	Generalised System of Preferences
IMF	International Monetary Fund
IPR	Intellectual Property Rights
ISI	Import Substituting Industrialisation
LAFTA	Latin American Free Trade Area
LAIA	Latin American Integration Association
MAI	Multilateral Agreement on Investment
MERCOSUR	Mercado Comun del Cono Sur (Southern Cone Common Market)
MFA	Multi-Fibre Arrangement
MFN	Most Favoured Nation
NAFTA	North American Free Trade Agreement
NIC	Newly Industrialised Country
NTB	Non-Tariff Barrier
OECD	Organisation for Economic Co-operation and Development
OMA	Orderly Marketing Arrangement

OPEC	Organisation of Petroleum Exporting Countries
RIA	Regional Integration Agreement
RTA	Regional Trade Agreement
SEA	Single European Act
SEM	Single European Market
TRIM	Trade Related Investment Measure
TRIP	Trade Related Intellectual Property Rights
USTR	United States Trade Representative
VER	Voluntary Export Restraint
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

## ACKNOWLEDGEMENTS

My interest in the subject of regional integration has developed over the years and I owe a debt to Gautam Sen for providing the direction, encouragement and insights which have contributed to the completion of this project. I am further indebted to Chris Mitchinson, Ron Napier and Nick Bedford for providing me with the opportunity to undertake such a commitment while at the same time pursuing a related career. Thanks also go to all the staff and students who contributed comments in the International Political Economy workshop at the LSE, as well as to Robert Aliber, Reza Arabsheibani, Phil Evans, Malory Greene, Mike Hodges, Daphne Josselin, Sheila Page, Jacques Polak and Ian Rowlands for their much-appreciated input. A final thanks must go to Mizue Honda who has tolerantly endured and supported this obsession over the last six years. Inevitably, all remaining errors are mine alone.

## CHAPTER ONE INTRODUCTION

Regional integration has become one of the major international political economy themes of the decade. In part this is due to the re-emergence of regionalism in the major economic areas.<sup>1</sup> This research will argue that although regionalisation appears to be the dominant trend in the world economy at the turn of the 20th century, a more appropriate label is that of "regional globalisation". This is because although regionalism is contributing to a rise in intra-regional trade and investment, it is also leading to greater globalisation of economic activity. Corporate strategies are increasingly global, and although at the moment they are manifested in regional organisational structures it is not necessarily the case that this will endure.

Although the terms are sometimes used interchangeably, regionalism is defined as the political measures aimed at promoting closer regional relations, while regionalisation (or regional integration) is the economic reality of closer regional links. Economic theory on the subject of customs unions is well-developed and it has been shown that it is possible to design welfare enhancing agreements, as noted in Chapter 2. A customs union can be a liberalising step which takes the world closer to free trade, but this is not automatically the case. Moreover, it is not clear that recent regional trade agreements have been designed on this basis, and the theoretical argument in their favour is only one possible explanation of the re-emergence of regionalism since the mid-1980s. Other explanations relate to the general spread of economic liberalisation, and defensive reactions to regionalism elsewhere. Outside the economic analysis of customs unions, the bulk of recent discussion tends to focus on the question of whether regional trading agreements are likely to support or hinder the progression of multilateral liberalisation.

This research takes the analysis in a different direction by using concepts from international business literature to discuss the likely impact of regionalism on the behaviour and structure of multinational corporations. From a microeconomic basis, it will be argued that organisational structures of firms are such that multilateral liberalisation has limited benefits over regional liberalisation.

One common failing of the analysis of regional integration is that it often has a weak empirical basis, which can detract from the conclusions reached. The

---

<sup>1</sup> Bhagwati (1993), WTO (1995).

inadequacies and complexities involved in various attempts to measure regionalisation are discussed in detail in Chapter 3. Faults in each approach help to explain why there is no standard methodology for measuring regional trends. In addition, the potential distortions from temporary price movements, such as nominal exchange rates, are noted. These distortions mean that studies which focus on discrete time intervals risk reaching inappropriate conclusions due to short-term price fluctuations.

One set of studies has used long-established methods for measuring bilateral bias, in the form of the trade intensity index. This methodology contains some statistical problems, especially when projecting the analysis to the regional level, even though most studies typically do not explore the inadequacies of this approach. These problems are discussed in detail in Chapter 3 and despite some imperfections in the approach, regional trade intensity indexes are seen as the most practical way to measure changes in the degree of regional trade bias over time. However, it is perilous to use this method to make comparisons between the degree of trade bias in different regions. The use of gravity models to attempt to explain the forces behind regional trade flows appears attractive and enjoyed a period of popularity, but more recently the findings from this approach have been shown to be "almost certainly wrong" by a long-time head of the IMF Research Department.<sup>2</sup>

Taking into account these methodological complexities, Chapter 3 uses regional trade intensity indexes to measure regional bias. The construction of time series facilitates the search for underlying regional trends in a way that has not previously been attempted. Distortions to the findings, such as those caused by the strong US dollar in the mid-1980s can more easily be seen when using a time series approach. A range of other data on cross-border investment flows are introduced, but flaws in the data mean they are of limited use in tracking regional trends.

The finding of a rising regional bias to trade flows in North America coinciding with moves to intra-regional liberalisation is perhaps unsurprising. On the surface, neither is the finding of a gradual increase in regional bias among members of the European Union. However, the initial six members of the European Economic Community are found to have experienced no increase in the positive bias of their trade flows with each other since the late 1960s. Detailed examination suggests this

---

<sup>2</sup> Polak (1996).

more surprising result is explained by the increase in trade bias with newly joining members of what is now the European Union. The situation in Asia is more complex, but recent trends have been for little change in regional trade bias. The rise in trade bias in Europe and North America has been accompanied by a more general opening of their economies which reduces fears that a rise in intra-regional trade bias has been accompanied by a reduction of integration with the rest of the world.

Regional integration is the product of regional bias and the overall openness of the economy. If both are increasing then economies are becoming more closely integrated on a regional basis. This appears to be the case in both Europe and North America. Moreover, the general increase in openness to trade appears to have been enough to offset a reduced bias towards non-regional trading partners. If it has not then this could be a suggestion of trade diversion away from non-members as their exports are replaced by intra-regional trade.

Exchange rates move to reflect the flow of trade and investment between countries, and Chapter 4 considers whether they contain evidence of policies or behaviour related to regional integration. It is found that changes in regionalisation, as measured by the trade intensity index, are unrelated to exchange rate volatility. Moreover, regional trade agreements have no identifiable impact on exchange rate volatility unless they are accompanied by an explicit agreement to co-operate to promote exchange rate stability. In addition it is argued that exchange rate volatility has little impact on trade flows, and European attempts to stabilise exchange rates owe more to political forces than economic ones.

Having identified a rise in regional bias in North America and Europe, Chapter 5 goes on to discuss the possible causes. Part of the rise in regional bias can be explained in terms of the trade creation stemming from reduced barriers to intra-regional trade. The "deeper" aspects of some regional agreements have less clear implications for regionalisation than more basic border-level tariff reductions, as some aspects are difficult to apply on a preferential basis.

In addition to the direct macroeconomic influence from regionalism, the organisational behaviour of multinational corporations is also seen as an important influence on regionalisation. Producing on a national scale is decreasingly efficient, in terms of economies of scale, while global production is technologically feasible, but often does not accord with optimal organisational structures. Regional production structures allow components and final products to be traded within the

region, with raw materials and intangibles exchanged between regions, while not preventing firms from serving global markets. In "knowledge" related areas such as research and development, design, finance and advertising, the trade regime is relatively unimportant as long as the fixed costs are spread over as broad a geographic base as possible. It is also noted that inter-regional trade contains a relatively high proportion of raw materials, relative to intra-regional trade in Europe and North America. In this case, the deteriorating terms of trade of raw material exporters will give a slight statistical upwards bias to measures of European and North American regionalisation.

Considering the forces acting to increase regionalisation, it is perhaps surprising that the trends identified in Chapter 3 do not show a stronger upwards bias. One explanation is that there is an offsetting trend towards globalisation as more domestically oriented firms realise that changes in physical and legal barriers to international trade have been falling, allowing them to become exporters or small scale MNCs. Lower barriers include factors such as the information technology revolution, falling transport costs, reduced uncertainty, looser and more transparent foreign investment regulations and lower tariffs.

Although there are persuasive economic arguments in favour of constructing regional agreements, there have been few major theoretical developments on the subject of customs unions for over two decades. As a result, it is difficult to ascribe the renewed enthusiasm for preferential regional agreements to a newly persuasive argument in favour, although a similar effect could be the result of the weakening of non-liberal ideology with the demise of the Soviet Union. Moreover, it is far from clear how regionalism fits in with the objectives of the World Trade Organization (WTO) for multilateral trade liberalisation. As one authority on the subject has noted "regional trading blocs can complement the world trading system .... However, regional trading blocs could get out of hand".<sup>3</sup>

It is necessary to consider not just why regionalism occurs from a static perspective, but also from a dynamic one, in order to explain its growth over the past decade. For example, regionalism can be seen as an effort by states to restore some lost authority and change the balance of power between states and markets. It can also be a defensive response to increased regionalism elsewhere.

---

<sup>3</sup> Jackson (1992) p. 501, Friedmann Award Address.

Much of the debate on regionalism relates to whether it is likely to complement multilateral liberalisation, or be a barrier to further progress (or even increase protectionism). The WTO has taken a more positive attitude towards regionalism than its predecessor, in part because the provisions against damaging forms of regionalism have been strengthened. One view is that "open regionalism" is constructive, and it is implicitly aimed at not damaging non-members. Another perspective is that institutional aspects of regionalism strengthen the mechanisms for either more liberalisation or protectionism, but it is unclear in which direction the bias lies.

The tendency to stress macroeconomic issues (such as the "building block—stumbling block" debate) can be to the detriment of two other perspectives. At a different level, regional co-operation can deliver significant benefits in terms of systemic stability, but these are often neglected as they are a by-product of the agreement itself, rather than its specific provisions. In effect the systemic gains means that the value of any trade agreement is worth more than the sum of its parts. Regionalism implies a commonality of interests and closer communication between members which lowers systemic risks to all firms operating within the region.

A further perspective on regional integration is a microeconomic one, with understanding of the trends at work enhanced by consideration of corporate strategies and organisational behaviour. Taking the analysis down to the corporate level offers a different perspective of the trends apparent in the macroeconomic data. There is also the question of how corporate attitudes affect the political process of regionalism through the use of lobbying power.

Although much is made of the differences between deep and shallow regionalism, it will be argued that from the perspective of the multinational corporation the act of lowering intra-regional barriers is more important than the nature of that liberalisation. The difference between deep and shallow regionalism will have more impact on *how* firms react as opposed to *whether* they do, but whether liberalisation is at or behind the border will not affect underlying business decisions if the overall change in preferential treatment is the same.

A further microeconomic aspect of regionalism is how it affects the merits to the multinational corporation of internalising transactions. Some aspects of regionalism will reduce market imperfections and lower internalisation benefits.



However, if an aspect of regionalism is lower transport and communication costs, then this will be an offsetting force in favour of more internalisation. This is discussed in Chapter 7, which also considers the likely impact on multinational corporations of various possible developments in the world trading system, from renewed multilateralism to a slide towards protectionism. Different strategic reactions mean that apparently similar firms can behave in different ways, but some general patterns are suggested. One feature is that a large number of firms will be most concerned about whether regionalism is protectionist or not. As long as production networks tend to be constructed on a regional basis, the differences between multilateral and regional liberalisation will be limited.

The main discussions and key findings are reprised in the conclusion in Chapter 8. Although the bulk of the work focuses on the issue of regional integration, the underlying trend in the international political economy can better be described as one of "regional globalisation". Economic behaviour is globalising, but the main evidence of such a development in the statistics available is in closer regional integration.

## CHAPTER TWO

### REGIONALISM: THEORY AND POST-WAR DEVELOPMENTS

#### 2.1 Introduction

In order to set the scene for subsequent chapters, this chapter will examine the theory behind regional trade agreements and their post-war development. It is useful to place recent developments in an historical context, in order to see whether trends of the past decade represent a structural shift in the world economy or are simply part of a long-term cycle which sees the political economy of countries and regions move together and then drift apart again.

This chapter will address two main issues. Firstly, the theoretical underpinnings for the formation of regional trade agreements. Secondly, the post-war experience with regionalism. The bulk of the literature on the subject emerged in the two post-war decades and coincided with the first round of formation of preferential trade agreements.<sup>1</sup> The renewal of activity in forming, reviving, or deepening regional agreements occurred from the mid-1980s and was not accompanied by significant theoretical advances, but in the case of Europe it did see calculations of impressive benefits from regional integration.<sup>2</sup> One of the key differences since the mid-1980s, compared to the earlier spate of regionalism, is that the second time around the United States was converted to the benefits of regionalism.<sup>3</sup>

Related to the issue of whether recent moves towards greater regionalism will endure is the relationship between economic cycles and trade liberalisation. There appears to be a link between periods of relatively strong economic growth and reduction in trade barriers, although the causality is unclear.

Before progressing further, it is useful to define the difference between regionalisation and regionalism. Regionalisation (or regional integration) is the closer interdependence between the economy of one country and that of one or

---

<sup>1</sup> De Melo and Panagariya (1993).

<sup>2</sup> Cecchini (1988) calculated the single European market would raise output by 2.5%-6.5, while Baldwin (1990) estimated it could add between 0.2% to 0.9% to the European Community's growth rate.

<sup>3</sup> Bhagwati (1993).

more other economies in the same geographic region.<sup>4</sup> Regionalism refers to political steps aimed at promoted regional integration. For example, a regional trading arrangement is a clearly defined set of rules aimed at promoting greater regional integration. In fact these agreements are often more broadly based than covering just trade issues, but the phrase "regional trading arrangement", albeit imprecise, has become the accepted terminology even though they could more accurately be labelled "preferential regional agreements". Whether or not a regional trading arrangement achieves regional integration is a sign of how successful it is, not whether such an arrangement exists.

Thus regional integration may or may not be the result of the formation of a regional trading arrangement, which itself may or may not succeed in promoting regional integration. Alternatively, increased regionalisation can lead to the formation of a regional trading arrangement. For example, it is sometimes said that a *de facto* regional trading bloc is forming in East Asia, where economies are becoming integrated as a result of the actions of private economic agents, such as regional multinationals, or the family ties of ethnic Chinese spread across the region, rather than as a result of any political initiative.<sup>5</sup> The Asia Pacific Economic Co-operation forum is seen as a political response to an economic reality.

Yoshida, Akimune, Nohara and Sato define regional economic integration as "deepening intra-regional economic interdependence .... through intra-regional trade and foreign direct investment, thereby differentiating it from regional trade agreements and institutional integration".<sup>6</sup> It is also differentiated from regionalism, which is defined as a "political movement towards the creation or expansion of regional trade agreements". Anderson and Blackhurst define regional economic integration as "the process of reducing significance of national political boundaries within a geographic area".<sup>7</sup> In fact it appears they are defining regionalism rather than regionalisation, which illustrates that the two terms are often taken as synonyms.

---

<sup>4</sup> Although note that there are examples of preferential trade agreements occurring between countries which are not geographically proximate, as was the case with colonial preferences and more recently with the 1985 US-Israel Free Trade Agreement.

<sup>5</sup> Oman (1994), Yoshida, Akimune, Nohara and Sato (1994).

<sup>6</sup> Yoshida, Akimune, Nohara and Sato (1994) p. 59.

<sup>7</sup> Anderson and Blackhurst (1993) p. 1.

The above definitions are reasonably broad, but they avoid some of the judgmental precepts that are evident in other analyses. For example Graham and Anzai address *The Myth of a de facto Asian Economic Bloc*, but are only able to demonstrate that no such regional bloc exists by implicitly defining a bloc as one dominated by Japanese interests to the exclusion of countries from outside the region.<sup>8</sup> To use the criterion of a bloc excluding non-regional countries to determine whether regional integration exists is to pre-judge one of the most interesting aspects of the subject. The point is that regional integration ties geographically proximate countries closer together: whether this is to the detriment of other countries and their home multinationals is a key issue.

According to Bhagwati regionalism can be "defined broadly as preferential trade agreements among a subset of nations".<sup>9</sup> Lorenz takes the same view and makes a lucid distinction between regionalism and regionalisation. The former is the creation of preferential trading arrangements, while the latter is "the outcome of natural locational phenomenon leading to closer economic ties within a region".<sup>10</sup> This final point illustrates the importance of differentiating between formal rule-based systems and the integrating effects of the actions of economic agents. Thus in this work I will use the terms "regional trade agreement" and "regionalism" to indicate political efforts to foster closer ties and "regionalisation" and "regional integration" to refer to closer economic relations.

## 2.2 Theoretical background

Much of the theoretical work on preferential trade agreements was conducted in the first two post-war decades. However, it is worth noting that the classic work on the subject, by Viner in 1950, post-dated the 1947 GATT agreement which included Article XXIV on preferential trade agreements.<sup>11</sup>

---

<sup>8</sup> Graham and Anzai (1994).

<sup>9</sup> Bhagwati (1992b) p. 535.

<sup>10</sup> Lorenz (1992) p. 84.

<sup>11</sup> Bhagwati (1993) has suggested the reasons for including Article XXIV were that it was viewed as offering a route towards freer trade and that it contained safeguards against a return to the protectionism of the 1930s.

The perspective offered by Viner did not unambiguously support the formation of preferential trade arrangements.<sup>12</sup> From a Vinerian perspective, customs unions can raise intra-regional trade flows as high cost production within one customs union member is substituted by lower cost production from another member. This process, labelled trade creation, should add to welfare. However, there can also be trade diversion from production by more efficient producers outside the customs union to less efficient ones inside, which have the advantage of not being subject to the external tariff. If both of the countries in a customs union were producers of a good before the union, but only one remains a producer once tariff barriers have come down, exporting to the other, then this is a trade creating result. However, if a non-partner country exported the good to one of the members before the customs union, but sees its exports substituted by less efficient production from another of the members after the formation of the customs union, then trade diversion occurs.<sup>13</sup>

Lipsey produced some rules of thumb which would give an indication of whether a custom union is likely to be welfare enhancing or reducing, on a world scale.<sup>14</sup> It had already been noted that if trade creation was going to occur, the gains would be greater if the differential in cost ratios between the two countries is relatively large.<sup>15</sup> Lipsey outlined two other generalisations to give an indication as to the likely impact of a customs union.

Firstly, Lipsey noted most analysis tended to relate to the effects of a marginal change in tariffs. However, with customs union formation, tariffs can change radically, with the result that demand and supply curves may not remain fixed. Lipsey's analysis relates to the general theory of second best that he developed with Lancaster.<sup>16</sup> This theory states that "if it is impossible to satisfy *all* the optimum conditions, then a change which brings about the satisfaction of *some* of the optimum conditions may make things better or worse".<sup>17</sup> Drawing from this, Lipsey argued welfare is more likely to be increased by a reduction in

---

<sup>12</sup> Viner (1950).

<sup>13</sup> Lawrence (1996) sets out a clear example of how the process can work.

<sup>14</sup> Lipsey (1960).

<sup>15</sup> Makower and Morton (1953).

<sup>16</sup> Lipsey and Lancaster (1956-57).

<sup>17</sup> Lipsey (1960) p. 498.

tariffs as opposed to their complete abolition.<sup>18</sup> This is a significant finding, as a feature of Article XXIV of GATT was the elimination of "substantially all" tariffs.

Lipsey's other generalisation relates to relative expenditure on each commodity. If trade volumes are given, then if trade with the customs union partner is high in proportion to trade with the rest of the world then it is more likely that the agreement will be welfare enhancing. Furthermore, the customs union is more likely to raise welfare the lower the total volume of foreign trade. That is because the lower the volume of foreign trade, the fewer the number of purchases from the outside world compared to those made domestically and the less the distortion to relative domestic prices.

Despite the attempts to provide generalisations, Lawrence has argued that "the theory does not produce rules that are foolproof. Indeed, it suggests that it is dangerous to try to rely on such generalizations".<sup>19</sup> As a result, Lawrence argues that each case needs to be examined empirically in order to judge its merits.

Cooper and Massell showed that a customs union is always inferior to an appropriate level of non-preferential protection, from the point of view of resource efficiency, as the former always contains an element of trade diversion. However, in their 1965 *Economic Journal* article they went on to argue that there were situations in which a customs union could be the most effective policy if the scope of the analysis is broader. Possible gains could occur in the areas of economies of scale, terms of trade improvements or reductions in disguised unemployment, which are not apparent in simple Vinerian models. Looking at the relative efficiency of protective regimes, they noted that concepts such as "market swapping" meant that customs unions in small countries could be viewed as a superior instrument compared to non-preferential protection. Protection is implicitly adopted in order to sponsor industrialisation. By using a customs union, participants could still protect their markets, but without the same income loss as would occur from a non-preferential tariff. This analysis depends on the view that

---

<sup>18</sup> Taking the example given by Lipsey (1960), assume that there are taxes, subsidies and monopolies which prevent optimal resource allocation. If only one tax is allowed to vary then a change in the tax could either reduce or increase overall welfare. Assuming there is a unique second best solution (which Lipsey argues is common), then a dramatic change in tariffs could move the economy towards the second best solution, but it could also move it *past* the second best position. For this reason a small shift in the tax is more likely to raise welfare than a large variation.

<sup>19</sup> Lawrence (1996) p. 25.

the state has a role to play in using trade policy to manipulate the allocation of resources and it helps to explain attempts to form regional groupings by some developing countries in the 1960s.

The most recent significant advance to customs union theory was made by Kemp and Wan. They showed, in a concise fashion, that a tariff system could be designed "which is consistent with pre-union world prices and, therefore, with pre-union trade patterns and pre-union levels of welfare for non-members".<sup>20</sup> Grinols subsequently showed how such a system could be constructed.<sup>21</sup> Kemp and Wan's argument was important in that it effectively takes the debate back to the pre-Viner view that customs unions can be a step towards free trade and "it implies that an incentive to form and enlarge customs unions persists until the world is one big customs union".<sup>22</sup> That is, from any starting point where tariffs exist, there are a series of steps, each of which benefits some without damaging others, until global free trade exists.

Another strand to the debate has come from the discipline of geography, and Krugman appropriated some geographic concepts to show that the greater the proximity of its members, the lower the likelihood of a preferential trading arrangement being trade distorting.<sup>23</sup> While interesting in terms of its application to the real world, it can be seen as a natural extension of the general rules expounded in the 1950s and 1960s.

To summarise the state of current attitudes towards customs unions, it could be said that, if suitably structured, most observers see them as likely to contribute to a move towards free trade and increased economic welfare, but it is recognised that exceptions can exist.

Much customs union analysis neglects political economy aspects and the comparison of pre- and post-customs union positions is not the only issue; also of significance is what happens after the customs union has been formed. For example, it can raise the stakes in the bargaining process with foreign MNCs, with the benefits of market access and costs of exclusion increased. The threat of higher tariff levels in the future can be a stimulus to foreign direct investment

---

<sup>20</sup> Kemp and Wan (1976) p. 95.

<sup>21</sup> Grinols (1981).

<sup>22</sup> Kemp and Wan (1976) p. 96.

<sup>23</sup> See Krugman (1980).

by multinational corporations. Economic analysis of customs unions also neglects international relations aspects in terms of increased bargaining power in international negotiations. The most notable example of this was in the Uruguay Round where the European Community negotiated on behalf of its twelve members.<sup>24</sup> Alternatively, Oman has noted that regional integration can be used to undermine powerful domestic interest groups, or what Olson has labelled "distributional cartels".<sup>25</sup> These and other issues will be considered in more detail in Chapter 6.

### 2.3 Typography of preferential agreements

Most theories related to international trade tend to focus on the reasons why trade takes place between countries and what determines the pattern that emerges. Vinerian analysis of customs unions is unusual in that it does not examine trade on a single country basis, but incorporates the concept of regional co-operation. One feature of the world system heading into the third millennium is the growing trend towards regional economic (and in some cases political) co-operation, via myriad regional trading arrangements or "trade blocs". There are various forms that this co-operation can take.

It is an oversimplification to view all regional trading arrangements in the same fashion. There are several, vastly different, types of integration. The lowest level of trade preference is that of **sectorial co-operation**. This involves two or more countries agreeing to co-ordinate policies towards a certain industry. On paper, an example of this was the European Coal and Steel Community of 1952, although in practical terms, there was a political undertone which meant the agreement was more than simply for co-operation among six European economies over coal and steel policies.

The lowest degree of co-operation on a general basis is the **preferential trade agreement**, where tariffs on imports from member countries are lower than on imports from non-members. A special version of this is the **free trade area**. In this case, members agree to eliminate barriers to trade in products created within

---

<sup>24</sup> Although not a trading arrangement as such, the Cairns Group was formed during the Uruguay Round to represent the interests of its agricultural product exporting members.

<sup>25</sup> Oman (1994) p. 15.



the area, but each state can still decide on its own tariffs with the outside world. As with sectorial co-operation, no strong political ties are needed. Rules of origin problems exist and the need to maintain customs posts is seen by some as a potential or actual hindrance to trade. The Canada-US Free Trade Agreement of 1988, which was subsequently widened to include Mexico in 1994, under the North American Free Trade Agreement, provides a recent example, but many others exist.

**Non-reciprocal preferential trade agreements** also exist, with one country or group of countries granting tariff concessions to another, without the usual requirements of matching tariff reductions from the other party. The ACP-EEC Fourth Lomé Convention is the most important example of this agreement, where EU members give preferential access to exports from African, Caribbean and Pacific (ACP) developing economies without demanding similar tariff reductions on EU exports.

A **customs union** is similar to a free trade area, but with a common external tariff and consequently no internal customs barriers. Some political ties will exist as there is a need for common decision-making in setting the level of tariffs, so there is some loss of trade policy independence. The MERCOSUR pact between Argentina, Brazil, Paraguay and Uruguay which was inaugurated at the beginning of 1995 is a recent example of a customs union. Extending a customs union to include factors of production results in a **common market**. In a common market there is free movement of factors of production as well as goods. As Mundell has shown, this increases the pressure for the equalisation of the price of both goods and factors of production.<sup>26</sup> A common market implies a more significant loss of economic sovereignty than a customs union, as there is a need for central co-ordination of more aspects of economic policy. The Closer Economic Relations Trade Agreement between Australia and New Zealand incorporates most features of a common market, with liberalisation of trade in goods and services together with a unified labour market.

An **economic union** is a common market, plus fiscal and monetary policy harmonisation. This requires the formation of supra-national institutions, within which are pooled some elements of national sovereignty relating to economic

---

<sup>26</sup> Mundell (1957).

affairs. A single currency exists, undermining the independent monetary policy of member states. The objectives outlined in the Maastricht Treaty are those of taking the European Union from being a common market to an economic union. The ultimate form of integration is that of **political union**. This contains all the elements of an economic union plus supranational decision-making on non-economic matters, such as foreign policy and defence. The former Soviet Union could be seen as a political union.

An **interest group** is a slightly different body, in that its aim is not to promote trade between members, but to look after the interests of its members in the world economy. The Cairns group of agricultural produce exporters and the Organisation of Petroleum Exporting Countries (OPEC) are two of the more striking examples. Virtually no political integration is needed, but there is a need to agree on a uniform agenda (and in the case of OPEC, a need to trust fellow members to stick to agreed production quotas).

Not surprisingly, the number of examples of each form of co-operation decreases as the level of co-operation rises, although there is often some overlap between the various forms of regional agreement. Free trade agreements abound, while there are relatively few examples of political union.<sup>27</sup> There is also a more subtle difference in that sectorial agreements tend to reflect producer interests, while broader trade agreements are more in the interests of consumers.<sup>28</sup> It is also worth noting that, even if a free trade agreement is not seen as the first step on the path towards a customs union or a common market, it can still be worthwhile in its own right, due to the benefits of trade creation. While there may be an efficiency gain in an economic sense from each deepening of integration, it comes at the loss of sovereignty. This is currently a highly charged area of political debate within Europe, but it seems logical that ceding decision-making power over aspects of economic policy must lead to a reduction of control over national policy-making. Even if the sovereignty does not disappear, but is pooled at some higher level, then the individual nation has still suffered a reduction in its ability to strike out on its own.

---

<sup>27</sup> There may be more examples of political union than is often recognised. For example, a treaty in 1833 established the German *Zollverein* (customs union) which was the precursor of the unified German state.

<sup>28</sup> Hufbauer (1989).

There is plentiful literature on the subject of economic co-operation, but as the UN has noted it is "not very good at answering questions about the welfare effects of moves from one distorted policy to another—that is, in dealing with the problem of the second best".<sup>29</sup> Current attitudes towards preferential trade agreements will be explored in more detail in later chapters, but it is worth noting that there has been an increased interest in regionalism in recent years.<sup>30</sup> Some attribute this to the apparent difficulties in completing the Uruguay Round of GATT negotiations. Rather than persist with multilateral negotiations many countries appear to be seeking closer co-operation with a limited number of neighbours with whom most trade is conducted. The chances of successful negotiations are seen as higher and the rewards are still significant.

## 2.4 Historical perspective

The idea that two or more nations can gain mutual benefit from bringing their economies closer together is not new. Until the 19th century, however, integrating one economy with another was generally seen as a means of extending or stabilising the military or political influence of the nation state. That is to say, it was essentially a mercantilist mechanism, with political interests superior to economic ones.<sup>31</sup>

Even in the 19th century, many trading arrangements were a result of exploiting unequal relationships. The scramble of the European powers for colonies was as much driven by strategic considerations as economic ones, but once acquired the power imbalance meant that colonies could be exploited by the Western imperialists.<sup>32</sup> The destruction of the Indian hand-loom cotton industry following market saturation by mass-produced cloth from the Lancashire mills is an oft-cited example of Great Britain abusing its military power for economic gain.<sup>33</sup> Commodore Perry's "Black Ships" which descended on Japan

---

<sup>29</sup> UN (1990) p. 22.

<sup>30</sup> WTO (1995).

<sup>31</sup> Gilpin (1987).

<sup>32</sup> Krasner (1976), Kennedy (1987).

<sup>33</sup> Strange (1988).

in 1853 are another striking example of the use to force, or the threat of force, to open up markets.<sup>34</sup>

As the intellectual arguments of advocates of free trade gathered pace and broader acceptance through the 19th century, lower barriers to trade began to occur not through force, but with the volition of both participants. A watershed was the Anglo-French Cobden Chevalier Treaty in 1860 which established the Most Favoured Nation (MFN)<sup>35</sup> principle and prompted other European countries to negotiate free trade agreements.<sup>36</sup> This was the start of a "Golden Age" of economic integration, with falling trade barriers, a stable rate of exchange (based on the gold standard) and free capital movements. The reduction of barriers to cross-border business on both a multilateral and regional basis continued up to the Great War. Anderson and Norheim find a rise in the preferential bias towards intra-regional trade within Europe in this period, but with trade growing in relation to GDP the overall readiness of Europe to trade with the rest of the world was also increasing.<sup>37</sup>

The inter-war years represent the main period of reversal of liberal trade policies and growing economic openness in the past century and a half. "Beggars my neighbour" policies after the Wall Street Crash in 1929 resulted in higher tariff barriers and contributed to the severity of the ensuing recession by reducing gains from trade.<sup>38</sup> World trade contracted 50% in current US dollars between 1929 and 1932, or by 30% once the effects of deflation are taken into account. Trade was slower to recover than output as a whole and by 1938 primary and industrial production were 7% and 11% respectively above 1929 levels, but trade volumes were still 10% lower.<sup>39</sup>

A common assertion is that this was a period of greater regionalisation of trade, due to the higher barriers to trade between regions. For example the

---

<sup>34</sup> Hunter (1984).

<sup>35</sup> Most Favoured Nation status means that the recipient is offered the same treatment as the most favourable terms offered to any other nation. See the List of Abbreviations for the mnemonics used in this paper.

<sup>36</sup> Kindleberger (1975), Lake (1991), Irwin (1993a).

<sup>37</sup> Anderson and Norheim (1993).

<sup>38</sup> Note, however, that the debate as to whether the Great Recession was due to monetary phenomena, a lack of demand or a result of rising trade barriers is unresolved.

<sup>39</sup> See Eichengreen and Irwin (1995) for details.

Ottawa Agreements signed in 1932 allowed for tariff preferences between Commonwealth members and "appear to have reinforced the existing tendency toward intra-Commonwealth trade".<sup>40</sup> Scherer has offered a different perspective, arguing that the reduced trade flows in the 1930s can partly be explained by increased cartelisation of major industries. For example, ICI and Du Pont agreed to cede spheres of influence to each other in order to reduce competition.<sup>41</sup>

By the time World War II began, the US had already initiated policies aimed at lowering trade barriers with the Reciprocal Trade Agreements Act of 1934. However, it was not until the Bretton Woods conference in 1944 that a concerted effort was made to create an international economic system based on liberal precepts.

### **2.4.1 Post-World War II Experience**

The history of the half-century following the Second World War is more relevant to the present day, due to the widespread adoption of the Fordist mode of production and globalisation of mass markets. As noted, it was also the period which witnessed the development of most of the theory surrounding preferential trade agreements. The period can be broken up into four different phases from the perspective of trade liberalisation and regionalism.<sup>42</sup> Of course, this being international political economy, phases of history are rarely defined by certain events or dates, and exceptions tend to occur to most generalisations. Nevertheless, trends can be categorised into rough chronological groupings.

#### **2.4.1.1 Reconstruction: 1947-1957**

Firstly, there was the immediate period after the end of the war and the establishment of the basic system envisaged by the Bretton Woods conference in 1944. This saw the re-establishment of peace, the reconstruction of Europe and Japan, and the first moves towards modern trading relationships. The

---

<sup>40</sup> Eichengreen and Irwin (1995) p. 16.

<sup>41</sup> Scherer (1994) pp. 44-45.

<sup>42</sup> Bhagwati (1993) chooses to make the divide between "failure in the 1960s" and "revival in the 1980s", although the basic approach is similar.

General Agreement on Tariffs and Trade was founded in 1947. Multilateralism was one of the guiding principles of the post-war system, although the first five GATT Rounds only included between 13 and 38 Contracting Parties (see Table 2.1).<sup>43</sup>

As Baldwin has pointed out, however, in the immediate post-war period, tariff reductions were essentially a series of simultaneous bilateral deals. The framework was provided by the US Reciprocal Trade Agreements Act of 1934 which gave the US president the right to cut US tariffs by up to 50% through bilateral negotiations. These tended to be agreements with major supplier countries for various goods and had already resulted in a cut in the average US tariff rate from the post Smoot Hawley Tariff Act of 1930 rate of 60% to 45% in 1945.<sup>44</sup>

The pressures of post-war reconstruction meant that the trade situation in the decade or so following the end of hostilities was one-sided, in that Marshall Plan funds paid for a large part of US exports.<sup>45</sup> In many cases the US was the sole supplier and by providing the means to create demand in Europe it eased the re-adjustment of US industry which could otherwise have faced over-capacity after the end of the war.

Year	Place	Name	Number of Participants	Issues
1947	Geneva		23	Tariffs
1949	Annecy		13	Tariffs
1951	Torquay		38	Tariffs
1956	Geneva		26	Tariffs
1960-62	Geneva	Dillon Round	26	Tariffs
1964-67	Geneva	Kennedy Round	62	Tariffs
1973-79	Geneva	Tokyo Round	102	Tariffs & anti-dumping
1986-93	Geneva	Uruguay Round	108	Tariffs, non-tariffs & framework agreements

*Sources: WTO (1995), Gibb and Michalak (1994).*

<sup>43</sup> Strictly speaking, signatories of the General Agreement on Tariffs and Trade are called "Contracting Parties" and not "members".

<sup>44</sup> Baldwin (1993).

<sup>45</sup> Baldwin (1993).

### 2.4.1.2 Lower Barriers: 1958-1973

The second phase in post-war trade occurred from the late 1950s until around the time of the first oil shock, the first enlargement of the EEC and the break-up of the fixed exchange rate system in 1973. During this phase there was growing interest in lowering trade barriers in general and in regionalism in particular. What eventually became the European Union began its life in this period, although the seed began to germinate in the early 1950s, with the formation of the European Coal and Steel Community. It was also a period when some developing countries attempted to challenge the existing trading regime which they saw as condemning them to a state of permanent underdevelopment. Thus regionalism was a feature of relations between developing countries, as well as within Europe. Meanwhile in North America, the Canada-US Auto Pact of 1965 laid the basis for the broader agreement of 1988. Several trading arrangements in the developing world which have gained dynamism in the 1990s were originally formed in the 1960s, but fell into disrepair in the intervening period.<sup>46</sup>

A feature of regional arrangements in the late 1950s and 1960s was that they tended to be between countries with similar levels of development.<sup>47</sup> Even the EEC at that stage excluded the lower income Mediterranean countries. Moreover Cable notes that the common feature of regional arrangements in developing countries was that they "either failed completely or failed by far to match expectations".<sup>48</sup> This was most notably the case in Africa and South America. Bhagwati explains that the regionalism of the 1960s failed, with the exception of Europe, because it did not receive the backing of the United States, which was more interested in multilateralism. He notes that "regionalism had virtually died by the end of the decade—except for the original Common Market and EFTA".<sup>49</sup>

Moreover, regionalism in small developing country blocs was often dominated by import substitution industrialisation (ISI) policies which were aimed

---

<sup>46</sup> De Melo, Montenegro and Panagariya (1992).

<sup>47</sup> This is labelled "North-North" and "South-South" regionalism by de Melo, Montenegro and Panagariya (1992).

<sup>48</sup> Cable (1994) p. 2.

<sup>49</sup> Bhagwati (1992a) p. 453.

at reducing dependence on the developed world, to break what was seen as an exploitative trade relationship.<sup>50</sup> However, such groupings were still unable to generate sufficient economies of scale. As Genberg and Nadal de Simone have pointed out "the relative failure of CACM [Central American Common Market] and LAFTA/LAIA [Latin American Free Trade Area/ Latin American Integration Association] .... can be traced back to the incompatibility of inward-oriented development—their import-substitution strategy—and regional liberalization".<sup>51</sup> Failure to agree on the allocation of targeted industries compounded the problem.

In addition, any increase in regional trade in developing country blocs tends to be of the inter-industry type,<sup>52</sup> which requires more adjustment assistance to compensate losers. Perhaps the most important cause of failure was an inability to devise an adequate compensation scheme. The failures of various developing country regional groupings are well documented by de Melo, Montenegro and Panagariya who also point out that reduction of barriers was not automatic and was often delayed.<sup>53</sup> Even the Central American Common Market, which had initial successes, was undermined by macroeconomic problems in the 1980s which led to the imposition of quantitative restrictions on trade. Other problems were that common external tariffs did not work as various countries wanted exemptions for "necessary" imports and that the revenues from tariffs were often too important a part of the budget to be lost.

It is interesting to note that while most of the economically oriented blocs that emerged in Latin America, Africa and the Middle East in the 1950s and 1960s did not succeed in promoting regional trade or reducing dependence on the OECD economies, the politically oriented bloc of the Association of South East Asian Nations (ASEAN) held together and has gradually changed to adopt an economic agenda.<sup>54</sup> ASEAN was formed in 1967 between Indonesia, Malaysia, the Philippines, Singapore and Thailand to offer mutual support in

---

<sup>50</sup> Nogués and Quintanilla (1993), Gwynne (1994).

<sup>51</sup> Genberg and Nadal de Simone (1993) p. 174.

<sup>52</sup> For example, one country could dominate the chemical industry while another could focus on steel making.

<sup>53</sup> De Melo, Montenegro and Panagariya (1992).

<sup>54</sup> Saxonhouse (1993).



order to counter the perceived communist threat from China and Vietnam. The economic dimensions of ASEAN grew to the extent an ASEAN Free Trade Area was inaugurated at the start of 1993.<sup>55</sup>

On the multilateral front, the nature of GATT negotiations changed in the 1960s. With successive Rounds involving more countries, the limitations of the previous item by item, principal-supplier approach became clear. Therefore, with the Kennedy Round (1964-67) a tariff cutting formula was used, requiring a 50% cut in duties, although exceptions were allowed. The result was an average cut in tariffs of around 35%.<sup>56</sup> Thus the 1960s saw a sharp drop in tariff restrictions on international trade, although the signs of some of the quantitative restrictions which were to grow in importance in subsequent decades were already emerging. In particular, the "temporary" restrictions on textile trade which were the precursor to the Multi Fibre Arrangement were implemented in 1961 and 1962.<sup>57</sup> In general however, the 1960s saw falling barriers to trade, rapid growth in trade volumes and a widespread rise in economic prosperity. Trade grew at an average rate of 8.3% in the 1960s, while GDP grew at 5.3%. This compares with growth rates of 6.5% and 4.2% respectively in the 1950s, 5.2% and 3.6% in the 1970s and 3.7% and 2.8% in the 1980s.<sup>58</sup>

#### **2.4.1.3 Stalled Progress: 1974-1985**

In terms of trade liberalisation, the process generally stalled from the early- to mid-1970s until the mid-1980s, when progress was limited on both a regional and a multilateral basis. Although this period saw the success of the Tokyo Round, GATT's seventh set of liberalising negotiations, and a broadening of the membership of the European Community,<sup>59</sup> these were exceptions in an

---

<sup>55</sup> ASEAN had tried but failed to set up a preferential trading system in the late 1970s.

<sup>56</sup> Baldwin (1993).

<sup>57</sup> Oxley (1990).

<sup>58</sup> UNCTAD (1993) p. 127.

<sup>59</sup> Denmark, Ireland and the United Kingdom joined the initial six in 1973, followed by Greece in 1981 and then Portugal and Spain in 1986.

otherwise difficult period.<sup>60</sup> Wider adoption of non-tariff barriers led to concerns that the world economy was sliding back into protectionism.<sup>61</sup>

Perhaps the nadir of this period came in 1982 with the failure of the US to gain acceptance by other GATT members for a new Round at the Ministerial Meeting. The US was eager to begin new GATT negotiations based around services and intellectual property rights, and its failure to secure agreement was a turning point in US trade policy. From 1982 the United States' previously enthusiastic support for the multilateral system began to be replaced by bi- and unilateral action.<sup>62</sup>

More intense competition from relative newcomers to international trade is one reason for the increase in protectionist pressures in this period. As tariff imposition had become progressively more difficult without contravening GATT rules, other non-tariff restrictions were imposed on trade flows. Voluntary export restraints were one method of restricting trade volumes, while others included orderly marketing arrangements and more vigilant use of anti-dumping tariffs. In the United States, voluntary export restraints (VERs) on Japanese automobiles had been on the agenda after the second oil shock in 1979. Rejected by the Carter administration, which chose adjustment assistance for auto workers instead, they were quickly agreed on under the new Reagan administration in 1981. Bergsten and Noland estimate that the resultant higher prices charged by Japanese automobile manufacturers in the US, which were followed by other producers, resulted in a transfer from US consumers to automobile producers of between US\$5.8 billion and US\$10.3 billion.<sup>63</sup> The beneficiaries were all world automobile producers, including Japanese firms as well as the US Big Three.

At the same time restrictions on trade through the use of anti-dumping, countervailing and safeguard procedures increased. Within the EC there were nine such actions between 1971 and 1975, 102 between 1976 and 1980 and 127 between 1981 and 1985.<sup>64</sup> The concern that growing trade impediments would at

---

<sup>60</sup> The majority of regional agreements notified to GATT in the 1970s were between European countries or between the EEC and countries bordering on the Mediterranean.

<sup>61</sup> Dicken (1992), Henderson (1994), Oman (1994).

<sup>62</sup> Baldwin (1993).

<sup>63</sup> Bergsten and Noland (1993b) p. 106.

<sup>64</sup> See Secchi (1990).

best slow growth, and at worst send the world into recession, helped to form a consensus in favour of a new bout of trade liberalisation which began in Punta del Este in 1986; the Uruguay Round.

#### **2.4.1.4 Renewed Liberalisation: 1986-1997**

From the mid- to late-1980s up to the present, there has been a renewed push towards greater liberalisation at both a regional and multilateral level. On a global basis this is demonstrated by the success in carrying through the Uruguay Round of GATT negotiations and setting up the World Trade Organization. On a regional basis, in some areas previously moribund regional arrangements have been revived, while in others new ones have been created.<sup>65</sup> Europe, as always a prime example, saw a marked acceleration in measures aimed at promoting integration in the decade from the mid-1980s, with the Single European Market programme, the Maastricht Treaty and the enlargement to 15 members being some of the key steps.

It is not entirely clear why there should have been a sudden revival of interest in trade liberalisation in general and regionalism in particular. Most of the major advances in economic theory related to liberalisation and regionalism were made well before the latest round of liberalisation began, so it does not appear to be the result of a newly convincing argument.<sup>66</sup> One explanation is that it is the result of the increased spread of democracies operating on liberal economic principles—what has grandly been labelled the "end of history".<sup>67</sup> Another interpretation is that periods of a relatively prosperous world economy create the conditions for trade liberalisation.<sup>68</sup> Other suggestions are that some regionalism is a defensive reaction to regionalism elsewhere, or attempts to lock in domestic policy reforms.<sup>69</sup> This issue will be explored in more depth in Chapter 6.

---

<sup>65</sup> WTO (1995).

<sup>66</sup> Although as Bhagwati (1993) has noted, the conversion of the US to the merits of regionalism has played a part in its spread.

<sup>67</sup> Fukuyama (1992).

<sup>68</sup> Irwin (1993a).

<sup>69</sup> Srinivasan, Whalley and Wooton (1993).

As with the 1960s, regionalism in the past decade has involved the developing world, which this time has focused more on outward looking trading arrangements. Kelly has pointed out that the regional trade agreements of the 1980s differed from those of the 1960s in that a recent feature has been agreements between developed and developing countries.<sup>70</sup>

Another new departure is that the US has begun to embrace regionalism. This last point was confirmed in a press conference given by then US Trade Representative Mickey Kantor on 16 May 1995. Speaking in justification of plans to impose US sanctions on Japanese automobile exports, Kantor stated the US would "act multilaterally where appropriate, regionally where we can, but bilaterally where necessary".<sup>71</sup> Leaving aside the apparent interpretation by Kantor that the proposal to impose US tariffs on Japan was a bilateral rather than a unilateral move, the emphasis on regional action is notable. Events in North America in recent years have run parallel to those in Europe with the signing of the Canada-US Free Trade Agreement, subsequently enlarged to include Mexico. Meanwhile the "Enterprise for the Americas Initiative" begun by President Bush and continued by his successor has made a pan-Americas trade group a genuine possibility.<sup>72</sup>

Irrespective of an increase in the number of regional agreements made in the past decade, the world appears to have headed away from the protectionist tendencies of the 1970s and early 1980s. The conclusion of the Uruguay Round means that a greater share of world trade is now governed by agreed rules, while tariff reductions have continued. Most Favoured Nation tariff reduction has proceeded to the extent that by the time the Uruguay Round is fully implemented 43% of imports of industrial products by developed countries will be duty-free. An average tariff of 6.6% will apply to the remainder.<sup>73</sup> Moreover, in that they have not resulted in higher barriers to inter-regional trade, it appears to be appropriate to consider the regional developments of the past decade to be in keeping with

---

<sup>70</sup> See Kelly (1992). This is a debatable assertion if the Yaoundé and Lomé accords are considered to be preferential trade agreements.

<sup>71</sup> *Financial Times*, 17 May 1995.

<sup>72</sup> Lawrence (1996).

<sup>73</sup> WTO (1995) p. 2.

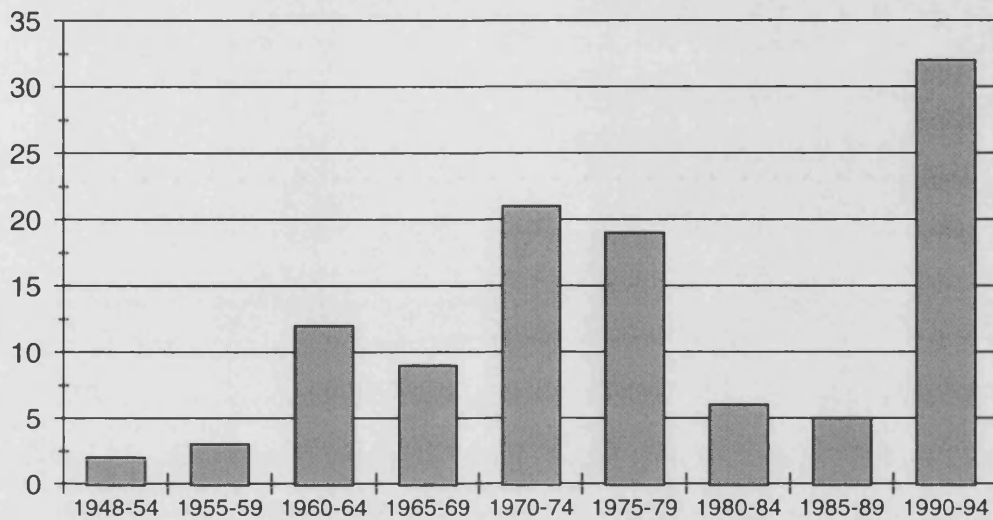
the liberalisation embodied in the Uruguay Round. Whether this is really the case or not will be considered below.

Of course history can never be neatly compartmentalised and there are counterexamples in every period—the most notable in the current fourth period being the break up of both the integrated Eastern Bloc and the Soviet Union itself. However, the Comecon system which applied in Eastern Europe for most of the post-war period was based on different ideological foundations, both politically and economically, so it is not unreasonable to exclude it from this analysis. Although it is not precise, this division of post-World War II history offers a convenient classification of events; reconstruction followed by trade liberalisation, then a pause due to economic difficulties until the past decade which has seen renewed liberalisation.

#### **2.4.2 Numbers of Regional Trading Arrangements**

In addition to the descriptive approach adopted above, it is possible to trace regionalism by the number of agreements signed, or by substantive deepening of existing agreements. The signing of regional trading agreements indicates that political co-operation is increasing. Although simply measuring the number of agreements signed contains no qualitative assessment and does not show whether they actually have an impact in bringing the economies of the signatories closer together, it is a means of measuring the political energy being expended. Presumably the political effort would not be made unless there were expectations of some kind of benefit, and as most agreements are structured around trade or investment flows, it must be assumed that a large part of the benefits will be economic. Information on the deepening of existing agreements is not readily available, and the judgement of what represents a material advance is partly subjective, so focus is on the formation of new agreements, or the broadening of existing ones.

**Figure 2.1. Number of Regional Integration Agreements Notified to GATT, 1948-1994**



Note: Data include agreements notified under Article XXIV or the Enabling Clause.  
Source: WTO (1995)

Figure 2.1 shows the number of regional agreements notified to the GATT between the first in 1948 (the South Africa-Southern Rhodesia Customs Union Agreement) to the last in 1994 (the accession of Austria, Finland and Sweden to the EC). It shows 98 notifications under Article XXIV as well as a further 11 agreements that were notified by developing countries under the 1979 Enabling Clause.<sup>74</sup> From Figure 2.1 it appears that there were two waves of activity related to regional integration. The first came in the 1960s and 1970s and the second in the 1990s. However, some caution is needed when looking at these figures. Note for example that several agreements had little material impact, with little progress made on implementing their provisions—or implementation ran well behind schedule.<sup>75</sup>

Of course, even if implemented fully, the degree of preferential treatment offered by treaties can vary considerably. Most agreements notified to the GATT

<sup>74</sup> WTO (1995) Appendix Table 1. The Enabling Clause allowed developing countries to form regional agreements without meeting the full requirements of Article XXIV.

<sup>75</sup> Nogués and Quintanilla (1993).

have been free trade areas, with few related to customs unions (the European Community, CARICOM and MERCOSUR are notable examples).<sup>76</sup> Note also that one agreement often superseded or enhanced another—for example there were three notifications to the GATT of agreements between the EEC (as was) and Turkey,<sup>77</sup> while the integration of later members as part of the EC enlargement process made earlier free trade agreements between them redundant. In contrast, the deepening of an existing agreement (such as the European Single Market programme) does not register, even though it might be more significant in terms of promoting economic integration than many of the notified agreements.

It is worth noting that 22 out of the total of 109 agreements were related to the formation or expansion of the EC or EFTA, or ties between their members. A further 54 of the notified agreements were between the EC, EFTA or their members and other countries or groups of countries. Only 33 regional agreements (30% of the total) did not involve members of the EC or EFTA. The political transition of Eastern Europe since 1989 has seen another round of intra-European agreements, and 24 of the 33 deals notified since 1990 have related to trade with Central or Eastern Europe.

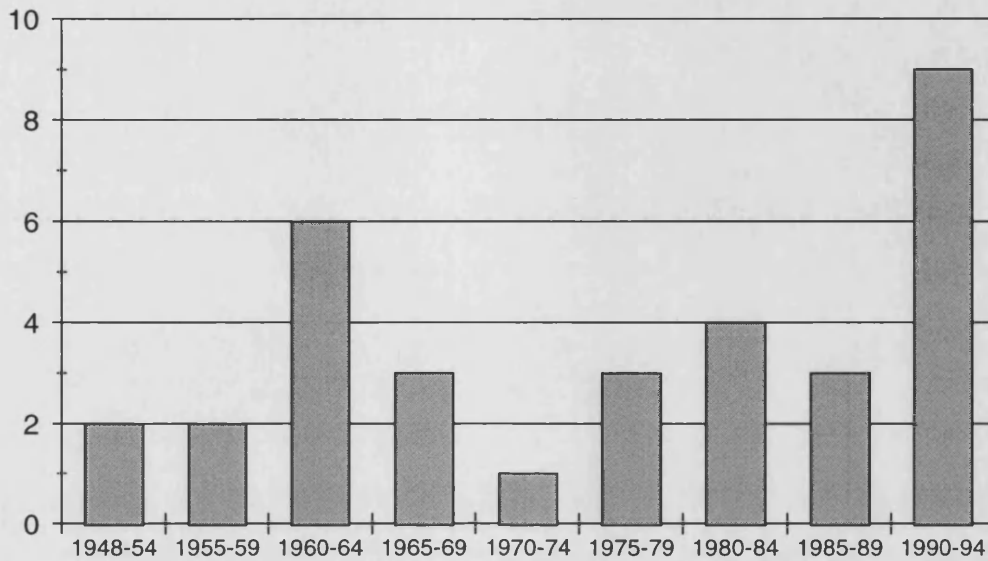
Excluding EC or EFTA related agreements allows us to consider the extent to which regional agreements have been on the increase outside of Europe. Figure 2.2 shows the number of regional agreements signed excluding those which involved the members of the EC or EFTA. Two features are worth noting. Firstly, there have been relatively few agreements signed at *any* point in time. Secondly, it was the 1960s more than the 1970s which was the first decade of enthusiasm for regional agreements in the rest of the world, but a similar resurgence of interest can be seen in the 1990s.

---

<sup>76</sup> WTO (1995) Appendix Table 1.

<sup>77</sup> In 1963, 1970 and 1973.

**Figure 2.2. Number of Non-EC/EFTA Related Regional Integration Agreements Notified to GATT, 1948-1994**



Note: Data include agreements notified under Article XXIV or the Enabling Clause.  
Source: WTO (1995)

Looking at the 109 agreements from another angle and it is seen that 30 of the regional agreements notified to the GATT involved only two countries. A further 33 agreements were between the EC and one other country. That leaves only 46 agreements (42%) which can really be seen as regional deals, rather than just bilateral ones.

The conclusion must be that formal attempts to promote regional integration are primarily a European phenomenon. Outside Europe, agreements have been few and frequently between only two countries. By the time the WTO began operating in 1995 few contracting parties were not signatories to one regional agreement or another—Hong Kong and Japan being notable exceptions. If APEC is transformed into a formal preferential trading area—its stated objective is to achieve regional free trade by 2020—then all WTO members will be tied to at least one regional trade group. That is to say, every WTO member will have regional as well as multilateral commitments.

Considering the importance of various preferential trade arrangements, just two can claim to have any real significance on a world economic scale. Only the European Union and NAFTA have membership which accounts for over 5%



of world output and world trade.<sup>78</sup> APEC (or any other regional group including Japan) would also be significant in world terms, but it does not yet have formal preferential agreements. With this in mind, the focus in Chapter 3 when examining the data for signs of regionalisation will be on these three regions. That is not to say that other groupings are unimportant for the countries involved: for example MERCOSUR could have a major impact on its members, but in terms of the world economy, they are of marginal importance.

The overall conclusion is that enthusiasm for regional agreements has reached levels in the 1990s which surpass the previous peaks of the 1970s in Europe or the 1960s for the rest of the world. Not shown by the figures on the number of agreements are three other indications that regionalism is a stronger trend in the 1990s than at any time in the post-war period. Firstly, existing but low-level agreements have been deepened; the ASEAN Free Trade Area is a good example. Secondly, existing but dormant agreements have been revived and pursued more actively; such as has been the case with the Andean Pact. Thirdly, new agreements have tended to involve a greater commitment to make genuine progress than was often the case in the past; MERCOSUR is notably more positive than the Latin American regional agreements reached in the 1960s.

## 2.5 Regionalism and Economic Cycles

History and theory suggest that trade liberalisation and economic integration both affect and are affected by the economic cycle.<sup>79</sup> It appears that healthy rates of economic growth reduce resistance of domestic interest groups to trade liberalisation—either regional or multilateral—which in turn boosts growth through gains from trade. This virtuous cycle was evident in the 1960s. Conversely at times of economic difficulty, such as in the 1930s and 1970s, domestic interest groups seek to restrict imports in order to lower competitive pressures.<sup>80</sup> On a

---

<sup>78</sup> ASEAN accounts for slightly more than 5% of world trade due to the large amount of re-exports from Singapore. The group represents only 1.6% of world GDP.

<sup>79</sup> Kindleberger (1973), Milner (1988).

<sup>80</sup> Conybeare (1987), Milner (1988), Oman (1994).

macroeconomic basis, this reduces the gains from trade and lowers overall growth.

While the link between the economic cycle and trade liberalisation can be something of a chicken and egg debate, a strong case can be made for ascribing the 1930s Great Depression to either monetary or fiscal phenomena,<sup>81</sup> or the stagflation of the 1970s to inflationary shocks. That is to say, neither of the major economic disturbances of the twentieth century appear to be attributable to increased trade barriers, although they may have contributed to the length and severity of the downturns.

This would seem to imply that the renewed liberalisation seen since the mid-1980s can be partly attributed to the end of the early 1980s recession and to the reasonably steady global growth since then.<sup>82</sup> If this is the case, then a renewed sharp recession could again threaten the progress towards more open exchange that has been accomplished over the past decade. It could also be argued that rather than being related directly to the economic cycle, shifts between the relative strength of forces in favour of protectionism versus economic integration have been determined by swings in general economic attitudes between liberalism and interventionism. However, this idea does not appear to fit closely with the facts: most notably in the first half of the 1980s, when the growing popularity of deregulation and free market solutions domestically coincided with economic stagnation and also saw more active use of non-tariff barriers. Perhaps a stronger influence is the attitude of the dominant world economy. From the end of World War II until 1973 the United States clearly led. The 1970s was a period of weaker leadership, while greater consensus appears to have emerged since the mid-1980s.<sup>83</sup>

---

<sup>81</sup> Friedman and Schwarz (1963) make the argument for monetary causes, while Temin (1976) sees the Great Depression as being explained by insufficient demand.

<sup>82</sup> Indeed some have gone so far as to proclaim the end of the economic cycle, but there is little empirical support for this view. See *Financial Times*, 10 April 1997.

<sup>83</sup> Frequent G7 meetings and agreements such as the Plaza Accord are indications of a trilateral governance of the world system.

## 2.6 Conclusion

In the post-war period, there have been two main bursts of regionalism. The first period, in a "long" decade around the 1960s, was accompanied by development of much of the theoretical work on customs unions. That theory suggested that the intuitive approach of viewing customs unions as a step in the direction of free trade, and thus a welfare enhancing development, was not necessarily justified. Kemp and Wan demonstrated that customs unions could be structured in such a way that they were welfare enhancing and represented a move towards free trade, but this is dependent on maintaining the level of trade flows with non-members. However, there are few signs that the Kemp-Wan prescription has had a strong influence on the structure of regional trade agreements.<sup>84</sup>

Europe persisted in making regional agreements through the 1970s, but there was a more general revival of regionalism from the mid-1980s. This revival has led to concern that it could involve welfare losses for non-participants, or undermine efforts for multilateral liberalisation. However, there is a question as to whether an increase in regionalism has had a significant impact on patterns of trade. This question will be addressed in the next chapter.

---

<sup>84</sup> McMillan (1993).

## **CHAPTER THREE**

### **REGIONAL INTEGRATION: METHODOLOGY AND RECENT TRENDS**

#### **3.1 Introduction**

Before analysing the implications of increased regional integration, an examination of whether such a trend really exists is first necessary. It is important to look at the available data to determine, as far as is possible, whether regional trade is becoming more preferential and whether national economies are genuinely becoming more integrated, and if so, in what ways this integration is manifested. This chapter examines a broad range of data and analyses various methodologies used to look for evidence of regionalisation. Inadequacies of data related to areas such as foreign direct investment frequently mean that in most studies only merchandise trade data are analysed when making judgements about regional trends. However, data on other forms of integration may also prove useful and should not be neglected.

The basic hypothesis is that regionalism leads to closer economic integration of the participants. This could be evident in several areas, but trade flows are the most readily measurable, with a move towards closer regionalism expected to produce an increase in the propensity to trade within the region. As will be shown, this is a surprisingly difficult hypothesis to test.

This chapter aims to make three contributions. Firstly, an examination of a broad range of data for evidence of regional preferences. Secondly, discussion of the merits and faults of attempts to manipulate the data to give a clearer picture. Thirdly, analysis of the data bearing in mind the statistical problems involved.

This chapter will demonstrate that a marked rise in regional trade bias in North America and Europe has occurred since the late 1980s. However, in the case of Europe the increase in bias is restricted to trade with the new members, rather than between the original ones. In both cases, the increase in regional bias has been accompanied by a rise in overall economic openness, which reduces fears that regionalism is detrimental to trade flows with non-members.

A range of measures can be employed in the search for bias in trade flows. These are considered below, starting with the ratio of intra-regional trade to total trade, followed by different forms of trade intensity indices. Trade intensity

indices allow differentiation between the impact of changing shares of world trade and that of genuine shifts in preferential trade bias. Some caution is needed in using such measures, and they cannot be used for inter-regional comparisons, but they do allow analysis of trends in individual regions over time. Attempts to measure regionalisation using gravity models are found to have serious flaws and it is shown that conclusions drawn from the gravity model approach are not well founded.

After considering the methodological problems, this chapter will search the available evidence for signs of regionalisation. It finds that regional trade bias rose in Europe and North America, and in the case of the former there are clear signs that membership of the EU affects trade bias. More surprising is the finding that the original six EU members have seen no increase in trade bias over the past three decades. Other data sets are examined, but are not comprehensive enough to allow reliable conclusions to be drawn. Later chapters will discuss the political, macroeconomic and microeconomic explanations for the findings, which will also consider how the identified trends might affect the various actors in the international political economy. The bulk of this chapter will be devoted to examining the available statistical evidence for signs of regional integration (the economic force).

### **3.2 Evidence of Regional Integration**

Before considering the impact of increasing regional integration on the international political economy it is necessary to examine whether this is a trend which exists in the real world or is simply an invention of academics, politicians, journalists and business consultants. Moreover, rather than simply calculating whether regional integration is increasing, it is also useful to examine the form that such integration takes.

On a statistical basis, there are four main areas that can be examined for evidence of regional integration. One of these—merchandise trade—is frequently studied for signs of regionalisation. Analysis of foreign direct investment flows is not uncommon. I also consider a third area for analysis, that of other non-equity forms of corporate activity and the income flows from foreign assets in general. Fourthly, financial flows are examined for signs of regional integration.

Regional integration (or regionalisation) is taken to be closer interdependence between the economy of one country and that of one or more other economies in the same geographic region. This involves two concepts. Firstly, it involves a regional preference (or bias) in the conduct of economic activity, such that regional neighbours are favoured over more geographically distant economies. Secondly, it relates to the overall degree of economic openness within which any regional bias is shown.

The two main issues involved in measuring regional integration relate to which methodology and which data should be used. This chapter will discuss the availability and merits of the various data sources and the different methodologies. A cautionary note is useful at this point. Trade and investment data can be used to show degrees of bias between countries and within regions, and whether that bias is rising or declining. However, this is only one aspect of the issue of regional integration, as will be discussed below in section 3.3.5. The relationship between trade bias and the degree of economic openness needs examination in order to widen the discussion from trade bias to regional economic integration.

### 3.3 Merchandise Trade Flows

Merchandise trade data are most frequently used to examine whether trends towards regionalisation exist. This is justified by their comprehensive nature, with a breakdown of almost every country's trade with other countries of the world available from the International Monetary Fund. The IMF publishes timely and consistent direction of trade figures from 1948.<sup>1</sup> These data can be examined in various ways, the basic concept being that if countries in a region show a preference to trade with each other to a greater extent than is implied by their share in world trade, then this is a sign of regional trade bias. The availability of time series data allows the analysis of trends over a long period of time. Indeed Bairoch has produced a series dating back to 1830, while Anderson and Norheim use detailed figures from 1928 onwards.<sup>2</sup>

---

<sup>1</sup> IMF, *Direction of Trade Statistics Yearbook*, although the most recent one or two years' data can be subject to revision.

<sup>2</sup> See Bairoch (1976) and Anderson and Norheim (1993).

The methodology used for merchandise trade flows also applies to the other data sets which are discussed later in this chapter. Because merchandise trade provides the most comprehensive data set, it seems sensible to begin a discussion of regional bias with an analysis of trade flows.

### 3.3.1 Direction of Trade Flows

The basic measure of the share of trade flows between pairs or groups of countries has several attractions. The calculation is straightforward, it is readily understandable, and the results can contain useful information. However, it is poor at dealing with a dynamic analysis of changes in trade shares over time, and at answering the question of whether trade flows are surprisingly high or low.

One basic measure of the degree of regional integration is the proportion of trade between members of the region as a share of their total trade.<sup>3</sup> This can be examined by setting out the data for the three major trading areas: North America, the European Community and East Asia.<sup>4</sup> The results are shown in Table 3.1 below, which are the author's own calculations, as one peculiar feature of the debate on regional integration is that different works can show surprisingly wide differences in their results, even where the calculation is straightforward.<sup>5</sup>

---

<sup>3</sup> See Lloyd (1992), WTO (1995), OECD (1995).

<sup>4</sup> There is always room for debate about the composition of an Asian bloc. Japan must be included or it will not be a significant economic entity, similarly for the People's Republic of China. South Asia is excluded, although its inclusion makes little impact on the findings. I have chosen to exclude Australia and New Zealand for geographical reasons.

<sup>5</sup> For example Frankel, Wei and Stein's (1994) calculations for 1990 for the three regions shown above are 29.3%, 47.1% and 24.6% respectively, while Anderson and Norheim (1993) calculate shares to be 48%, 72% and 40% although their Asian and European measures are slightly broader as figures for Asia include Australasia and those for Europe are for all of Western Europe. Calculations by Yoshida *et al.* (1994) show 41.3%, 59.2% and 36.9%. Not one EC member had an intra-EC trade share below 50% in 1990, which indicates a problem with Frankel, Wei and Stein's data.

	1965	1970	1975	1980	1985	1990	1995
East Asia <sup>a</sup>	25.5	28.9	29.2	35.4	37.2	42.0	50.0
European Community <sup>b</sup>	47.6	51.8	51.2	52.5	53.5	59.3	55.9
North America <sup>c</sup>	35.7	38.6	35.7	33.2	38.6	37.4	42.2

*Source:* Author's calculations from IMF *Direction of Trade Statistics*.  
a: East Asia includes Brunei, the People's Republic of China, Hong Kong, Indonesia, Republic of Korea, Japan, Malaysia, the Philippines, Singapore, Taiwan and Thailand.  
b: The EC 12 pre-1995 enlargement, excluding the former German Democratic Republic.  
c: Canada, Mexico and the United States of America.

The data presented in Table 3.1 appear to support the idea that regional integration has increased in recent years in North America, Europe and Asia. However, there are serious inadequacies with this form of analysis. From the static point of view, the share of intra-regional trade will be affected by the number of countries in the region, as well as the relative openness of the economies (which tends to be inversely related to the size of the economy).<sup>6</sup> As a result, comparisons between the regions shown in Table 3.1 can be misleading. As we are more interested in whether trade bias is increasing, as opposed to the degree of bias, this is not necessarily a problem, but of course the *size* of the countries within the region is also changing, due to differential rates of economic growth. For example, between 1970 and 1994, the economies of the industrialised world grew by an average 2.7%, with the European Community growing 2.4%, while non-Japan Asia grew 6.5% per annum.<sup>7</sup> Each country's weight in world trade is also changing as trade growth varies between countries. In addition, factors which affect transaction costs, such as language and transportation costs, will also affect the degree of intra-regional trade.

In effect, data on intra-regional trade shares does not show whether trade has risen more or less than would be expected by any overall change in world trade patterns. Shifts in trade preferences or bias imply a change in bilateral or regional trade shares even when each country's share of world trade is

<sup>6</sup> Kuznets (1959, 1966).

<sup>7</sup> Calculated from indices in the International Monetary Fund's *International Financial Statistics Yearbook* (1994). EC figures from Eurostat *National Accounts*.



unchanged, or after allowances have been made for changing shares of world trade. This is discussed in detail below, where use of synthetic indicators of trade bias gives an insight into regional trends that is not available from simply looking at trade shares. For example, in the case of Europe, intra-regional trade shares have been roughly flat in the past three decades. However, indicators that correct for Europe's declining share of world trade reveal a rising trade bias between the founder members and the later entrants.

Considering the handicaps discussed above, Anderson and Norheim go so far as to say "the share of intra-regional trade in a region's total trade is a very inadequate indicator of preferential policy-induced regional trade bias".<sup>8</sup>

Interestingly, looking at trends in intra-regional trade shares is exactly the approach that the World Trade Organization (WTO) used in its 1995 report *Regionalism and the World Trading System*. The WTO concluded that the "analysis does not support the conclusion of an increasing regionalization of world trade, nor does it confirm the often-alleged emergence of trading "blocs" centred in North America, Western Europe and the Asia-Pacific region".<sup>9</sup> This appears a bold conclusion, given the inadequacies of the use of simple direction of trade figures, and as will be demonstrated, it is not borne out by a more detailed examination of the data. The WTO claimed that Western Europe is the only region to have seen a policy-induced increase in regional trade flows. However, it did not attempt to relate the claimed increase in European integration with specific policy initiatives. Many other authors utilise this crude measure of regionalisation, which tends to provide little substantiation for the arguments they then propose.<sup>10</sup> Presumably the reasons for this are that collecting the necessary data is an onerous task, while the methodology for more suitable manipulation of the data is open to debate.

Although the conclusions of the WTO may be comfortable for a body concerned with promoting greater openness and equity in world trade, they are based on an inadequate examination of the statistics available. In its defence, the WTO argues that major structural differences between various regional

---

<sup>8</sup> Anderson and Norheim (1993) p. 22.

<sup>9</sup> WTO (1995) p. 2.

<sup>10</sup> Recent examples have been Yoshida *et al.* (1994) and OECD (1995). Lloyd (1992) acknowledges the faults of such a measure, but uses it nevertheless.

agreements makes statistical analysis difficult, so it chooses to look at "institutional complementarity". That is, whether the objectives of regional and multilateral liberalisation have been complementary or conflicting. Nevertheless, it seems advisable to consider other statistical measures of economic integration in search of a clearer picture.

### 3.3.2 Bilateral Trade Intensities

The standard method of analysing bias in bilateral trade flows is provided by the trade intensity index that was first proposed by Brown and later developed by others.<sup>11</sup> This looks at the share of one country's exports to another as a proportion of that country's overall share in world import markets. The idea behind such a measure is to ask whether one country trades with another to a greater or lesser degree than is implied by its share in world trade. That is to say, although France's exports to Germany are twice the size of its exports to Belgium, in itself this tells us nothing about any bias in French trade towards the two countries, as we need to consider the relative size of Belgium and Germany's trade flows.

The trade intensity index aims to show both natural and policy-induced effects on the geographic distribution of trade. Assuming that "natural" factors (such as relative size and income, language or distance) change little over time,<sup>12</sup> movements in the index can be attributed to shifts in other influences on trade bias, such as discriminatory tariff policies. Analysis below will expand this bilateral measure of trade bias to a regional level. By looking at a time series of trade bias the aim is to observe changes in barriers to liberal economic exchange or changes in economic actors' treatment of existing barriers. The standard formula for the trade intensity index is:<sup>13</sup>

---

<sup>11</sup> See Brown (1949), Kojima (1964) and Drysdale and Garnaut (1982).

<sup>12</sup> Petri (1994) controversially argues that even transport costs are surprisingly unaffected by distance (as much of the costs are taken by handling charges). He claims that there is little evidence that bilateral trade is significantly affected by changes in transportation costs, such as those resulting from the oil price shocks of the 1970s.

<sup>13</sup> Brown (1949), Drysdale (1988).

$$I_{ij} = \frac{X_{ij} / X_i}{M_j / (M_w - M_i)} \quad (1)$$

Where

$I_{ij}$  is the trade intensity index between countries  $i$  and  $j$ .

$X_{ij}$  is the amount of exports to country  $j$  from country  $i$ .

$X_i$  is country  $i$ 's total exports.

$M_j$  is country  $j$ 's total imports.

$M_i$  is country  $i$ 's total imports.

$M_w$  is total world imports.

The denominator is adjusted to account for the fact that "a country cannot export goods to itself".<sup>14</sup> The idea is that if imports in country  $j$  are 5% of the world total (excluding  $i$ 's imports), but it takes 10% of  $i$ 's exports, then the trade intensity is 2. This is because country  $j$  takes twice as large a share of  $i$ 's exports as is implied by country  $j$ 's share of world trade. The aim is for the denominator to be the neutral measure, or control, and the interest is in the degree to which the numerator differs from this neutral value. Petri claims that "If each partner's share of a country's trade was equal to that partner's share in world trade, then all intensity indexes would be one".<sup>15</sup>

Results from this type of calculation are typically used in three ways. Firstly, if the trade intensity is greater than one, then this is taken to indicate that the exports of the first country to the other are greater than would be expected by the second country's share in world trade. There is said to be a positive bias in the first country's exports to the second country. Secondly, if the value of the trade intensity index with a certain country is higher for one trading partner than for another, then the former is seen to have a greater preferential bias. Thirdly, if the trade intensity index is rising over time, then there is said to be an increasing bias in exports from the first country to the second.<sup>16</sup>

There is a problem in all three of these interpretations as, strictly speaking, the results only hold if all countries are an equal size and are equally open to

---

<sup>14</sup> Drysdale and Garnaut (1994) p. 25.

<sup>15</sup> Petri (1994) p. 117.

<sup>16</sup> See for example Brown (1949), Kojima (1964), Drysdale and Garnaut (1982), Drysdale (1988), Petri (1994), Primo Braga and Bannister (1994).

trade. Even in a world where there is no actual bias in the direction of trade flows, problems arise when some countries trade more than others, perhaps because they are larger, or when some countries are growing faster than others. Clearly these qualifications are a fair description of the "real world" and so before attempting to extend the analysis to the regional level it is first necessary to consider how serious the problem might be. It is unclear whether previous studies have failed to recognise this problem, or whether they have simply chosen to ignore it as being relatively insignificant. Drysdale and Garnaut refer to the 1993 study by Petri which calculates trade intensities without subtracting  $M_i$  from  $M_w$  in equation (1), (i.e. not adjusting the denominator) and claim "the variability in the indexes which results from this is only minor".<sup>17</sup> However, they make no reference to the bias noted below in the index resulting from the calculations in equation (1), which is the one that they use.

As an example, consider a world made up of only six countries. The trade flows of five are equal in size and the other is larger (as it is a larger economy). Assuming the large country's exports are 200 units and those of the small countries are 120, then it is relatively straightforward to deduce bilateral trade flows, assuming no bias in direction of trade, and no trade imbalances. The large country exports 40 units to each of the small countries (as the 200 must be split into five equal parts). The small countries in turn export 40 to the large country (as there are no imbalances) and split the remaining 80 equally among the other four countries, exporting 20 to each. World trade is 800 (200 plus five times 120). This can also be demonstrated algebraically.

---

<sup>17</sup> Drysdale and Garnaut (1994) footnote 8.

$X_L^i$  Exports of large country (L) to each small country,  
where  $i=1, \dots, n$  (and  $n=5$ )

So

$$X_L^i = X_L / n$$

So in this case

$$X_L^i = 200 / 5 = 40$$

$$\text{Exports from small country } X_s = X_s^L + \sum X_s^i$$

$X_s$  = exports of each small country

$X_s^L$  = exports from small country to large country

$\sum X_s^j$  = exports from small country to other small countries..  
 $j = 1, \dots, (n-1)$  because you cannot export to yourself

$$X_s^L = X_L^i = X_L / n \quad \text{by symmetry}$$

$$X_s^i = \frac{X_s - (X_L / n)}{n-1}$$

$$X_s^i = (120 - 40) / 4 = 20$$

Taking these results to calculate trade intensities using formula (1) gives the first sign of problems. The trade intensity index for exports from the large country to the small countries is 1.000,<sup>18</sup> but the trade intensity index for exports from the small countries to the large country is 1.133<sup>19</sup> and between the small countries it is 0.944.<sup>20</sup> We have already established that there is no preferential bias in the above example (as trade flows are determined by the differences in total exports of each country), but the trade intensity index is diverging from 1.0. The use of the formula shown in (1) is based on the assumption that the trade intensity index should read 1.0 when there is no trade bias.

This shows that the attempt by Brown *et al.* to correct the denominator to give a result of 1.0 when no actual trade bias exists has not quite worked. Even though each country trades with each other in proportion to its share of total trade, two of the three trade intensity indices generated do not have the value of

---

<sup>18</sup>  $(40/200) / (120 / (800-200))$

<sup>19</sup>  $(40/120) / (200 / (800-120))$

<sup>20</sup>  $(20/120) / (120 / (800-120))$

1.0. It is also evident that exports to the large country generate an apparently positive bias, while exports between the small countries generate a figure below unity. This is a consequence of the attempt to adjust the denominator to account for the fact that "a country cannot export goods to itself".

This tells us that, even in a world where no bias exists, trade between a large and a small economy will give a larger reading by this measure than trade between two small economies. As a result, the trade intensity index cannot be used to make strict comparisons between the trade bias of different pairs of countries. Unfortunately this is how it has been used from Brown onwards.<sup>21</sup>

Another question is whether such an index can be used to make comparisons of the degree of bias between pairs of countries over time. As is probably expected, again a distortion occurs. In the above example, assume the large country grows (and total world trade grows with it) to give a situation where exports from the large country are 300 units and the small countries each export 140. With the same conditions of unbiased trade and no imbalances, this time exports from the large country to the small are 60 units. Exports from the small to large country are also 60, while the remaining 80 units are still traded equally among the other four countries, 20 units going to each. World trade is now 1000 units.

Now the export intensity index from the large country to a small country is still 1.000,<sup>22</sup> but the export intensity index from a small country to the large country is 1.229<sup>23</sup> and the export intensity index between small countries is 0.878.<sup>24</sup> Comparing these results with those above shows a lower value for the export intensity index between the small countries, but a larger value for the export intensity index from the small to the large country.

The implication is that as the large country has grown in size, even without it developing any bias in the direction of its trade flows, the trade intensity indices have changed. Export intensities of trade to the large country rise as that country grows in size relative to the others, even without the development of a bias in

---

<sup>21</sup> Brown (1949), Kojima (1964), Drysdale and Garnaut (1982), Drysdale (1988), Petri (1994), Primo Braga and Bannister (1994).

<sup>22</sup>  $(60/300) / (140 / (1000-300))$

<sup>23</sup>  $(60/140) / (300 / (1000-140))$

<sup>24</sup>  $(20/140) / (140 / (1000-140))$

trade flows. Also note that export intensities between the small countries decline as the large country grows in size. Again the reason is the shift in the denominator caused by the change in the size of the large country.<sup>25</sup>

From this it is clear that comparisons of trade intensity measures between different pairs of countries must be approached with caution. In the event that some countries account for a relatively large share of world trade, even when there is no bias in the direction of trade flows, the trade intensity of exports to these countries will suggest a positive bias. This problem diminishes with a reduction in the relative size of the largest traders and is probably not a critical issue in a world containing over 180 countries<sup>26</sup> where the largest trader has a share of just 12.5%. As we will see, the distortion caused by size differences is problematic when looking at relatively large regional groupings. Moreover, if any one country is seeing a change in its share of world trade (even with no change in trade bias), then all other trade intensities will be affected, because of the impact on the size of world trade in the denominator.

Table 3.2 shows the largest dozen exporters in the world in 1995, as well as how their share of world trade has changed since 1965. This shows that even the largest exporter (the USA) accounts for only one-eighth of world exports, with another two (Germany and Japan) each taking a share of just below one tenth. In the second above example, the highest trade intensity index was the 1.229 from the small countries to the large country, when the former were 14% of world trade and the latter was 30%. Compared to the changes in the direction of trade flows identified below, the changes that have taken place in the share of world trade of the major economies is relatively minor.

Much of the discussion below relates to the degree to which trade bias might have changed over the years. As noted above, when there is no bias in trade flows, the export intensity index to any country grows with the share of world trade of that country, and again the "real world" situation is relatively encouraging. In the above example, when the large country grew from 25% of world trade to 30%, the export intensity index from the small country to the large

---

<sup>25</sup> The problems in simply looking at trade shares are apparent in this example. The share of the large country in the small countries' exports would rise from 33.3% to 42.9% as its exports grow from 200 to 300, even though no change in trade bias takes place.

<sup>26</sup> The 1997 issue of the IMF *Direction of Trade Statistics Yearbook* contains trade data for 184 countries and territories.

country rose from 1.133 to 1.229. Changes in world trade shares of the magnitude seen in the past thirty years are not so great that they render all results meaningless. Because world trade shares are neither evenly distributed nor stable, caution is needed in drawing conclusions from this methodology, but in the analysis below the trends are generally sufficiently pronounced that minor distortions caused by changing shares of world trade do not have a serious impact on the overall conclusions.

	1965	1970	1975	1980	1985	1990	1995
USA	16.6	15.2	13.4	12.3	11.7	11.6	12.5
Germany	10.1	11.0	10.2	9.2	9.2	11.4	9.6
Japan	4.2	5.6	5.9	6.5	9.6	8.8	9.3
France	5.5	5.8	5.9	5.4	5.0	6.1	5.3
China	0.8	0.6	0.8	1.0	1.6	2.5	4.5
UK	7.9	6.5	5.1	5.2	5.1	5.0	4.5
Italy	4.0	4.2	4.0	3.9	3.9	4.8	4.2
Canada	5.1	5.8	4.0	3.4	4.6	3.7	3.8
Holland	3.8	3.9	4.2	3.7	3.6	3.9	3.3
Benelux	3.6	3.8	3.4	3.1	2.7	3.4	2.8
Korea	0.1	0.3	0.6	0.8	1.3	1.7	2.3
Singapore	0.0	0.2	0.4	0.7	0.9	1.2	1.8

*Source: IMF Direction of Trade Statistics.*

The reason for these distortions is that, as Drysdale and Garnaut noted, a country cannot trade with itself, but as is demonstrated above, subtracting the exporting country's trade from the denominator does not provide an unbiased result. Thus, to argue as Petri does that "If each partner's share of a country's trade was equal to that partner's share in world trade, then all intensity indexes would be one"<sup>27</sup> is only true if each country trades the same amount.

The problems become more pronounced when bias in trade flows is introduced into the picture. In this case the trade intensity index between large countries can return a lower figure than for small countries, even when the same degree of bias occurs. This is a particularly important feature when discussing intra-regional flows. In a world of an infinite number of equally-sized countries

<sup>27</sup> Petri (1994) p. 117.



with no bias, the trade intensity index will be 1.0, while if just two of those countries trade twice as much with each other as with any other countries, their trade intensity index will be 2.0.

The first example above, where the large country exports 200 units and the small countries each export 120, shows the effect of relative size. Assume two of the small countries have a preferential bias which doubles their bilateral trade, while leaving all other trade flows unchanged. These two now export 40 units to each other and 140 in total, so total world trade rises to 840.<sup>28</sup> The export intensity index between these two countries is now 1.429<sup>29</sup> compared to the earlier measure between the two small countries of 0.878.

In contrast, assume one of the small countries trades twice as much as before with the large country (so each exports 80 units to the other) while all other trade flows remain unchanged. World trade rises to 880 and the export intensity index from that small country to the large one is 1.500<sup>30</sup> and from the large to the small is 1.333.<sup>31</sup> In this case the increase in the export intensity index is less than when trade flows between two small countries doubled. As will be seen with intra-regional trade, the constraint is the adjustment to the denominator which has the result of limiting the maximum trade intensity index reading in an inverse proportion to the country's share in world trade.

Taking an extreme example, if there are two large countries, each of which accounts for 20% of world trade, but which trade only bilaterally and not with any other country, then their bilateral trade intensity index will be 4.0.<sup>32</sup> However, if another two countries also only trade bilaterally, but each only accounts for 5% of world trade then these countries' trade intensity index will be 19.0.<sup>33</sup> From this it is apparent that bilateral trade intensities could be rising simply because the countries' share of world trade is falling, which has the result of increasing the maximum possible reading from the trade intensity index due to the depressive effect on the denominator. The reverse is also true, and so when

---

<sup>28</sup>  $(200 + (3 \times 120) + (2 \times 140))$

<sup>29</sup> The result of  $(40 / 140) / (140 / (840 - 140))$

<sup>30</sup> The result of  $(80 / 160) / (240 / (880 - 160))$

<sup>31</sup> The result of  $(80 / 240) / (160 / (880 - 240))$

<sup>32</sup> The result of  $(20 / 20) / (20 / (100 - 20))$

<sup>33</sup> The result of  $(5 / 5) / (5 / (100 - 5))$

a pair of countries which have a positive bias in their trade are seeing their share of world trade increase significantly, the bilateral trade intensity index will fall. However, looking at the experience in post-WW2 Asia, Petri notes that "spectacular growth of the region's economies was accompanied by a substantial decline in their regional trade bias".<sup>34</sup> He argues that the observed decline in the trade intensity indices was a result of greater inter-linkages with the rest of the world stemming from multilateral liberalisation, increased economies of scale in trade linkages and the competitive rather than complementary nature of Asian manufacturing. However, part of the decline in the trade intensity indices can be explained by the statistical effects of the formula used, resulting from the rise in the share of world trade of the Asian economies. This was illustrated in the changes in the shares of world trade shown in Table 3.2.

Also significant for the later analysis in this chapter, is that when the relative size of trade flows among the small countries changes, the bilateral trade intensity with the larger country is affected. So when two of the small countries double their trade with each other (as above), the export intensity index between an unaffected small country and the large country rises from 1.133 to 1.200.<sup>35</sup>

Three situations have now been identified where the export intensity index from a small country to a large country rises. In the first case, although there is no change in actual trade bias, it is because the large country is accounting for a larger share of world trade, as its total exports rise from 200 to 300. In the second case it is because trade flows with one of the small countries have doubled, to show a genuinely preferential bias. In the third case, trade flows between the two countries have not changed, but a change in trade flows among other small countries has increased the total size of world trade, thereby creating a bias.

These findings are important, as the trade intensity index provides the backbone of attempts to measure preference in bilateral trade relations. However, in a world consisting of large and small economies, comparisons between pairs of countries at any point in time are sensitive to their relative share

---

<sup>34</sup> Petri (1994) p. 116.

<sup>35</sup> The result of  $(40 / 120) / (200 / (840 - 120))$ . The decline in the export intensity index is due to the reduction in the denominator stemming from the rise in world trade. In effect the rise in the index is because there is now a positive bias towards the large country and away from the two countries which have seen bilateral flows double.

in world trade. Similarly, in a world consisting of countries growing at different rates, comparisons over different points in time are sensitive to differentials in growth rates.

Ideally, the next step would be to propose a solution that allows construction of an unbiased bilateral trade measure. However, I have been unable to derive such a measure as there is no satisfactory means of adjusting the denominator to provide unbiased results when countries are a different size and growing at different rates. As will be seen, these problems recur as attempts are made to expand the bilateral trade intensity onto a regional basis.

The conclusion from the above is that results based on the methodology originally developed by Brown contain some flaws. However, this does not make all analysis stemming from such an approach worthless, as in large regions whose share of world trade has not changed significantly the distortions from the faults in the methodology are generally small relative to the changes in the revealed trade bias. Comparisons of trade intensities between different pairs of countries is particularly problematic, but looking at trends over time is more acceptable due to the relatively slow rate of change in other determinants of trade flows such as income. In the absence of other satisfactory means of measuring trade bias, there follows an attempt to extend this analysis to the regional level.<sup>36</sup>

However, before moving on to the regional level, it is worth considering another possible distortion to results, which can apply to whichever measure of trade preference is used. That is the effect of price distortions, such as swings in the relative prices of traded goods, or in the level of exchange rates.

### **3.3.3 Price Distortions**

Another important feature in the analysis of direction of trade flows is that most studies focus on the level of trade bias, or changes in bias, at discrete points in time—usually at five yearly intervals.<sup>37</sup> No doubt this is mainly due to the large amount of data which must be manipulated. However, there are potentially distortive effects from using this approach, in that the years chosen are to some

---

<sup>36</sup> See section 3.4.1.5 for a critique of the approach using the gravity model.

<sup>37</sup> See for example Anderson and Norheim (1993) and Frankel, Wei and Stein (1994).

degree arbitrary. This leaves the studies open to distortions from short-term price effects, either from volatility in relative prices of traded goods, or in exchange rate fluctuations. These fluctuations can mean that the nominal trade data paint a different picture from the real (inflation adjusted) series. Very few countries produce data on trade flows by country in real (inflation adjusted) terms, so there is no substitute for the IMF value-based data.

Unfortunately, the tendency to use end and mid-decade data points produces a particularly high risk of distortions in recent years. In 1980 oil prices were unusually strong, in relative terms 25% higher than in 1990.<sup>38</sup> Similarly, 1985 was the peak of the Reagan strong dollar episode. The US real effective exchange rate appreciated by 33.5% between 1980 to 1985 and then depreciated by 36.5% from the 1985 peak to 1990.<sup>39</sup> Studies which concentrate on these points in time risk having their results distorted by temporary price shocks which disguise the underlying trend in the real economy. However, selecting data points which appear to be less influenced by short-term volatility can leave the results open to the accusation that the time periods have been chosen to deliver the desired results.

There are two main potential distortions which need noting. Firstly, volatility in the relative prices of traded goods can affect trade intensities (or any other measure of regional bias). For example, for some countries a shift in the price of a major traded commodity (such as oil) could cause their trade intensity index to move in a way that does not reflect underlying movements in the volume of trade. As a result, selecting a data point immediately after oil prices have just doubled, or just halved, could result in unjustified conclusions being drawn.

A second distortion is that sudden shifts in the exchange rate can also cause the trade intensity index to move. For example, if the values of European currencies appreciate against the US dollar, then the dollar value of intra-EU trade rises accordingly. If we assume that the dollar value of extra-EU trade is unaffected, then the trade intensity indices between European countries will rise.<sup>40</sup> This should not be a surprise, as this would be the equivalent of all

---

<sup>38</sup> Calculated from IMF *International Financial Statistics*, commodity price indices.

<sup>39</sup> Calculated from the real effective exchange rate index in IMF *International Financial Statistics*.

<sup>40</sup> In terms of equation (1) above, the value of  $M_w$  rises, causing the value of the denominator to fall.

European countries raising intra-EU trade, while leaving trade with the rest of the world unchanged. This analysis ignores the effects that exchange rate shifts will have on trade volumes, but gives some idea of the possible short-term distortions involved in measuring trade bias using nominal data.

Large swings in commodity prices and exchange rates have been commonplace since the early 1970s, and so, in order to allow clearer identification of underlying trends, in the discussion below a time series of the data is presented. Graphs are used to show trade intensities for North America, Asia and Europe.<sup>41</sup> While many other regional groupings exist, I have chosen to focus on the three main areas in the world economy. None of the others is sufficiently large to have a marked impact on world trade flows, even though initiatives such as MERCOSUR are important to the countries concerned.

### **3.3.4 Regional Trade Intensities**

The above two approaches (bilateral trade intensities and intra-regional trade shares) form the basis for the calculation of regional trade intensities. However, combining the two contains more hazards than there might appear at first sight. As a result, the existing literature consists of several different approaches, with no consensus on the most appropriate methodology. The main problem in broadening out Brown's bilateral trade intensity measure to a regional basis is how (and whether) to make an adjustment to the denominator. As noted above, Brown adjusted the denominator to allow for the fact that the potential export market for any country is total world imports minus that country's own imports. As was also noted above, the methodology laid out by Brown gives slightly distorted results either when countries trade different amounts, or different growth rates occur. This is also relevant to an analysis of regional trade flows.

The failure of most studies to calculate trade intensity indices for regions, as opposed to countries, is perhaps a result of the uncertainty surrounding the methodology.<sup>42</sup> The main problem is that when a region (as opposed to a single

---

<sup>41</sup> Tables showing the data for the trade intensity indices used in the charts are presented in Appendix A1.

<sup>42</sup> For example, there are large differences in the results for 1990 shown by Frankel, Wei and Stein (1994) and Anderson and Norheim (1993). These are shown in Tables 3.3 and 3.4 below. Both use exports and imports in their calculations, for a more complete picture, and this is

country) is involved, the calculation is more complicated in terms of what adjustments to make to the denominator to allow for intra-regional trade. One approach is not to attempt to make any corrections to the original formula set out by Brown, and to examine all developments within a region in terms of the bilateral relationships of its members. This is the approach taken by Primo Braga and Bannister, who calculated trade intensity indices for ten Asian economies. They found that although there is evidence of a regional bias in Asian trade, for all countries except Hong Kong and Singapore the degree of intra-regional bias declined between 1970 and 1990.<sup>43</sup> It is also worth noting that the role of these two city states is a peculiar one, often acting as little more than an entrepôt.

Primo Braga and Bannister found that all major economies in the region witnessed a decline in the intensity of bilateral trade with the rest of the region in the two decades to 1990. Looking at the 1980s alone, only Taiwan and Hong Kong experienced a rise, albeit marginal, in their intra-regional trade bias. Thus they concluded that Asia showed an increase in globalisation in the 1970s and 1980s and a move away from regionalisation, when measured on this basis. Primo Braga and Bannister limited their analysis to calculating indices for various Asian economies and did not produce figures for a general Asian grouping. However, the conclusion that East Asia experienced decreasing regional bias in the two decades from 1970 is also reached in section 3.3.4.6 below.

The different methodologies discussed below mean divergent magnitudes of change are shown by trade intensity indices. However, in the section below which analyses data for Europe, North America and Asia, this approach is most useful for showing the underlying trend as well as showing the timing of when new trends emerge. For example, in the case of Europe it can be used to show how the trade bias of European countries shifts with each expansion of the European Union.

This approach can address issues such as whether trade bias is rising or falling and whether trade integration rising or falling, as well as identifying the timing of those changes. However, it does not show whether the degree of trade bias higher or lower than we would expect, or whether one region more or less

---

also the approach used below.

<sup>43</sup> Primo Braga and Bannister (1994) effectively measured bilateral flows between individual countries and the rest of the region.

integrated than another. In effect, the trade intensity index can be used in a dynamic analysis of changes in bias over time within a region, but not to conduct a static analysis of the degree of trade bias in relation to other macroeconomic variables.

### 3.3.4.1 Unadjusted denominator (Method 1)

In terms of calculating general regional measures, the most straightforward approach is that which makes no attempt to correct for intra-regional trade.<sup>44</sup> The method used is intra-regional trade divided by total trade of the region, as a proportion of total trade of the region divided by world trade.

$$I_{ri} = \frac{T_{ri} / T_i}{T_i / W} \quad (2)$$

$I_{ri}$  is the trade intensity index within region  $i$ .

$T_{ri}$  is the amount intra-regional trade in region  $i$ .

$T_i$  is total trade of the region.

$W$  is the total amount of world trade

Frankel, Wei and Stein also make calculations of intra-regional trade intensities using this approach and the results are shown in Table 3.3. Although Frankel, Wei and Stein's main focus is on a gravity model, they conclude that trade intensities show that East Asia's bias did not increase over the period while "In the case of APEC, the Western Hemisphere, the EC and most of the other groupings, however, there was indeed a trend towards intra-regional trade bias over the period by this simple measure".<sup>45</sup>

---

<sup>44</sup> That is to say, no adjustment is made to the denominator. This is the measure used by Frankel, Wei and Stein (1994) and Page (1996).

<sup>45</sup> Frankel, Wei and Stein (1994) p. 8.

	1965	1970	1975	1980	1985	1990
East Asia <sup>a</sup>	1.219	1.011	0.974	0.913	0.842	0.931
APEC <sup>b</sup>	0.529	0.911	0.908	0.872	0.967	1.015
European Community <sup>c</sup>	0.566	0.640	0.677	0.716	0.790	0.802
Western Hemisphere <sup>d</sup>	0.787	0.784	0.878	0.795	0.783	0.848

*Source:* Frankel, Wei and Stein (1994).  
a: East Asia includes the People's Republic of China, Hong Kong, Indonesia, Republic of Korea, Japan, Malaysia, the Philippines, Singapore, Taiwan and Thailand  
b: APEC is the fifteen members prior to the 1994 enlargement. Australia, Canada, People's Republic of China, Hong Kong, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, the Philippines, Singapore, Taiwan, Thailand, and the USA.  
c: The EC 12 (pre-1995 enlargement), excluding Luxembourg and the former German Democratic Republic  
d: Argentina, Bolivia, Brazil, Canada, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, the United States of America, Uruguay and Venezuela.

From equation (2) it can be seen that if the proportion of intra-regional trade is held constant, then the higher the share of the region in world trade, the closer the value of  $I_{ri}$  is to one.<sup>46</sup> This explains some of the apparently odd results from using this formula for regions which are only a very small part of world trade. In effect, the maximum value possible of  $I_{ri}$  for any region is the reciprocal of that region's share in world trade (i.e. the inverse of the denominator in equation [2]), as when  $T_{ri} \rightarrow T_i$ , then the trade intensity index  $I_{ri} \rightarrow W/T_i$ . For example, if we have a region which trades only internally (i.e. the numerator in equation [2] is 1), and where trade is one third of the world total, the value of  $I_{ri}$  is 3. However, a different region which again only trades internally, but which accounts for only five percent of world trade would have a trade intensity of 20. This is the reason why regions which account for only a small share of world trade can have a very high trade intensity, when calculated by Method 1, in equation (2). So although Page uses this approach and finds an export intensity of 12.4 for MERCOSUR in 1995, compared to 1.7 for the EU,<sup>47</sup> this is a reflection of the relatively small share of MERCOSUR in world exports (just 1.5%) compared to the EU (34.6%). It does not necessarily mean that there is higher degree of trade bias within MERCOSUR compared to the EU.

<sup>46</sup> The typical case is where  $T_{ri} / T_i > T_i / W$ , in which case  $I_{ri} > 1$ . Holding the numerator constant, as  $T_i$  rises relative to  $W$ , the value of  $I_{ri}$  falls towards 1.

<sup>47</sup> Page (1996) p. 18.



From this it is clear that cross-regional comparisons of the results generated by this method are not valid as the value of  $I_{ri}$  varies depending on the share of the region in world trade. However, the calculation can be used to track the development of regional bias in any given set of countries over time and as Page notes "the only interesting measure, I think, is changes in the intensity, not the level".<sup>48</sup> An attempt to normalise the denominator to account for this bias by expressing the value of  $I_{ri}$  recorded as a proportion of the maximum possible value of  $I_{ri}$  simply gives the result of regional trade as a proportion of total trade.<sup>49</sup>

This measure of regional trade bias will tend to give a relatively low result compared to the other two methods outlined below, as no attempt is made to adjust the denominator for intra-regional trade. The other two methods discussed below involve an adjustment which has the effect of lowering the value of the denominator and thereby raising the regional trade intensity measures.

### 3.3.4.2 Adjusted denominator A (Method 2)

The numerator of equation (2) used by Page, and by Frankel, *et al.*, is not the problem in producing an unbiased measure of regional trade intensities. Difficulties lie in the denominator. When there is only one country involved, simply subtracting its imports from the total world trade figure in the denominator (as Brown does in equation [1] above) is straightforward (while bearing in mind the caveats noted above). When a region is involved the calculation is more complicated as the issue is how to make adjustments to allow for intra-regional trade.

The most detailed study which makes an adjustment to the denominator is by Anderson and Norheim, who amended the basic formula developed by Brown to make allowance for the fact that countries in a region trade among themselves as well as with the rest of the world.<sup>50</sup> Anderson and Norheim study a wide range

---

<sup>48</sup> Page, "personal correspondence", 8 October 1997; on file with the author.

<sup>49</sup> An attempt to express the value of  $I$  returned as a proportion of the possible maximum value would give  
 Normalised  $I_{ri} = I_{ri} \cdot W / T_i$   
 Which reduces to  
 Normalised  $I_{ri} = T_{ri} / T_i$  using equation (2), which is the numerator in (2).

<sup>50</sup> Unfortunately, Anderson and Norheim (1993) do not state their formula for the intra-regional trade intensity index, but it can be "reverse engineered" as shown in equation (3).

of data, calculating trade intensities for various groups of countries at various points in time since 1830. Some of their findings are shown in Table 3.4.

Anderson and Norheim conclude that there is evidence of an increase in the intra-regional trade bias of most regions in the post-war period. However, they go on to look at the relative openness of the regions in terms of trade to GDP ratios and conclude that "even if RIAs [regional integration agreements] have caused some trade diversion, integration between regions—at least as measured by merchandise trade—has continued for the world as a whole".<sup>51</sup>

	1948	1958	1968	1973	1979	1983	1990
Western Europe <sup>a</sup>	1.21	1.38	1.51	1.54	1.57	1.72	1.60
Eastern Europe <sup>b</sup>	10.22	7.62	7.30	7.67	7.88	7.28	10.88
Asia <sup>c</sup>	2.74	3.15	2.84	2.88	2.77	2.41	2.31
North America <sup>d</sup>	2.24	2.72	2.90	3.22	3.09	2.98	3.21

*Source:* Anderson and Norheim (1993).  
a Includes Turkey and Yugoslavia.  
b Includes the USSR.  
c Includes Australia and New Zealand as well as the countries listed under "East Asia" in Table 3.1 above.  
d Canada, Mexico and the United States of America.

The formula used by Anderson and Norheim can be "reverse engineered" from their description and their published results:

$$I_{ri} = \frac{T_{ri} / T_i}{(T_i \times (N-1)/N) / (W - (T_i \times 1/N))} \quad (3)$$

Where

$I_{ri}$  is the trade intensity index within region i.

$T_{ri}$  is the amount intra-regional trade in region i.

$T_i$  is total trade of the region.

Thus the numerator of the equation is essentially the same as that in the single country example in equation (1).

$W$  is the total amount of world trade

$N$  is the number of countries in the region

<sup>51</sup> Anderson and Norheim (1993) p. 45.

What is happening in this case is that the denominator is being adjusted to take into consideration trade among countries in the region. The more countries there are in the region, the less adjustment is made to the denominator and the closer the result to that under Method 1. Using an adjustment based on the number of countries in the region might appear crude, but it is quite effective. If all countries within the region trade the same amount, then when no regional bias exists the trade intensity will be unity.

For example, assume there are only ten countries in the world, each of equal size, all of which trade in equal proportions with each other. There are two trade groups, one with four countries and the other with six. By this measure the trade intensity indices for the four country group and the six country group will both be unity.<sup>52</sup> In contrast, using the formula in equation (2), the four country group gives an index of 0.833 while the six country group returns 0.926. Some distortions arise when the value of trade of the various countries differs, but even then the index does not diverge significantly from unity in the base case when no regional bias actually exists. That is to say, the error of the trade intensity index finding a bias, when none exists in reality, is reduced.

The adjusted denominator A (Method 2) is more effective than the unadjusted denominator (Method 1) in showing no bias (in terms of deviation from 1), when no bias exists. However, it is worth considered another means of adjusting the denominator to take into account intra-regional trade.

### **3.3.4.3 Adjusted denominator B (Method 3)**

Another means of adjusting the denominator for intra-regional trade is one which says that in equation (1) the denominator is supposed to be the control or neutral measure of the share of the country or the region in world trade. That is to say, it indicates how much the countries not under examination (i.e. the rest of the world) trade with the country or the region. Thus an alternative calculation of the trade intensity could involve subtracting all of the region's trade with itself from the denominator. This allows the denominator to show the share of the region in world trade excluding all intra-regional trade.

---

<sup>52</sup> Assuming each exports 2 units to each other, the calculation for the four country group is  $(24/72) / (54/162)$ , while for the six country group it is  $(60/108) / (90/162)$ .

$$I_{ri} = \frac{T_{ri} / T_i}{(T_i - T_{ri}) / (W - T_{ri})} \quad (4)$$

Where

$I_{ri}$  is the trade intensity index within region i.

$T_{ri}$  is the amount of intra-regional trade in region i.

$T_i$  is total trade of the region.

$W$  is the total amount of world trade

Although this appears to be a sensible approach it does not give a result of unity when no trade bias exists. In the example noted above with ten countries split into two groups, formula (4) gives a reading of 1.083 for the four country group and 1.389 for the six country group.<sup>53</sup> Larger blocs will return a higher figure, so the results must be treated with caution, with comparisons between regions not valid.

In terms of the difference between the three methods outlined above, Method 1 will tend to understate the degree of preferential trade bias because of the lack of adjustment to the denominator. Method 3 gives an upwards bias as a result of the adjustment to the denominator, while Method 2 usually sits between the two. As a result, it is possible to make observations about trends over time when all three measures are pointing in the same direction. In fact, as long as a consistent formula is used, minor differences in its structure are not that important if the objective is to look at trends over time within the same region. As has been discussed, however, making comparisons between regions is much more problematic. In the following section, the results of calculations based on these three approaches are shown.

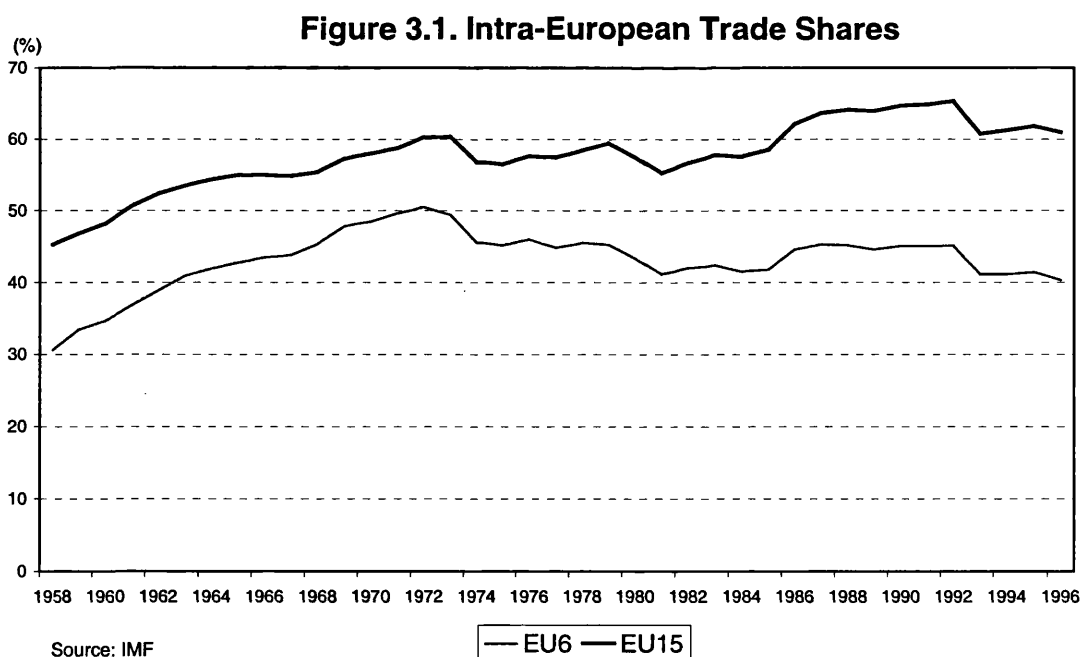
---

<sup>53</sup> Again assuming each exports 2 units to each other, the calculation for the four country group is  $(24/72) / (48/156)$ , while for the six country group it is  $(60/108) / (48/120)$ .

### 3.3.4.4 Europe

The Europe Union has gone through several enlargements and structural changes since its foundation and there are three main areas of interest related to this progression.<sup>54</sup> Firstly, how the overall level of regional trade bias has been affected by initiatives to promote regional integration. Secondly, how the trade bias of the original members has changed through the course of their membership. Thirdly, what has been the behaviour of the trade bias of later members, both before and after their membership.

As with other regional groups, the basic hypothesis is that the establishment of, or accession to, the EU leads to an increase in preferential bias in trade flows between members. Similarly, subsequent steps to reduce restrictions on cross-border activity should lead to a rise in the degree of regional bias. This section focuses on merchandise trade flows, with other data sources discussed later in the chapter.



Looking at data for shares of intra-regional trade does not offer much support for this hypothesis. As Figure 3.1 shows, the share of trade between the

<sup>54</sup> What is now the European Union (EU) has also gone through several name changes; in general we will use the most recent form.

original six members was lower in 1995 than it was 30 years earlier. The share of trade between the current 15 members shows only a moderate increase over the same period, from 55.0% in 1965 to 61.8% in 1995. This is a surprising result, considering the political effort expended on promoting European integration.

However, the situation is not quite as straightforward as the trends in Figure 3.1 suggest. Rather than coming to the conclusion that the preferential bias between the original six members has fallen and that of the current 15 members has risen only slightly over the past three decades, the trade intensity index provides more insights into developments. The share of world trade accounted for by the 15 EU members fell from 47.0% in 1965 to 38.6% in 1995 and this gives a downwards bias to measures of regionalisation such as intra-regional trade shares. This is because as world trade grows more rapidly than intra-European trade, then trade between Europe and the rest of the world will grow more rapidly than trade within the region, even if no change in trade bias is taking place. As discussed above, in order to correct for this effect an adjustment needs to be made to account for the reduction in the importance of EU members in world trade. This is a case where the trade intensity index can provide more useful insights than pure trade shares.

An additional factor is that the behaviour of the broad measures of trade shares conceals some interesting trends. Most notably, there has been a rise in trade bias between EU members over the past three decades, which has taken the form of rising preferences stemming from the incorporation of new members, rather than increases in bias between the initial members. This will be illustrated by breaking down the EU aggregate figures into smaller groups of countries, according to the date of membership. Again, the use of the trade intensity index allows differentiation between shifts in trade flows due to changes in the share of world trade, and those due to a genuine preferential trade bias. The findings from this process lend support to the hypothesis that broadening and deepening of the EU has led to an increase in trade bias. The use of a time series approach gives a clearer indication of the timing of changes in trade bias, compared to examining discrete points in time, as is the norm.

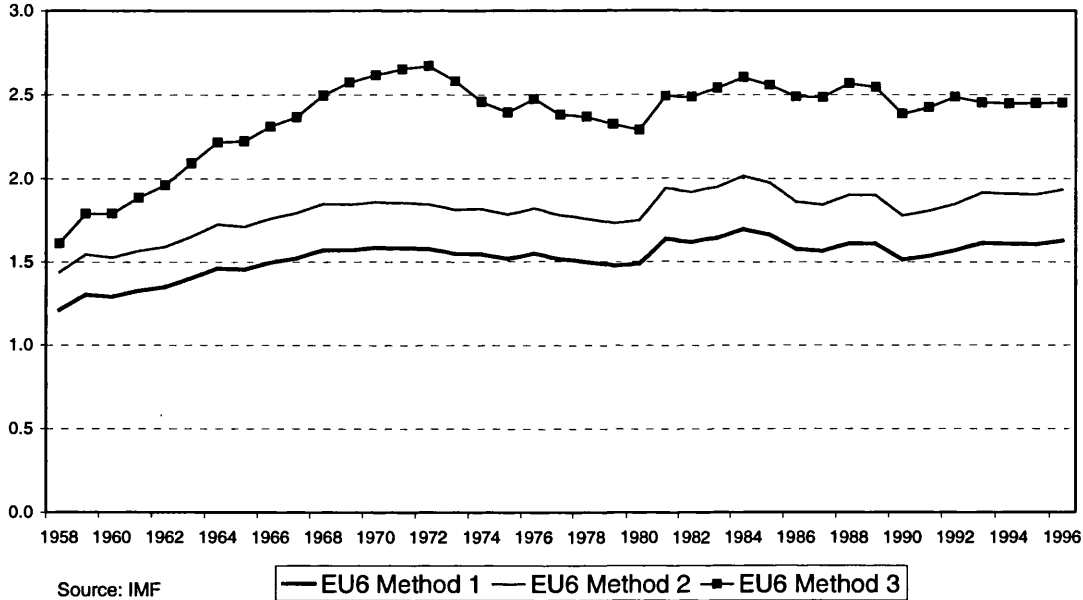
Using the trade intensity index, Figure 3.2 shows the behaviour of the trade bias of the original six members.<sup>55</sup> The trade intensity index is useful in

---

<sup>55</sup> For the sake of comparison, the results of the three methodologies discussed above in

showing trends as well as identifying the timing of any new trend. This shows that after a quite rapid rise in trade intensities in the first ten years of the EU, there has been virtually no increase in the regional bias of the original six since the end of the 1960s. This finding deserves elaboration. It also contrasts with the impression given simply by looking at intra-regional trade shares (Figure 3.1), without making any adjustment for changes in the relative size of the region. The implication is that the falling shares of intra-European trade of the original six members were the result of a decline in the share of Europe in world trade, and not the result of a reduction in preferential bias between EU members.

**Figure 3.2. European Union 6 Trade Intensity Index**



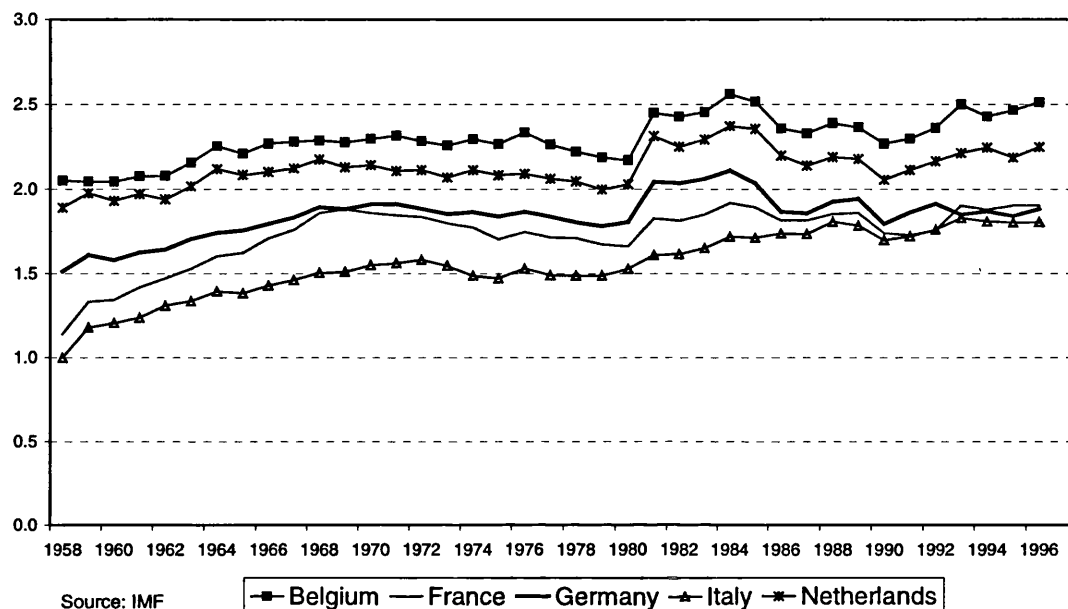
A more disaggregated approach both confirms the results shown in Figure 3.2 as well as showing that individual EU6 members' trade bias has been stable, as well as their aggregate bias. This is demonstrated in Figure 3.3, which examines the flows of individual countries with other EU founder members, by showing the trade intensity of each country with the other four combined.<sup>56</sup> The lack of an increase in the trade intensity index for Germany, France and the

3.3.4.1 to 3.3.4.3 are shown. Although different level are shown, each has the same behaviour of rising until the late 1960s and then trending sideways.

<sup>56</sup> Trade data for Luxembourg are included with Belgium, which is the practice of the IMF.

Netherlands since the late 1960s is evident, accompanied by a very moderate rise in the measures for Italy and Belgium. This confirms that there is no evidence of a significant increase in trade preferences within the core of the EU6 in the past three decades.

**Figure 3.3. Trade Intensity Index Between EU6**



Using the original methodology set out by Brown *et al.* it is possible to disaggregate the process even further and examine the behaviour of the bilateral trade bias of individual member countries. The data are set out in the appendix and show that very few bilateral relationships between the EU6 founder members saw a meaningful increase in trade bias since the late 1960s, with small declines being recorded in several instances. Such a pattern confirms the findings shown in Figures 3.2 and 3.3. Again, this is a useful progression from simply looking at trade shares, as it adjusts for the reduction in the share of world trade and gives a clearer view of changes to trade preferences.

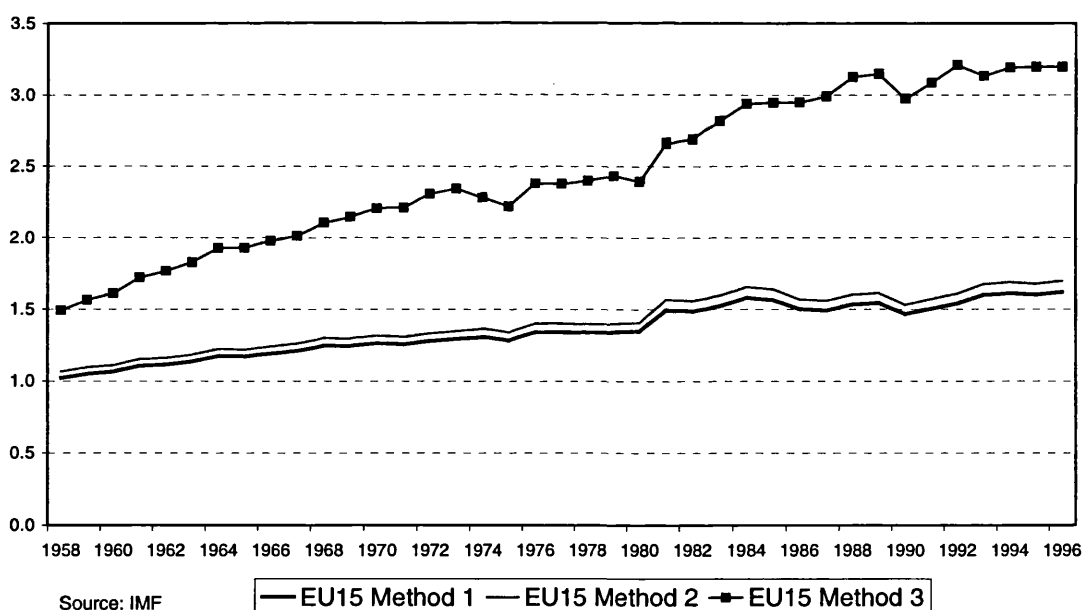
So although the preferential trade bias between the six founder EU members has not declined over the past three decades (unlike the intra-regional trade share), neither has it shown an increase. The absence of a noticeable change in the trade bias of the core of the EU over the past three decades comes as something of a surprise, set in the context of steady policy



development.<sup>57</sup> As will be shown, the most likely explanation is that there has been an increase in bias towards new EU members and towards other countries concluding free trade agreements with the EU. Trade bias is a relative concept, with an increase in bias towards some countries necessarily offset by a reduction in bias towards others.

Although preferential bias between the EU6 core members has been neutral, this does not mean that economic integration has shown no increase. As will be demonstrated in section 3.3.5, a rise in the degree of openness within Europe, as shown by rising trade to GDP ratios, means that economic integration has increased. As discussed below in section 3.4, attempts to examine foreign direct investment flows (FDI), to see whether stability in trade bias is offset by an increase in the bias of FDI, prove difficult due to data problems.

**Figure 3.4. European Union 15 Trade Intensity Index**



A gentle rise in the intra-regional trade share of the current EU15 was shown in Figure 3.1 and that is more pronounced once adjustment is made for the decline in the share of world trade of the EU. Figure 3.4 shows a rise in trade

<sup>57</sup> As discussed, the trade intensity index shows whether trade bias has changed, but it does not show whether it has changed by more or less than expected, given macroeconomic developments. However, it does allow us to test the hypothesis that regionalism leads to greater regional trade bias.

bias as measured by each of the approaches outlined in sections 3.3.4.1 to 3.3.4.3 since the foundation of the EEC in 1958. Although the degree of increase differs according to which method is adopted, the same trends are evident. The absence of an increase in trade bias through much of the 1970s suggests that the EEC had little impact on trade preferences until it broadened its membership and then adopted the single European market agreement at the end of the 1980s. Since then an increase in preferential bias has resumed.

However, a deeper examination of the trade flows between the EU membership is more informative. By disaggregating the trade flows of the overall 15 countries according to the timing of participation in the organisation, then other trends become apparent. Again, the trade intensity index is useful as it shows trends in trade bias once allowance has been made for shifts in the share of world trade. In the discussion below the trade intensity index is also useful for showing the timing of shifts in the trend of trade bias, which allows inferences to be drawn in relation to the timing of EU broadening and deepening.

If the preferential bias between the EU15 has been rising over the past three decades, while that of the core EU6 has shown little change, then this implies a fairly substantial rise in the bias of the other nine members with the core EU6 and/or with each other. This will be shown below and to demonstrate the significant points the 15 members are split into four groups, determined by the timing of their membership:

- |          |   |
|----------|---|
| Founders | Original six members  |
| Stage 1  | First stage expansion to Denmark, UK and Ireland (1973)                   |
| Stage 2  | Second stage expansion to Greece (1981), Portugal (1986) and Spain (1986) |
| Stage 3  | Third stage expansion to Austria, Finland and Sweden (all 1995).          |

Figures 3.5 to 3.8 show the trade intensity indices of each of these four groups in turn, related to trade with the other three groups and to themselves.<sup>58</sup> This allows us to see swings in trade preferences within the EU, after adjusting for the impact of changing shares of world trade. Figure 3.5 shows the trade

---

<sup>58</sup> The lines show the degree of bias of each of the groups in trade with the EU6, using equation (1) as set out by Brown et al. The intra-group measure (ie. Founders' trade with the Founders) is calculated using the methodology in 3.3.4.2 above.

intensity index of the Stage 1, Stage 2 and Stage 3 groups vis-à-vis the Founder group. It also shows the trade intensity index for intra-regional trade within the Founder group,<sup>59</sup> and this ability to examine intra-group flows is another advantage of using the trade intensity approach.

Figure 3.5 shows how the bias of new EU members towards the original members has changed. Stage 1 countries saw a steady rise in their trade bias towards the Founder group in the decade after they joined the EU and it seems likely that membership had a positive influence on their trade preferences. However, the bias has been little changed from the early 1980s. Stage 2 countries also saw a rise in trade bias towards the Founders from when they joined the EU, in the early 1980s.

**Figure 3.5. Trade Intensity Index Towards EU6 'Founders'**

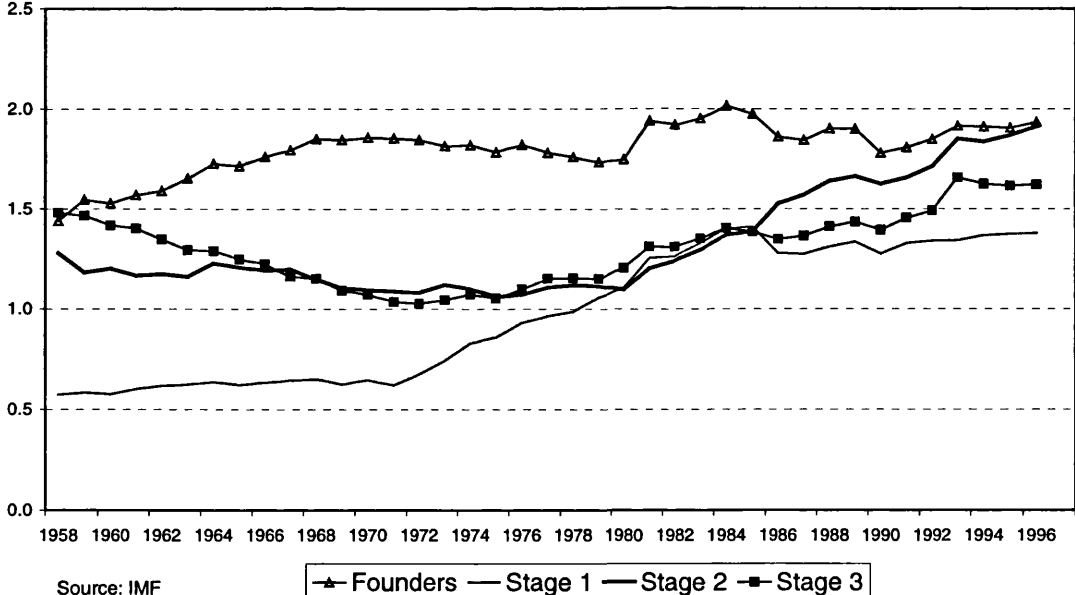
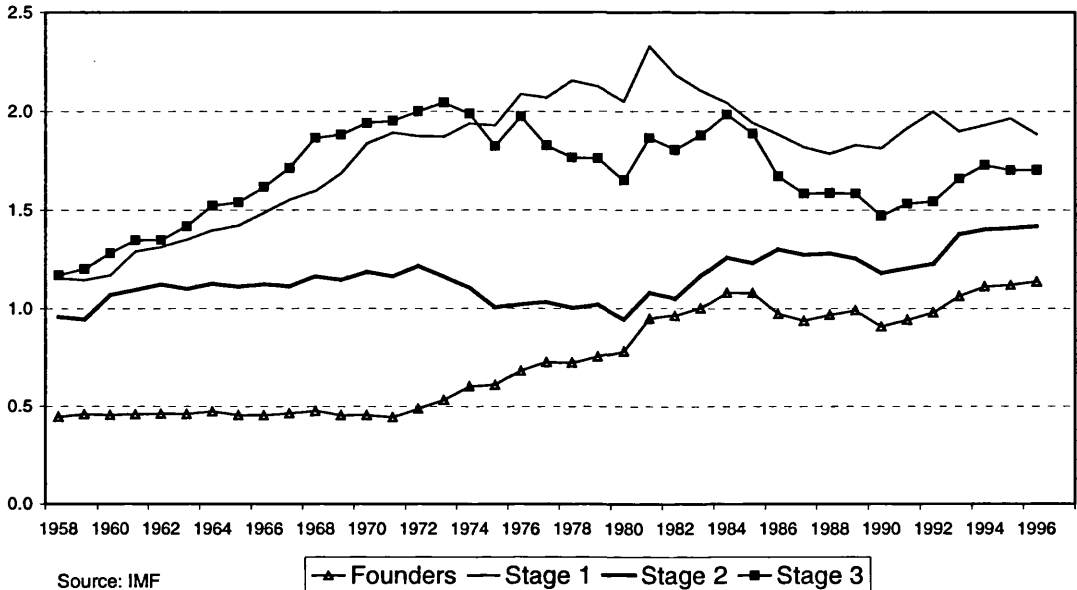


Figure 3.5 also shows that Stage 3 countries saw a decline in bias towards the Founder group until the mid-1970s. The next chart, Figure 3.6, suggests that this was because they were experiencing a rise in bias towards members of the European Free Trade Area (such as those countries which later became the Stage 1 enlargement group) after its formation in 1960. This bias then reversed

<sup>59</sup> In Figure 3.5 the line showing the intra-regional trade of the Founder's group is the same as the middle line in Figure 3.2, labelled "EU6 Method 2".

when the Stage 1 group joined the EU and saw its trade bias towards the Founder members rise. It is notable that the bias of trade between the Stage 3 enlargement group and the Founder group began to rise from the late 1970s. This indicates that full membership of the EU was not necessary for an increased trade bias. In 1973 a free trade agreement which removed most tariffs was signed between the EEC and EFTA, followed by comprehensive liberalisation in the formation of the European Economic Area between the two groups in 1992.<sup>60</sup>

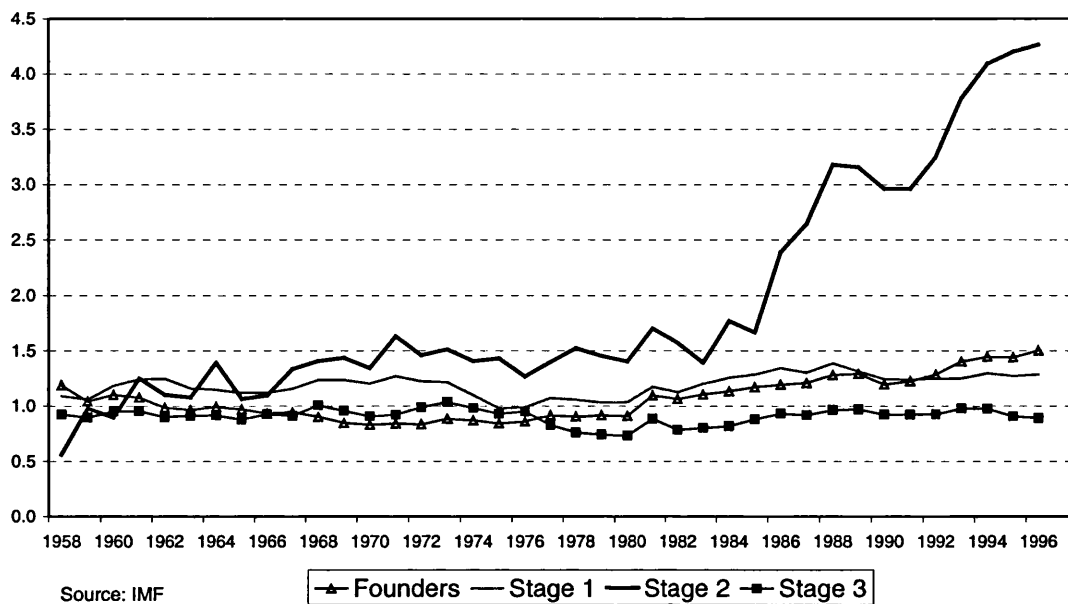
**Figure 3.6. Trade Intensity Index Towards Stage 1 Enlargement**



As discussed above, the absolute levels of the trade intensity indices for different groups shown in Figures 3.5 to 3.8 should not be compared. Such an approach would suggest that the Stage 2 countries have a stronger bias towards Stage 1 countries than do the EU6 Founder members, which seems implausible. The indices should only be used to indicate direction and the timing of changes in bias.

<sup>60</sup> WTO (1995).

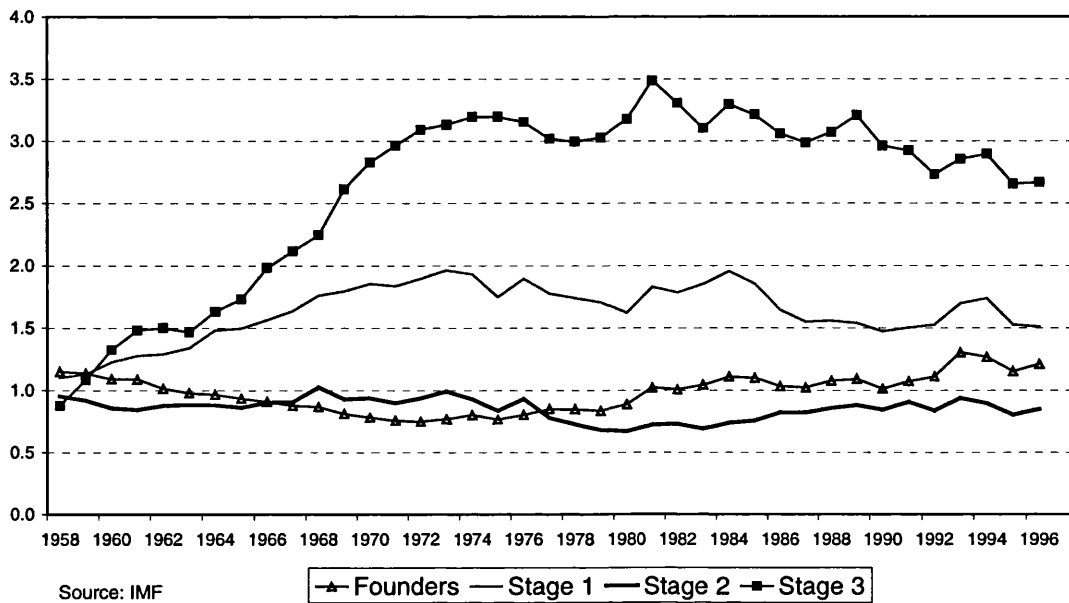
**Figure 3.7. Trade Intensity Index Towards Stage 2 Enlargement**



It is notable that the trade intensity indices towards the Stage 2 group show relatively little change over the period, as shown in Figure 3.7, although there are indications of a rise in bias of trade with the Founder group after the Stage 2 countries join the EU. In fact it appears that the major consequence of membership was an explosion of trade bias between the State 2 countries of Spain and Portugal. This could be a reflection of the EU's ability to improve relationships between members in all areas, not just trade.

Similarly, the most marked rise in bias for the Stage 3 group was between the three members themselves in the period up to the mid-1970s, presumably due to the effect of EFTA membership. Otherwise, their trade preferences appear to be strongly influenced by membership of regional groupings. Up until 1973 preference was growing towards Stage 1 countries, but when the UK, Denmark and Ireland left EFTA and joined the EU, the Stage 3 countries also gradually shifted their focus towards all EU countries, assisted by the preferences which resulted from the 1973 EEC-EFTA free trade agreement.

**Figure 3.8. Trade Intensity Index Towards Stage 3 Enlargement**



This analysis leads us to an explanation for the surprising observation that there was no increase in the trade bias between the original six European members from the late 1960s. The Founder members were seeing a rise in trade bias towards the nine new members from 1973. Of course bias is a relative concept and the rise in bias towards one group implies a reduction in bias towards another. The ability of the bias between the Founder six members to remain stable while the bias towards new members was rising implies a positive response to continued integration effects, which means that it was trade bias towards non-European countries that declined over the period.

This more disaggregated approach is useful as it explains why there has been a steady rise in trade bias within the EU15, as shown in Figure 3.4. This rise in trade bias first occurred mainly through increased trade bias between the EU founder members, but this came to a halt in the 1970s and was replaced by an increase in preferences between the EU6 and the new members, and among the new members. The original six members of the EEC eliminated internal tariffs and quantitative restrictions on trade by 1968 which also marks the point at which the increase in preferential bias between the original six members levelled off.<sup>61</sup> None of the deeper integration that occurred in Europe after 1968 was

<sup>61</sup> Lawrence (1996).

manifested in an increase in the trade intensity indices between the original six members.

Using the trade intensity index allows these patterns to be seen without being clouded by the impact of changing shares of world trade. Using simple trade shares it is not possible to differentiate between the conflicting impact from rising trade bias and a declining share of world trade. Rather than coming to the conclusion suggested by measures of regional trade shares, the trade intensity approach shows that intra-European trade has become more positively biased due to increase bias between Founder members and new entrants, and between the new entrants.

The increase in the intra-regional trade intensity of all European groups since 1990 suggests a renewed policy-led increase in trade bias. The timing of the implementation of the Single European Act makes such a conclusion appear credible, and later discussion will examine whether this has been to the detriment of trade ties with the rest of the world. Although the creation of a single European market was frequently referred to as "1992", in fact many of the relevant measures were implemented prior to 1992 and others took much longer.<sup>62</sup> Moreover, the "deep" nature of the agreement suggests that its impact on trade intensities could well have been seen prior to 1992. This is because firms would begin to ready themselves for the consequences of the programme, as well as anticipating greater safeguards once it was in place. However, the integrating process is also likely to be a lengthy one, with effects seen through most of the 1990s. This would indicate that measures of regional intensity are likely to rise above their pre-1988 trend line (which was around the time business began to treat the single European market as a reality).

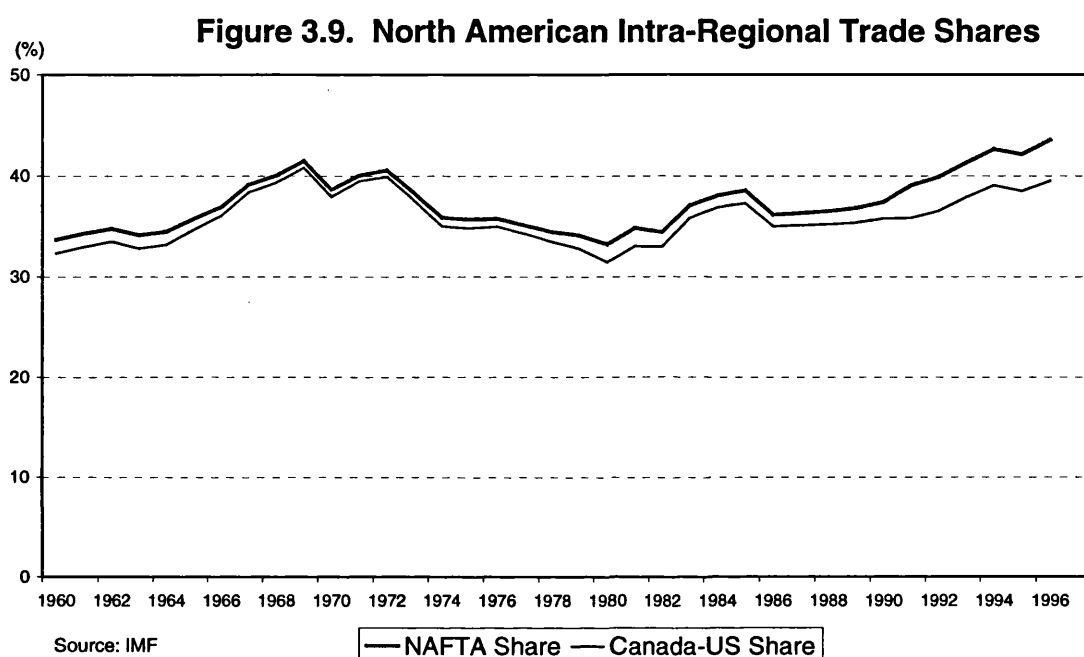
### **3.3.4.5 North America**

There have been three major landmarks in North American regionalism in the past four decades. The first was the Canada-US Auto Pact of 1965, which eliminated duties on 95% of bilateral automobile trade (which made up 10.9% of

---

<sup>62</sup> In fact even by the end of 1994 on average only 92% of the measures related to the Single European Market had been implemented. In areas such as public procurement or intellectual property, fewer than 80% implementation was recorded by the European Commission. *Daily Telegraph*, 23 February 1996.

total bilateral trade in 1965). The second was the broad Canada-US Free Trade Agreement (CUSFTA) which was signed in 1988 and liberalised trade flows across the board, including provisions for services and FDI. The third was the North American Free Trade Agreement (NAFTA) which, in 1994, brought Mexico into the agreement between the US and Canada.<sup>63</sup> A reasonable hypothesis is that the regional bias of trade would increase as a result of such deals due to the preference granted to each partner.



Looking at intra-regional trade shares, in Figure 3.9, by the end of the period under examination, the share of trade between regional partners was only slightly higher than at the previous peak in 1969. The pattern is one of decline in intra-regional trade shares until 1980 and then a revival through the 1980s and 1990s. However, North American trade was growing relatively slowly through this period, so the decline in intra-regional trade shares in the 1970s does not necessarily mean that intra-regional trade *preference* declined. CUSFTA's share of world trade fell from 20.7% in 1965 to 16.8% in 1995, while NAFTA's share fell from 21.5% to 18.3% and, other things being equal, this will reduce the intra-

<sup>63</sup> See Lipsey, Schwanen and Wonnacott (1994) for details of the differences between NAFTA and CUSFTA.



regional trade share. As with the above discussion of the European Union, using the intra-regional trade intensity approach gives a different perspective, because this adjusts for changing shares of world trade.

North America also provides a good example of the merits of using a time series of annual data rather than comparing certain time periods. For example, Anderson and Norheim show data for 1968, 1973, 1979, 1983 and 1990 and conclude that for Canada and the USA "the intensity of its intra-regional trade rose in the 1970s before falling slightly since then".<sup>64</sup> However, this conclusion is far from clear when looking at Figure 3.10, where the line labelled "CUSFTA Method 2" reflects the same methodology used by Anderson and Norheim.<sup>65</sup> Observation of trends shown in Figure 3.10<sup>66</sup> leads to the conclusion that the underlying trade intensity index in North America rose in the 1960s, was flat through the 1970s and much of the 1980s before climbing again from the late 1980s. Short-term fluctuations in the 1970s and 1980s are most likely explained by movements in the dollar exchange rate and oil prices, rather than by changes in the underlying degree of economic integration.<sup>67</sup> A strong dollar has the effect of lowering the trade intensity measure for North America, as it lowers the dollar value of non-dollar denominated trade and thus raises the value of the denominator in each of the three calculation methods used.

---

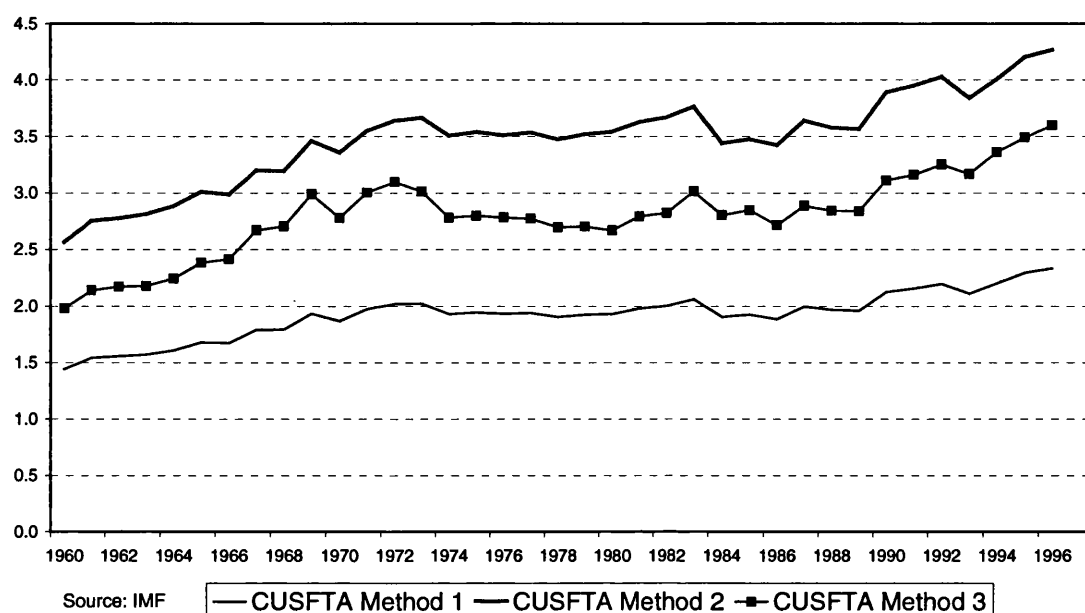
<sup>64</sup> The intensities Anderson and Norheim calculate are 3.57, 3.93, 3.63, 3.63 and 3.50 respectively. (1993) p. 33. Using the same methodology (i.e. Method 2 in Figure 3.10) the corresponding five points on Figure 3.10 are 3.20, 3.67, 3.52, 3.77 and 3.89.

<sup>65</sup> It would be possible to represent CUSFTA trade bias in terms of bilateral flows, but the regional approach is adopted in order to allow the comparison with Anderson and Norheim's findings. The bilateral export intensity index between Canada and the USA is shown in Figure 3.11 and that shows a similar trend to the series in Figure 3.10.

<sup>66</sup> The data represented in the charts in this chapter are shown in Appendix A1.

<sup>67</sup> In theory it is possible to use a given year as a base and to calculate trade volume growth figures, but any base year will contain some currency misalignments, while volume growth data are less reliable than measures of trade value. Moreover, volume trade data are not generally available on a country by country basis. Trade in oil could be excluded, but lower oil prices also affect prices of other related primary, intermediate and final traded goods.

**Figure 3.10. Canada-US Trade Intensity Index**

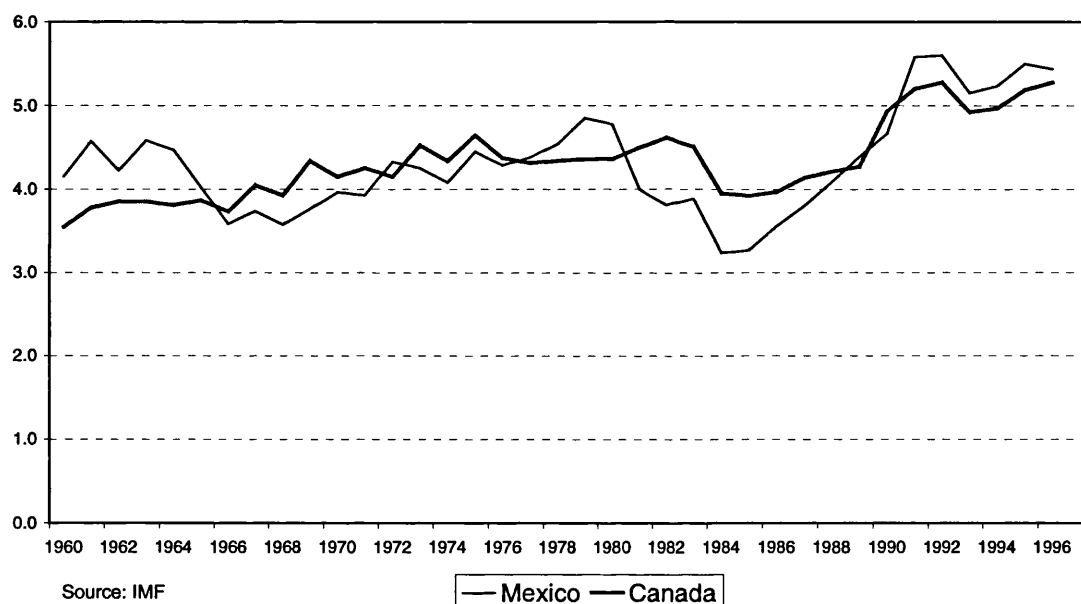


The conclusion for CUSFTA is that the Auto Pact of 1965 had little impact on regional bias, which was rising steadily through the 1960s. Given that it affected only around 10% of bilateral trade, this is unsurprising. The Canada-US Free Trade Agreement (CUSFTA) precedes the increase of trade intensities since the late 1980s. There has been a change which cannot be explained purely by price movements, and the timing and liberalisation involved in CUSFTA suggests that it has been a factor in increasing trade preferences between Canada and the United States. The CUSFTA was implemented in 1989 after eighteen months of negotiations produced a treaty in 1988. As a result, it tells us little about the time lags that might be involved in terms of the response of economic actors to discussions over trade deals. Incorporating Mexico into the analysis does not produce significantly different trends from those shown in Figure 3.10. Mexico is only 18% of intra-regional North American trade, compared to 48% for the USA and 34% for Canada. The result of the trade intensity index calculations for NAFTA are shown in the Appendix.

Mexico was not a part of CUSFTA, but nevertheless saw its trade bias with the US rise from the late 1980s; the export intensity of Mexico and Canada with the USA is shown in Figure 3.11. The more extreme volatility in Mexico's export intensity index with the US can be ascribed to fluctuations in the price of

one of its main exports; oil. As discussed above, price and exchange rate volatility can distort findings, especially if discrete data points are used in the analysis. This highlights the benefits of using a time series approach. It is striking to note the parallel rise in Mexico and Canada's export intensity indices with the USA since the late 1980s, in spite of a period of relative weakness in oil prices. This implies that there were other factors at work in North American trade flows besides the liberalisation that was part of the 1988 CUSFTA. Possible explanations will be discussed in more detail in Chapter 6, but a likely reason is that production was becoming regionalised, perhaps in anticipation of the eventual NAFTA deal.

**Figure 3.11. Mexico & Canada Export Intensity Index with USA**

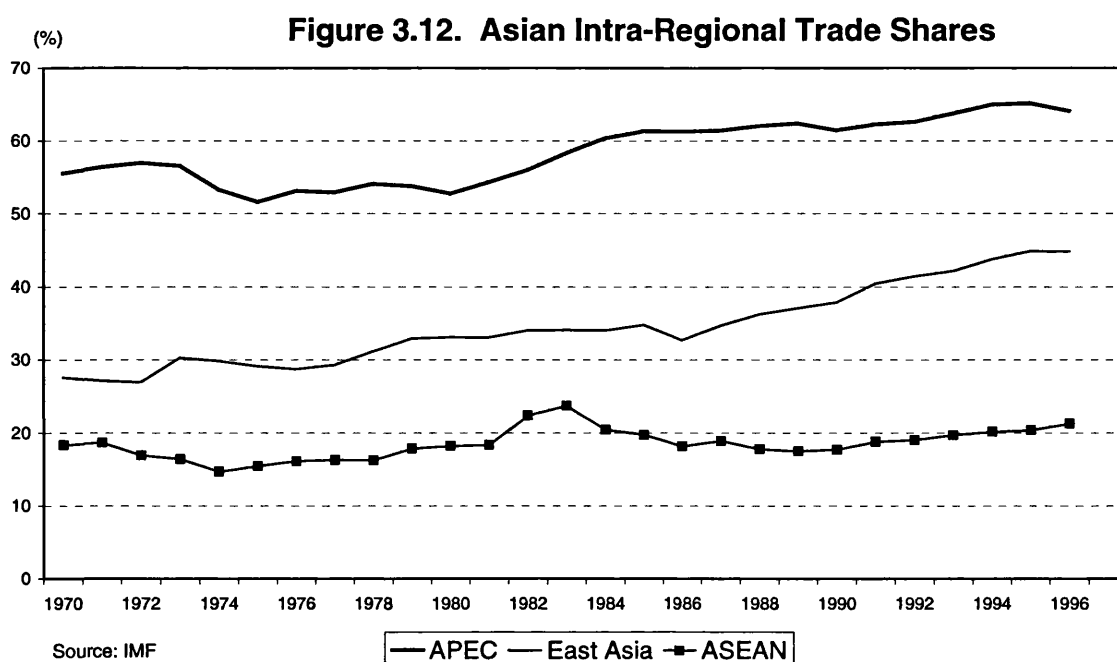


NAFTA only came into effect in 1995, so as yet it is too early to say conclusively whether it has provided an additional boost to regional trade bias. However, it is worth noting that 1996 saw the highest level for the NAFTA intra-regional trade intensity index in the past 30 years by all three measures used.

### 3.3.4.6 East Asia

While the geographic scope of both North America and Europe is reasonably well defined, with decisions on whether the smaller peripheral economies should be included in statistical calculations having only a marginal effect on the result, the same is not true of Asia. There are three realistic measures of a regional group in Asia; the small, but clearly defined ASEAN bloc; the large, but loose trans-Pacific APEC grouping; and the East Asian subgroup, the definition of which is based on the East Asian Economic Group proposed by the Malaysian Prime Minister Mahathir Mohamad in 1990.

As Figure 3.12 shows, the share of intra-regional trade within East Asia and APEC has risen steadily for two decades. With the economies of the region also becoming more open (see section 3.3.5 below) this means that regional integration has increased through the period. However, it does not necessarily mean that the preferential bias of trade between regional partners has risen over the same period. In fact, the increase in the share of intra-regional trade in APEC and East Asia is the result of a rising share of the region in world trade, rather than a function of increased bias between regional countries, as discussed below. Again, using a trade intensity index helps to differentiate between changes in regional trade shares that are a result of an increase in trade preferences and those that stem from differential rates of trade growth. Although the conclusion that intra-regional trade has not become more strongly biased is surprising, given the trends evident in Figure 3.12, it is a sign of greater integration in the global economy. This integration has helped to deliver the relatively high growth rates that lead to a growing share of world trade for the region, and produce the upward bias in Figure 3.12.



The East Asia group<sup>68</sup> shows a rising share of intra-regional trade, from 27.5% of the total in 1970, to 44.9% by 1995 in Figure 3.12. This is not particularly surprising, given the relatively rapid growth in the region, which has seen its share of world trade more than double from 10.7% to 25.1% over the same period. As with Europe and North America, in order to see whether this change is more or less than implied by the rise in importance of the region to world trade, it is useful to use a trade intensity index. Simply observing the rising share of intra-regional trade does not show whether this is a result of changing trade bias or of differential growth rates.

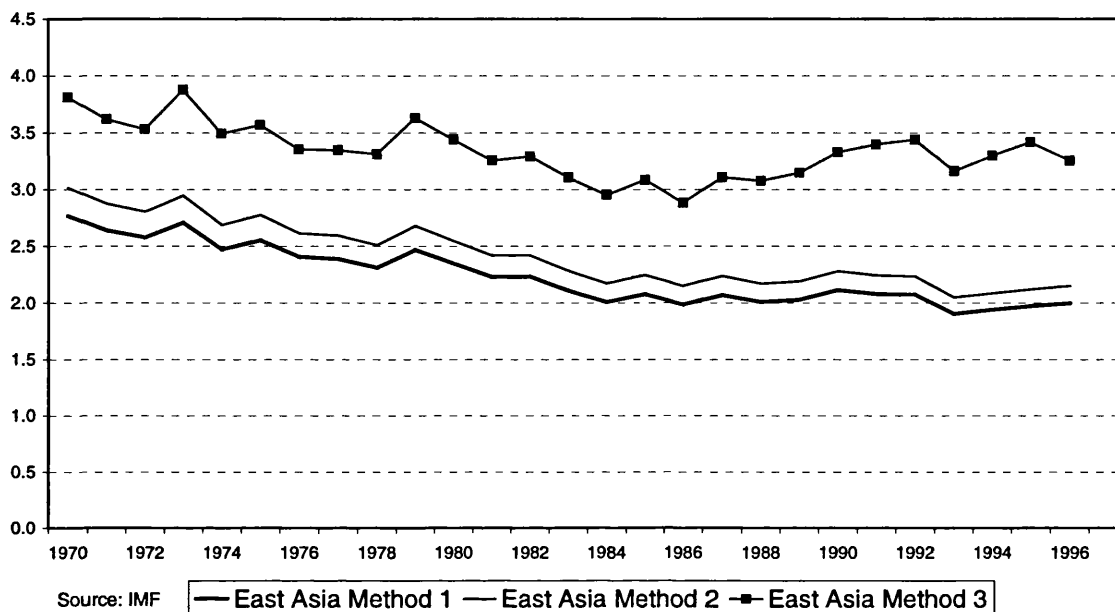
Using this trade intensity approach, Figure 3.13 shows a gently declining intra-regional trade bias until the mid-1980s, since when there has been basic stability. In part, the decline in regional trade intensities up to the mid-1980s can be ascribed to the increased flow of trade being concentrated on the developed economies of Europe and, particularly, North America. The dominance of Japan in East Asian trade is not as complete as that of the United States in North America,<sup>69</sup> but shifts in Japan's trade bias tend to tell the story of the East Asia group as a whole. Thus the decline in intra-regional East Asian bias up until the

<sup>68</sup> Appendix A2 shows which countries are included in each group.

<sup>69</sup> In 1970 Japan's trade was 60.6% of the East Asian total, declining to 30.6% by 1995. In North America, the United States' trade comprised 70.7% and 71.7% in those same two years.

mid-1980s (around the time that US trade policy became notably more restrictive) shown in Figure 3.13 was partly a reflection of Japan focusing on US markets.

**Figure 3.13. East Asian Trade Intensity Index**



Part of the rise in the measured bias between Japan and the USA can be attributed to the strong dollar through the first half of the 1980s, peaking in the year of the Plaza Accord, 1985. Stability in the measure of trade bias since then reflects a greater balance in Japanese trade relations. For example, the share of Japan's trade with the USA rose from 21.2% in 1976 to a peak of 33.3% in 1986 (a much greater rise than implied by a rise in the USA's share of world trade from 13.5% to 14.3%), and then declined to 25.5% in 1996, as the USA's share of world trade fell to 13.3%. In terms of the bilateral trade intensity measure,<sup>70</sup> the index for exports from Japan to the USA rose from 1.56 in 1976 to 2.02 in 1986 before declining to 1.71 by 1996. Over the same period the trade intensity index for exports from the USA to Japan went from 1.30 to 1.95 and then back down to 1.79. Again, in part this can be ascribed to the effects of the exchange rate, with a reversal in the over-valuation of the dollar since 1985.

<sup>70</sup> Using the original measure developed by Brown (1949) shown in 3.3.2.

A second factor related to the trends shown in Figure 3.13 is that there has been some genuine regional integration within East Asia since the late-1980s, with an increasing number of Japanese firms setting up production networks within the region. In particular, this has served to increase trade flows between Japan and the rest of Asia.<sup>71</sup> Despite this integration, the trade intensity index has remained flat, which suggests that either the integration has primarily occurred through FDI, or that ties between the region and non-Asian developed countries have also increased.

The finding that preferential trade bias in East Asia has not increased over the past two decades is a fairly surprising result, especially given the increase in regional trade shares shown by the raw data in Figure 3.12. As the trade intensity index shows, the rise in intra-regional trade is due to the higher growth rate of the region, which means that export markets in the region are relatively more important than in the past.

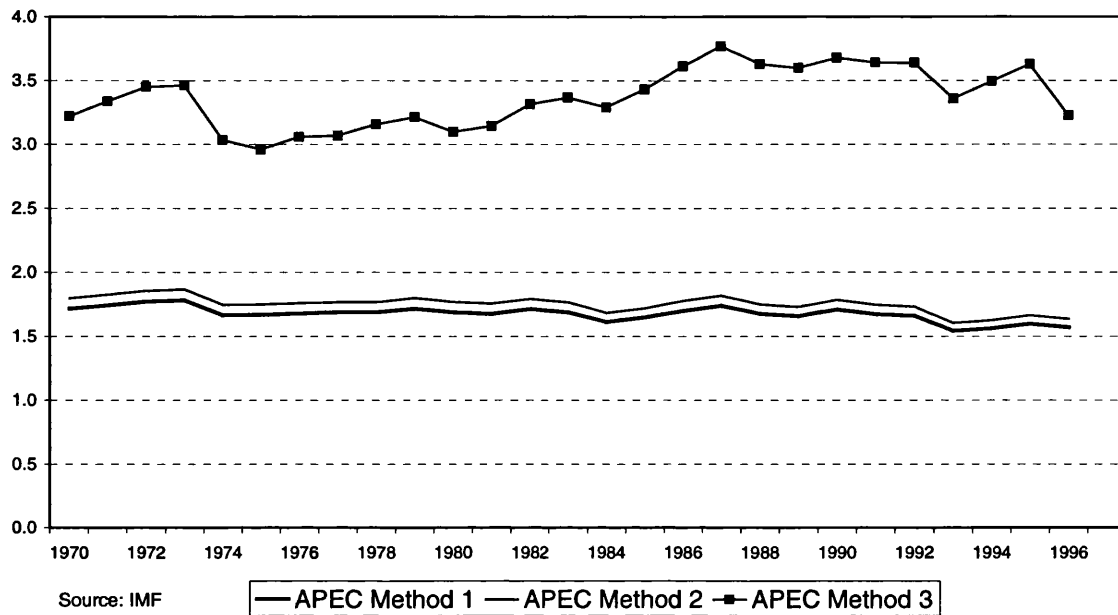
In Figure 3.12, the broad APEC group also shows a steady rise in regional trade shares. APEC's share of world trade rose from 33.1% in 1970 to 43.3% in 1995. However, using intra-regional trade intensities, virtually no change is seen in the broad APEC group over the past three decades, as shown in Figure 3.14. The key difference is the inclusion of the United States in the APEC measure.

Thus the decline in the intra-regional trade intensity of East Asia up to the mid-1980s was offset by a rise in the bias of trade towards North America (as indicated above by the bilateral relationship between Japan and the USA). This has since been reversed, leaving the bias of the APEC group as a whole little changed. The dynamics are the same as those noted above for the East Asian sub-group: exchange rate factors, a genuine re-direction of trade flows and the statistical effects of Asia accounting for a greater part of world trade flows.

---

<sup>71</sup> Between 1990-95 8457 Japanese companies conducted foreign direct investment in Asia, raising the total number of ventures by 50%, Ministry of Finance (1996).

**Figure 3.14. APEC 15 Trade Intensity Index**



The lack of solid initiatives to promote economic integration in Asia until the 1990s means that movements in trade intensities cannot be ascribed to the workings of the political force of regionalism.<sup>72</sup> APEC was not formed until 1989 and a decision to establish a secretariat was not made until September 1992, with the first summit taking place in late 1993. Moreover it lacked a substantive agenda until the long-term plans for a free trade area which were agreed at the 1994 APEC meeting in Bogor, Indonesia,<sup>73</sup> and any early effects from this initiative will only be seen in the final data in Figure 3.14. This underlines the importance of looking at any change in trade shares or trade intensities in the context of political and economic events in the region, as well as suggesting caution when attempting to impute causality between political and economic changes.

<sup>72</sup> Prior to APEC the Pacific Basin Economic Council (PBECC) had been set up in 1967 to provide a forum for business interests; the Pacific Trade and Development Conference (PAFTAD) was established in 1968 and is largely a forum for academics; the Pacific Economic Co-operation Council (PECC) founded in 1980 also promotes discussion between business, academia and government. None can be said to have exerted a significant influence on policy. See Holder (1994).

<sup>73</sup> Bergsten (1995).



The situation for ASEAN<sup>74</sup> countries is less clear, with the share of trade flows between members showing fluctuations, but only a small increase from the early 1970s. This observation is somewhat surprising, as the ASEAN members saw a collective rise in their share of world trade from 2.8% in 1975 to 6.4% by 1995.<sup>75</sup> So although they were more than doubling in importance to other trading partners, they hardly rose in importance to each other. The implication is that there was a decline in the bias towards regional trade between ASEAN members.

The relatively low share of ASEAN in world trade and the low degree of intra-regional trade compared to Europe, North America or broader Asian groups suggest that this is not an issue to pursue. For most of this period, ASEAN was predominantly a political grouping, aimed at the perceived regional communist threat. The ASEAN Free Trade Area was only established in 1993, but relatively low income levels suggest that the potential for intra-industry trade between members is limited.<sup>76</sup> Moreover, competitive industrialisation strategies have limited intra-regional trade flows, with each member keen to exploit the developed markets of North America, Europe and Japan, while far less ready to accept exports from the other members.<sup>77</sup>

Overall, Asia provides another useful example of the merits of using the intra-regional trade intensity index as opposed to simply looking at regional trade shares. Figure 3.12 indicates a growing importance of intra-regional trade within East Asia. However, correcting for relative changes in growth in trade, as the trade intensity index does, no such rise in intra-regional bias can be seen; the difference is explained by the growing importance of the region in the world economy.

---

<sup>74</sup> Vietnam joined the Association of South East Asian Nations (ASEAN) in 1995, but is not included in this analysis. As a relatively small trader, its inclusion would have little effect. The countries shown in under ASEAN are Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand.

<sup>75</sup> IMF, *Direction of Trade Statistics*.

<sup>76</sup> Saxonhouse (1993).

<sup>77</sup> Saxonhouse (1993).

### **3.3.4.7 Summary**

Various observations can be made from the above discussion. One technical assertion is that oil price fluctuations and currency misalignments may distort the results in the short term, but over the long term the effects balance out. Therefore looking at the long-term time series gives a clearer picture of the underlying trends than readings at discrete time intervals that run the risk of mistaking short-term price effects for underlying changes in trade preferences.

In North America until the end of the 1980s it has been difficult to attribute changes in trade intensities to specific policy initiatives. In Europe, achieving membership of the core of the EU has brought a sustained rise in bilateral trade bias. With the East Asian measure broadly flat in recent years, it also seems reasonable to conclude that trade in the rest of the world has also become more regionalised, simply as a mathematical result of rising intensities in two of the three largest trading areas. That is to say, with over four fifths of world trade accounted for by the three regions under examination, an increase in trade bias in two of them and no change in the other will most likely produce an increase in regional trade bias in the rest of the world.

The hypothesis that since the late 1980s wide-ranging agreements such as the Canada US Free Trade Agreement and the Single European Act have succeeded in promoting greater regional integration appears worthy of further examination, which will take place in Chapter 5. Certainly, there has been an increase in the European and North American trade intensity indices since 1989 which is difficult to explain away as a short-term fluctuation, while the moves appear too sharp to be explained by underlying structural economic forces. A policy-led influence suggests itself as one explanation. This finding directly contradicts the WTO (1995) which claims that there has been no regionalisation in world trade.

### **3.3.5 Trade Intensities and National Income**

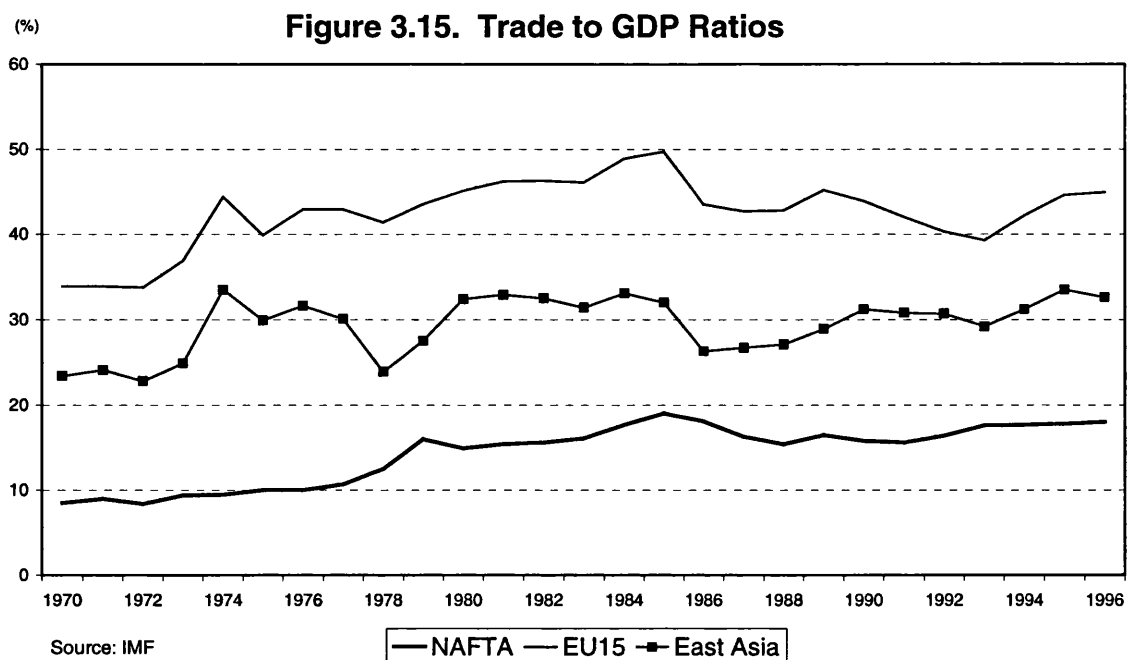
So far the discussion has concentrated on trade bias, and in order to move on to examine regional integration it is necessary to incorporate a measure of economic openness. By incorporating trade to GDP ratios into the above analysis

it is possible to examine whether any change in bias has been accompanied by a closing of a region to extra-regional trade. The concern is that although a preferential trade agreement might increase trade between members, it could reduce trade with non-members, with the net result not necessarily an improvement in total welfare. By introducing a measure of economic openness, the idea is to examine whether or not any increase in regional preferences has been accompanied by a reduction in trade with non-regional countries.

One problem with the analysis of regional groupings is that examining the changing shares of intra- and extra-regional trade is not the same as measuring trade creation and diversion, or welfare gain and loss. For example, it is quite possible for both intra- and extra-regional trade to be growing, but if the former rises relatively quickly then the measure of intra-regional trade bias will increase. A further problem is that there are other determinants of trade flows apart from trade policy. For example, openness is usually inversely correlated to size, and positively correlated to per capita income.<sup>78</sup> In addition, some regional integration agreements result in non-preferential changes in trade policy as well as those directly related to the agreement, so the importance of trade to the economy as a whole increases. In this case, a regional agreement can mean that trade with countries outside the region increases, even if at a slower pace than trade within the region, so the degree of openness to the rest of the world rises, even if the extra-regional trade intensity falls. To determine whether or not this is the case it is necessary to look at trade in proportion to the region's output.

---

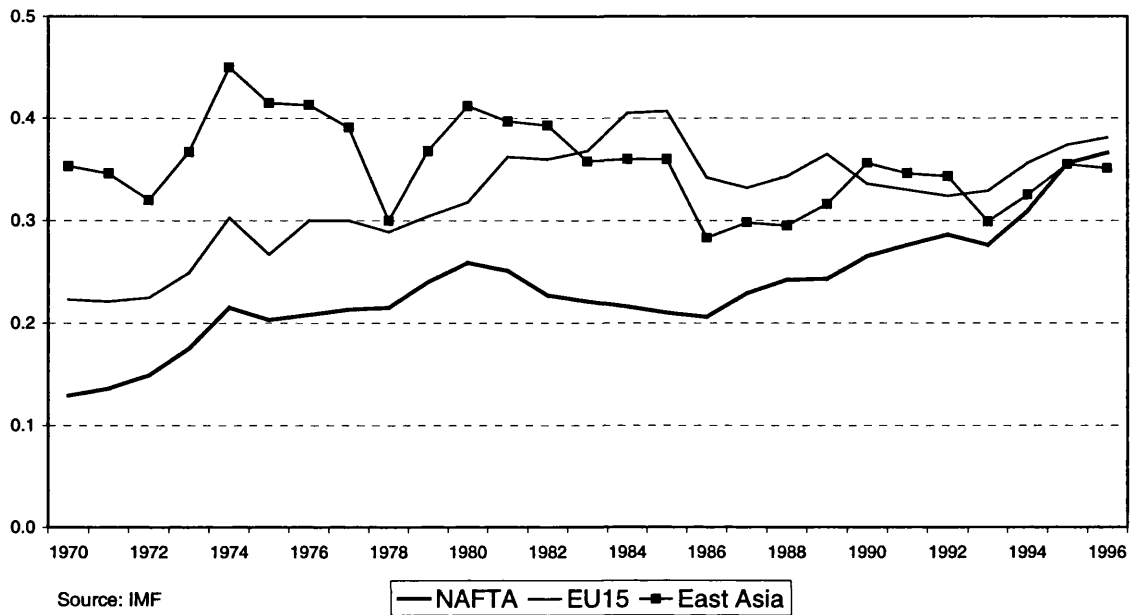
<sup>78</sup> See Kuznets (1959, 1966).



In terms of measurement, the propensity to export intra- and extra-regionally is simply the relevant regional trade intensity index multiplied by the share of merchandise trade in gross domestic product (GDP). Effectively there are two parts to the question. The first is whether the share of trade in the output of the region has been increasing. Figure 3.15 shows the ratio of merchandise trade to GDP for the three regions discussed above. As can be seen, these are relatively volatile ratios, largely because of the nominal effects of exchange rate movements and commodity price fluctuations. The impression is one of a gradual increase in trade to GDP across all three regions, although at times such as the first oil shock (1973-74) the nominal effect of rising oil prices outweighs other factors.<sup>79</sup> For example, the East Asian measure of trade to GDP was depressed from the mid-1980s due to the weakness of the US dollar against the Japanese yen, which has the effect of raising Japanese GDP (which was 71.3% of East Asia's total in 1995) compared to trade values.

<sup>79</sup> Data used in these charts are shown in Appendix A1.

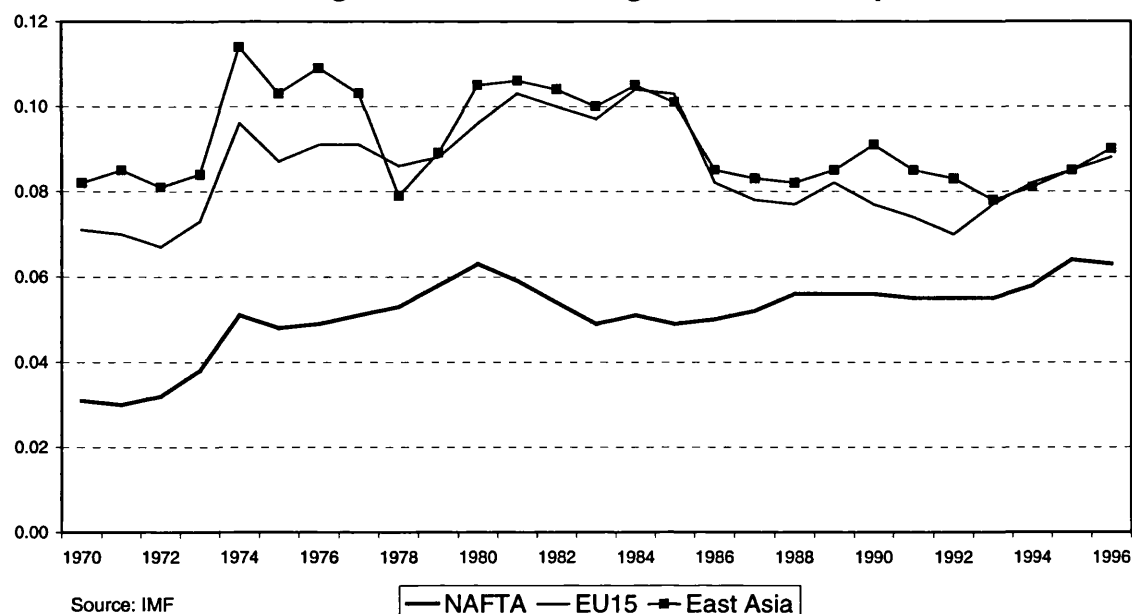
**Figure 3.16. Intra-Regional Trade Propensities**



The second part of the question is where the impact of rising trade to GDP ratios has been seen. Is it spread evenly across all countries, or is it mainly seen among regional partners? Figure 3.16 shows the intra-regional propensity to trade.<sup>80</sup> This is a measure of economic integration as it combines the concept of trade bias with that of economic openness. From this it appears that the propensity to trade with regional partners has increased in both Europe and North America, reflecting a combination of the rise in the degree of trade bias within the regions, as well as their greater openness. In the case of East Asia the situation is less clear, and over the past decade the stable intra-regional trade bias noted in 3.3.4.6 combines with a flat trade to GDP ratio to leave the measure of regional integration little changed.

<sup>80</sup>The intra-regional trade propensity is the intra-regional trade intensity (using Method 2) multiplied by the trade to GDP ratio.

**Figure 3.17. Extra-Regional Trade Propensities**



Looking at extra-regional trade propensities<sup>81</sup> and the underlying trend is difficult to discern amidst the fluctuations in the series. In particular, the effects of oil price fluctuations are particularly strong in both Europe and Asia, generating large rises in the extra-regional trade propensity measure in 1973-74 and 1979-80, and a large fall in 1985-86. In all three cases the ratios in the first half of the 1990s are above the second half of the 1960s, considerably so in the case of North America. As neither of those periods is seen as having a serious misalignment of either currencies or commodity prices, this leads to the conclusion that the increase in regional trade bias in Europe and North America noted in 3.3.4.4 and 3.3.4.5 has not been at the expense of trade with other regions. Note that these figures cannot be used for comparisons between regions, as they are sensitive to the size of the economy.

Fluctuations in Europe in the 1980s are seen as a function of oil price volatility and exchange rate shifts, rather than representing underlying swings in trade openness. The peak in the extra-regional trade propensity in 1984 was presumably a reflection of the strong dollar which would have reduced the dollar value of Europe's GDP more than it affected trade values, with the decline in the

<sup>81</sup>The extra-regional trade propensity is the extra-regional trade intensity index multiplied by the trade to GDP ratio.

dollar accompanied by falling oil prices, this pushed down the measure through the second half of the 1980s.

In the case of Europe, developments in recent years help to allay fears that the Single European Market programme would lead to benefits to European Union members at the expense of the rest of the world. In reality there has been a moderate increase in overall trade to GDP ratios, and a clear rise in the extra-regional trade propensity.

The examination of extra-regional trade propensities is useful as it helps to analyse the impact of regional integration on the rest of the world. It is possible to argue that greater regional integration accompanied by a general opening of the region to trade is an inferior development compared to an unbiased increase in the propensity of the region to trade. However, the two factors are often related in that the policies required to increase regional trade are often the same as those which result in a general opening of the economy.<sup>82</sup> It could even be argued that without the preferential regional policies, the opening of the economies would not take place.

### 3.3.6 Gravity Models

It is possible to attempt to conduct the analysis of trade preferences from another perspective by constructing a "gravity model" which attempts to estimate the impact of natural determinants on trade flows. In the basic form of such models the variables used are size and distance, although others add GDP per capita, common borders and a common language. If there were nothing in the concept of regional blocs creating preferential trade relations, then these variables would explain all trade flows. Tinbergen provided the first thorough examination of trade flows using this method.<sup>83</sup> By constructing a multiple regression model the aim is to show the significance of the variables used in explaining trade flows.

More recently Frankel, Wei and Stein have conducted this exercise for a variety of regions and find "some regional groupings show significant bloc effects:

---

<sup>82</sup> This point is discussed further in Chapter 5.

<sup>83</sup> Tinbergen (1962) Appendix VI. See also Balassa and Bauwens (1988) and Jacquemin and Sapir (1988) for more recent examples.

the EC, the Western Hemisphere, East Asia and APEC".<sup>84</sup> By using a dummy variable for membership of each group, their regression analysis indicates that there is a regional intensity to trade which cannot be explained by the natural determinants alone.<sup>85</sup> For example trade between East Asian economies in 1990 was more than four times higher than countries which were similar apart from the characteristic of being located in East Asia. They also find strong evidence of preferential flows across APEC, despite the lack (at the time) of a formal trading arrangement, and use this as an argument in favour of pushing ahead with the creation of appropriate institutions.

The scale of the analysis is impressive although there are concerns over the validity of the findings. For example, the appendix Table 4 of Frankel, Wei and Stein's report shows that in 1980 members of APEC traded with each other almost five times more than would be expected from their location and size. By 1985 this preference had increased to 17 times, and then it plunged to just 2.5 times in 1990, so the proclivity of APEC members to trade with each other has apparently fallen sharply as the countries began to be organised as a regional entity.

In addition, the volatility of the coefficients of some of the "natural determinants" also suggests inadequacies in this approach. For example, in 1980 the coefficient on GNP per capita indicated that rich countries trade 36% more than poor ones. In 1985 this coefficient fell to show a 6% preference and in 1990 had recovered to indicate rich countries only trade 17% more than poor ones. Similarly, Frankel finds that in 1975 two adjacent countries apparently traded 60% more than if they were not adjacent. However, by 1990 they traded twice as much. Such volatility in the coefficients suggests serious problems in the formulation of the model, as in reality the influence of a factor such as GDP per capita is likely to be relatively stable over time.

One explanation comes back to the use of discrete points in time which makes the findings sensitive to short-term price fluctuations. In particular, it is worth noting that Frankel, Wei and Stein find a quite steady  $R^2$  in the 0.7 to 0.8 range, with the exception of 1985 when the  $R^2$  falls to 0.57. As noted above in

---

<sup>84</sup> Frankel, Wei and Stein (1994) pp. 1-2.

<sup>85</sup> Frankel, Wei and Stein use GDP, GDP per capita, distance and a common border as their "natural" determinants.



the discussion on regional trade intensity measures, fluctuations in the mid-1980s are most likely attributable to movements in exchange rates, with the dollar peaking in 1985 on a real effective exchange rate basis.

Another problem relates to the use of a dummy variable to act as a proxy for regional membership, either because it is reflecting a relationship which can best be explained by another factor (perhaps cultural) or there is multicollinearity between the dummy variables for the trade groupings and the "natural determinants" used. In particular, the distance variable, the adjacency measure and the dummy variable for trade groupings are likely to show a close relationship. Adjacent countries presumably have relatively little distance between their economic centres, while close and adjacent countries are likely to form trade groupings. The likely existence of such multicollinearity leads to "uncertainty as to which variable deserves the credit for the jointly explained variation in the dependent variable .. [and] .. uncertainty as to the true values of the coefficients being estimated".<sup>86</sup> Moreover, it is noted that "in cases of high multicollinearity, the sample data may be compatible with a diverse set of hypotheses. Hence the probability of accepting a false hypotheses (i.e., Type II error) increases."<sup>87</sup> In particular it is a concern that Frankel, Wei and Stein find that the dummy variables for the EC, EFTA, NAFTA, MERCOSUR and Andean Pact are not significant at the 15% level on the majority of occasions.<sup>88</sup> Ideally the calculations would be repeated without the dummy variables in order to see how much they add to the explanatory power of the regression, and to see the impact on the coefficients and errors for the distance and adjacency variables.

In fact, there are deeper concerns with the use of a gravity model approach. Deardorff referred to the gravity model's "somewhat dubious theoretical heritage",<sup>89</sup> while a former head of the IMF's Research Department is less forgiving, asserting that "these findings [produced by the gravity model] are almost certainly wrong".<sup>90</sup> Polak attributes the findings produced by the gravity model used by Frankel, Wei and Stein to "a misspecification inherent in the

---

<sup>86</sup> Kennedy (1979) p. 129.

<sup>87</sup> Gujarati (1988) p. 292.

<sup>88</sup> Frankel, Wei and Stein (1994) Appendix Table 4.

<sup>89</sup> Deardorff (1984) p.503.

<sup>90</sup> Polak (1996) p. 533.

traditional gravity model".<sup>91</sup> Polak concludes that "The gravity model lacks the theoretical foundation for such far-reaching conclusions. Instead, their findings should have led the authors to re-examine the gravity model itself."<sup>92</sup> In a similar vein, following on from Polak's criticism, Matyas has shown that "all gravity models used in this area are misspecified from an econometric point of view .. [and] .. this leads to the incorrect interpretations of the trading bloc dummy variable(s) and improper economic inference".<sup>93</sup>

Polak points out that the root of the problem is that the gravity model underestimates the trade flows of *any* country which is geographically distant from its trading partners. This is because demand for imports is determined more by income levels than by distance, with additional transport costs absorbed in the country's terms of trade. The distance measure produces a "downwards bias for far-away countries and an upward bias for close-in countries. The downward bias means large positive residuals for any set of far away countries".<sup>94</sup> In Frankel, Wei and Stein's case, the large residuals are, in effect, allocated to the dummy variables for regional groupings, producing the illusion of a preferential trade grouping in APEC. Similarly, Polak argues that the misspecification of the model produces "not only phantom regions but also phantom anti-regions"<sup>95</sup> which explains the finding of Frankel, Wei and Stein of the non-existence or weak effect of the European Union. Polak suggests an improvement to the basic gravity model using a term for relative rather than absolute distance, but this still leaves no place for the introduction of dummy variables for membership of regional groupings.

A gravity model is a superficially attractive approach, but as Polak argues, the most interesting findings stem from a misspecification of the model.<sup>96</sup> In

---

<sup>91</sup> Polak (1996) p. 534.

<sup>92</sup> Polak (1996) p. 540.

<sup>93</sup> Matyas (1997) p. 363.

<sup>94</sup> Polak (1996) p. 538.

<sup>95</sup> Polak (1996) p. 539.

<sup>96</sup> As Polak has noted, "Frankel, with whom I had an extensive correspondence before I finalized the paper has never responded to my paper. My assumption is that this is a silent acknowledgement that my criticism is correct." Polak, "personal correspondence", 11 October 1998; on file with the author. The author has similarly failed to elicit a response from Frankel regarding some of the issues raised above.

Polak (1996) p. 539.

addition, the volatility of factors influencing international trade, in particular the difficulties concerning exchange rate movements, mean that using such an apparently sophisticated approach as a gravity model is questionable, as the mass of data required means that calculations are performed at discrete time intervals, rather than on an annual basis. Moreover, problems with multicollinearity mean that the importance assigned to the dummy variables representing group membership are both volatile and not reliable. A gravity model approach gives an impression of precision which is misleading and, other than confirming that proximate and wealthy countries trade more, while large countries trade less, adds little to the discussion related to regional trade intensities. Viewed over a reasonable time period the simpler trade intensity calculations are sufficient to make a judgement on whether regional bias is increasing.

### **3.3.7 Summary of Findings from Trade Data**

Using studies of merchandise trade data to measure the degree of regionalisation is favoured above other approaches. This is largely due to the availability of a detailed, consistent time series, split by country and produced in a timely fashion. Calculating regional trade intensity indices from the merchandise trade data shows a clear increase in the regional bias of trade in both Europe and North America since the late 1980s. In both of these regions the increase in bias coincides with liberalisation aimed at promoting economic integration.

In the case of Europe, preferential bias has been rising since the formation of what is now the European Union. Initially this took the form of greater trade preference between its original six members, while over the two decades it has reflected a shift in trade bias towards new members. For all but the broadest definitions of Asia, regional trade bias has diminished over the past three decades. In part this reflects a statistical feature of the measures used, which give an upwards bias to smaller regions which diminishes as they increase their share of world trade, but it also likely reflects an increase in trade relations with North America. This interpretation is supported by stability in the bias shown by the broader APEC measure which includes the USA.

The rise in regional trade preferences in Europe and North America inevitably means a reduced bias to trade with the rest of the world. However, this is offset by an increased openness of those regions to international trade. The net result is that neither of the regions has seen a reduction in the degree of overall integration with the rest of the world. This gives support to what had appeared to be an optimistic assessment of the World Trade Organization, in that regional integration agreements are more likely to complement the objectives of WTO than be in competition.<sup>97</sup>

There are concerns about focusing too closely on trade data alone. Firstly, trade in services is growing more quickly than merchandise trade, but exports of services broken down by country are not available on an internationally comparable basis. Secondly, it is questionable as to whether merchandise trade is the driving force in economic integration: investment flows in various guises are growing more rapidly. As the United Nations has reported, by 1991 the value of sales of foreign affiliates of multinational corporations exceeded merchandise exports.<sup>98</sup> In the light of these considerations, this chapter goes on to examine other data for evidence of regional trends.

### 3.4 Foreign Direct Investment

A similar analysis to that used to calculate trade intensities can be conducted with data for foreign direct investment (FDI). By analysing FDI flows, it should be possible to conclude whether a country is showing a preferential bias to invest in its regional neighbours. As Mundell has shown, movements of goods and transfers of factors of production can be substitutes.<sup>99</sup> Therefore, if increased regional integration in trade flows is matched by a decline in the regionalisation of FDI, then it is not necessarily the case that the region is becoming more integrated. If regionalisation is progressing then an increase in trade bias will be complemented by FDI flows. In fact the experience of some regional agreements

---

<sup>97</sup> WTO (1995) p. 62.

<sup>98</sup> United Nations *World Investment Report, Executive Summary* (1994) p. 9.

<sup>99</sup> Mundell (1957).

is that as they become deeper, the incremental measures promote integration of FDI more strongly than trade.<sup>100</sup>

A major problem is that the data series for foreign direct investment flows are far less reliable than those for trade, as definitions vary from country to country as do the mechanisms for reporting and measuring FDI flows. Even when data from a multilateral body such as UNCTAD are used, these problems are not necessarily overcome as the original sources are still the individual countries, with their inconsistent standards. Another problem in using annual bilateral data is that a single project can cause a major fluctuation and make trends difficult to isolate. As a result, some studies use five year averages, although the lack of availability of reliable lengthy time series data is a further limitation.<sup>101</sup> A further problem in making calculations is that FDI flows can be negative, because the sale by country X of an asset held in country Y is counted as a negative flow from country X into country Y, rather than a positive flow from country Y into country X.

Portfolio flows and foreign direct investment (FDI) both involve the purchase of a stake in a company, with the definitional difference between the two being that FDI involves some degree of control over the asset. The definition used by the International Monetary Fund (IMF) is that "Direct investment is the category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one economy in an enterprise resident in another economy".<sup>102</sup> As defined by the IMF, the level at which an investment ceases to be classed as portfolio investment and is defined as foreign direct investment is when a single foreign investor owns 10% or more of the outstanding stocks in a company, as long as this includes some voice in the management of that company. This is now the generally accepted definition across the OECD. In reality, however, FDI tends to be thought of as meaning majority ownership and this is generally the case. As Graham and Krugman have pointed out, in the United States, on average the foreign parent controls 77.5% of

---

<sup>100</sup> For example, the Australia-New Zealand Closer Economic Relations Trade Agreement began in 1983 with a focus on liberalising trade flows, but later broadened to include measures to integrate capital and labour markets.

<sup>101</sup> Primo Braga and Bannister (1994).

<sup>102</sup> IMF *Balance of Payments Manual* (1993) p. 84, paragraph 359.

the subsidiary. Raising the ownership threshold to 20% or even 50% would have minimal impact on the measure of the amount of FDI.<sup>103</sup>

Primo Braga and Bannister looked at regional integration in Asia from the point of view of FDI data, using figures from the UNCTAD database. They calculated that in the first half of the 1980s, 42% of total FDI in East Asia came from North America, with East Asia accounting for 36%. However, in the second half of the decade the position was reversed, with shares of 21% and 57% respectively. They also found "evidence of a significant intra-regional bias with respect to FDI originating from the Asian newly industrializing economies".<sup>104</sup>

As with trade data, looking at proportions irrespective of the size of the home and host economies does not paint a true picture of any bias in flows. Undertaking an exercise similar to the one they used to calculate trade intensities, Primo Braga and Bannister calculate that in the 1980s the intra-regional FDI intensity rose significantly for Korea, Taiwan and Singapore, as it did for Hong Kong if China is included in the regional totals. At the same time, FDI into Japan became less regionally biased, as had been the case with its trade flows. Primo Braga and Bannister use a formula which is essentially the same as Method 1 used in section 3.3.4.1 above in calculating trade intensities.<sup>105</sup>

---

<sup>103</sup> Graham and Krugman (1995).

<sup>104</sup> Primo Braga and Bannister (1994) p. 108.

<sup>105</sup>  $B_{ij} = F_{ij} / I_{wj} = (FDI_{ij} / FDI_{iw}) / [(FDI_{wj} - FDI_{ij}) / (FDI_w - FDI_{iw})]$

Where

i is the home country

j is the host country

w is the world

$B_{ij}$  is the FDI intensity index between countries or regions i and j. That is to say, it is a measure of the importance of country j as a recipient of FDI from country i, relative to total receipts of FDI from the rest of the world.

$F_{ij}$  is the share of country j in country i's FDI.

$I_{wj}$  is the share of FDI from the rest of the world into country j as a share of total FDI in the rest of the world.

$FDI_{ij}$  is foreign direct investment from i to j.

	1980-1984	1985-1989
East Asia	3.637	5.808
Japan	2.551	3.149
Hong Kong	4.722	6.664
Korea	1.855	5.654
Singapore	24.172	39.620
Taiwan	6.049	5.880

*Source:* Primo Braga and Bannister (1994).  
a: The investment intensity index shows the importance of East Asia as a host for investment from each country or region listed.

Table 3.5 summarises some of the findings of Primo Braga and Bannister. Only Japan and the four Asian Newly Industrialised Countries (NICs) are included, as investment flows from other Asian economies are too small to show meaningful trends. The definition of East Asia excludes China, which results in a lower measure for Hong Kong and Taiwan in particular, and the rest of East Asia in general,<sup>106</sup> in the second half of the 1980s when FDI flows into China began to surge. As the table shows, there was a positive and (for all except Taiwan) increasing bias towards intra-regional investment in the 1980s. These results contrast with those derived for trade intensities above, which showed no increase in regional trade bias occurring in the 1980s. One interpretation is that in East Asia regionalisation has been taking place through FDI rather than through trade flows.

Primo Braga and Bannister's findings demonstrate two of the major problems with using FDI data: a reliable long-run of statistics is not available, while the volatility from one year to the next means that relatively long-term aggregates must be used for all but the largest economies. Moreover, FDI tends to be more volatile than trade as it is more dependent on the economic cycle. For example, Japanese FDI outflows hit a peak of US\$51 billion in 1990 and then slid to just US\$14 billion in 1993 as the domestic recession hit capital spending

<sup>106</sup> Legally, Taiwan and Korea were not able to invest in China in the 1980s. The ban on Korean investment was lifted in 1994. Taiwanese companies overcame the restrictions by conducting investment via Hong Kong. There is also a problem with investment funds "round tripping" out of China into Hong Kong and back into China where it becomes FDI and as such is able to exploit favourable treatment. See Lardy (1994).

plans, and then recovered to \$23 billion in 1996 as the domestic capital spending cycle temporarily revived.<sup>107</sup>

Another problem with using aggregate data on FDI flows is that it reveals nothing about the use to which the investment is put. Simply looking at the value of the investment gives no information about the numbers or skill levels of employees in the host country, the degree to which supplies are procured locally, the destination of the end product or the technology used. In short, the raw figures tell us nothing about the *quality* of the investment or what it means for regional integration on a broader scale, as whether the output is sold domestically, is exported back to the home country or is exported to a third country will have an impact on the level of regional integration. Total employment effects are unclear: for example, the US sports wear maker Nike employs 9,000 people outside the US, but its subcontractors employ another 75,000,<sup>108</sup> which is a creation of employment not captured by measures of the value of the FDI flow.

For this reason some studies have attempted to disaggregate the data in order to analyse its impact on the host economy and on links between home and host. As the 1994 United Nations *World Investment Report* noted, the impact of MNCs in terms of numbers employed may be small, but "the longer-term consequences through stimulating economic growth and improving international competitiveness cannot be underestimated".<sup>109</sup>

Using OECD data,<sup>110</sup> I have calculated FDI intensities for investment flows between Canada and the USA. Although some data for Mexico are available, they are insufficient. Figure 3.18 shows the annual trend over the past decade. In spite of the extreme volatility of the series, there is the impression of rising investment intensities in North America. Net disinvestment in Canada by US firms in 1985-86 accounts for the negative readings in those years. However, even for two countries with generally good quality data sources there are doubts as to the reliability of the figures (for example in any given year, US reported outflows to Canada can be very different from Canadian reported inflows from

---

<sup>107</sup> Ministry of Finance (1997).

<sup>108</sup> UN *World Investment Report* (1994)

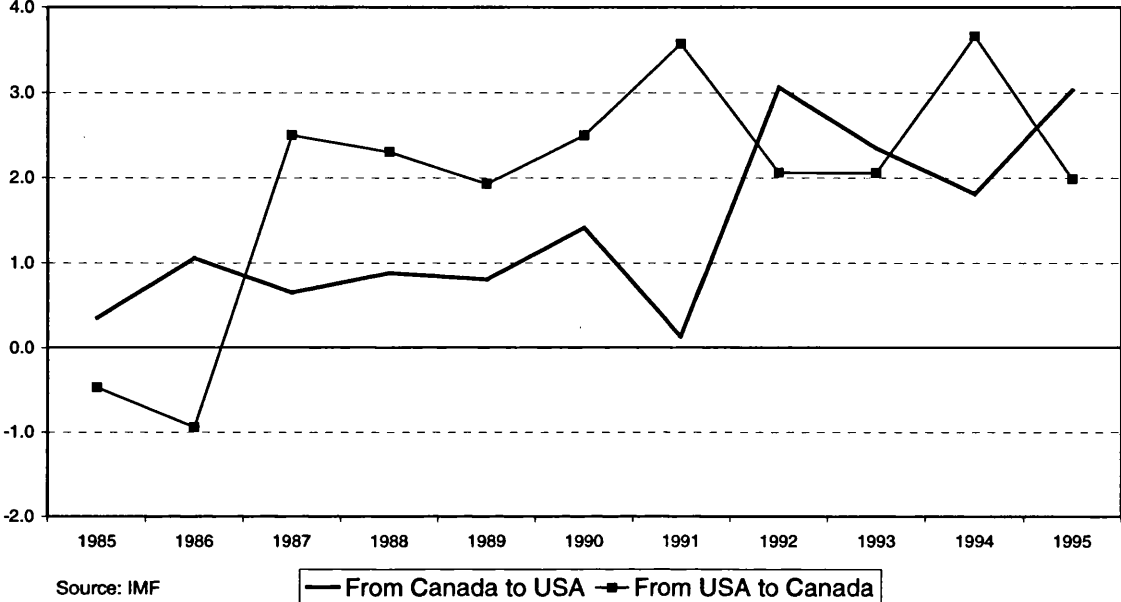
<sup>109</sup> UNCTAD (1994) p. 1.

<sup>110</sup> OECD *International Direct Investment Statistics Yearbook* (1997).



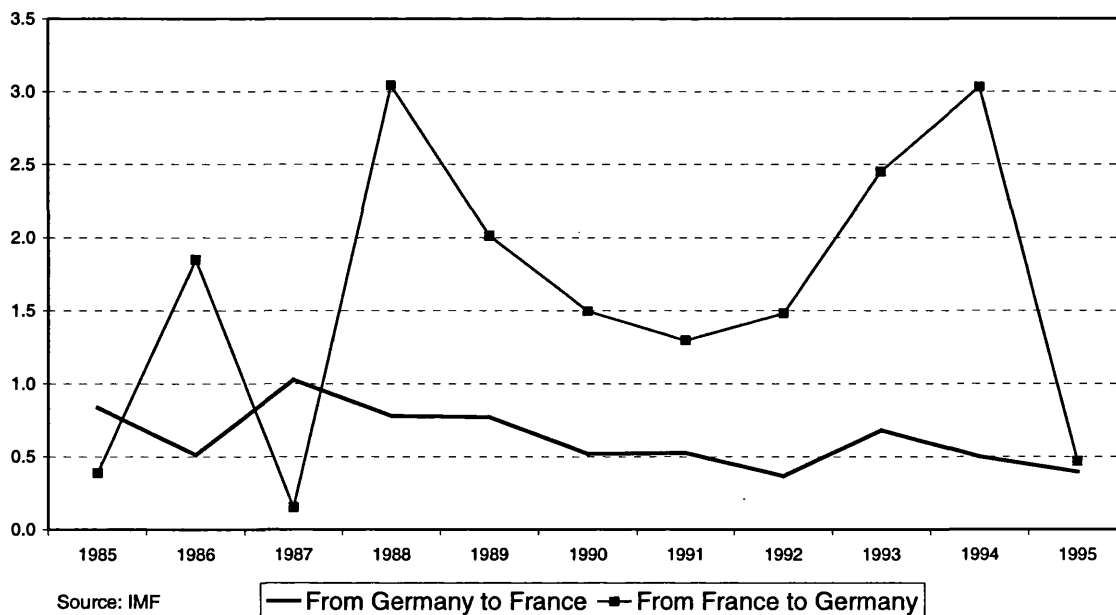
the US) and combined with the volatility of the series, this makes any conclusions provisional.

**Figure 3.18. North American FDI Intensity Index**



Let us now consider Europe. One of the notable features of the analysis of trade flows in 3.3.4.4 was the absence of an increase in trade bias between the two largest original members of the EU, France and Germany, since the late 1960s (Figures 3.10 and 3.11). As such it is interesting to take France and Germany, and see if the bias of their FDI flows differs from that of trade. This is shown in Figure 3.19.

**Figure 3.19. European FDI Intensities**



Just as with the USA and Canada the data are relatively volatile, which makes any underlying trend difficult to discern. Nevertheless, it is not possible to make a case that there has been an increase in the bias of FDI flows over the past decade. In fact, flows from Germany into France appear to show a declining bias. In the case of flows from France to Germany the volatility stems from the fact that FDI can be a negative flow as well as a positive one, and in 1994 the flow of FDI from France into Germany was larger than the entire flow of FDI from the OECD into Germany. The reason for this is that North America dis-invested from Germany in 1994 to the sum of DM1909 million, while net investment from France was DM1188 million, among OECD total FDI of minus DM381 million. Total FDI into Germany was DM2507 million in 1994.<sup>111</sup>

In conclusion, examination of the available statistics tentatively indicates a growing regional bias of FDI flows in East Asia and North America. However, the quality of the statistics is poor, which makes any findings indicative rather than conclusive. This may become a more practical approach in coming years, as a longer time series becomes available.

<sup>111</sup> OECD *International Direct Investment Statistics Yearbook* (1997). Table 3, pp. 120-121.

### 3.5 Non-Equity Relationships

Although trade and direct investment flows make up a large part of cross-border corporate activity, non-equity relationships are of growing importance. Licensing, franchising and other vehicles a company uses to extend its influence across borders, without leaving a trace in trade or investment data, all appear significant, but are difficult to track.

The vast amount of manpower needed to search through newspaper articles, press releases and other historical records of non-equity co-operation makes it an impractical approach. Even if such an exercise were to be conducted, it would by necessity be incomplete, with a bias towards countries with the best reporting systems. Much would be omitted. Moreover, the value of such agreements is rarely immediately apparent.

One reasonably comprehensive survey of cross-border mergers and acquisitions (M&A), as well as strategic alliances, is conducted by KPMG, one of the leading advisors on these ventures.<sup>112</sup> Although containing useful information on the number of M&A, joint-ventures and minority investments, broken down by country, the data available do not show the regional direction of the investments. The lack of a long time series as well as the possibility that the data are biased by the location of KPMG's operations are also arguments against using these data as a base for analysis.

The challenge is therefore to find a more efficient and reliable method which is not biased by the source reporting the data. While some countries publish a data series showing income flows from royalty payments and licenses, it is not broadly available from a source such as the IMF's *Balance of Payments Statistics*. Moreover, the data that are available are not broken down by country or by region which prevents analysis similar to that used to identify signs of regional bias in merchandise trade flows. Hopefully improved data reporting will allow such an analysis in the future.

---

<sup>112</sup> The United Nations has begun using KPMG data to measure M&A activity. See UNCTAD (1996).

### 3.6 Investment Income Flows

While detailed information is not available about the flow of income from non-equity relationships, some detail is available on the income flow from all foreign assets. Data on interest, profits and dividends (IPDs) flows show the income stream generated by a country's foreign assets. Again, the idea is that these data can be examined for signs of regional bias in the allocation of the underlying assets which generate the flow.

Unfortunately, few countries produce figures showing anything other than a total for IPD flows. However, Japan does release figures for interest, profits and dividends flows disaggregated by some countries and regions and these can be used to examine any bias in foreign investment holdings on a broadly defined basis.

Undoubtedly there are problems associated with looking at data on the income flow from an asset and drawing conclusions about the underlying value of the asset. It must be assumed that each asset generates the same rate of return irrespective of the country or the asset in question. This might seem far-fetched, but it can be justified. For example, it could be expected that in a higher risk environment, such as China, a firm will be seeking a higher payback ratio than in a lower risk country like Belgium. In theory, resources will be allocated until the expected total return, which is a function of risk and profitability, is equalized.<sup>113</sup>

Looking at income flows is a reasonably efficient means of measuring the current value of foreign assets. This contrasts markedly with most data on foreign direct investment, where one year's flow is simply added to the accumulated stock of previous years. This is clearly unrealistic, as the value of that stock may well have appreciated in the interim. This is demonstrated by the contrast between data which show the United States as the world's largest debtor country,<sup>114</sup> while at the same time, looking at the interest, profits and dividends

---

<sup>113</sup> That is to say that, for example, although an investment in Belgium is expected to yield, say US\$5,000 per annum, there would be a target return of US\$10,000 for the same investment in China. However, the higher return is justified by the higher degree of risk and there is the chance that the return would actually be zero. So making two investments expected to yield US\$5,000 each in Belgium generates US\$10,000 while making two investments aimed at yielding US\$10,000 in China also generates US\$10,000 as one pays in full while the other pays nothing.

<sup>114</sup> Graham and Krugman (1995).

data in the current account figures and the US is seen to have recorded a net US\$3 billion surplus in 1995.

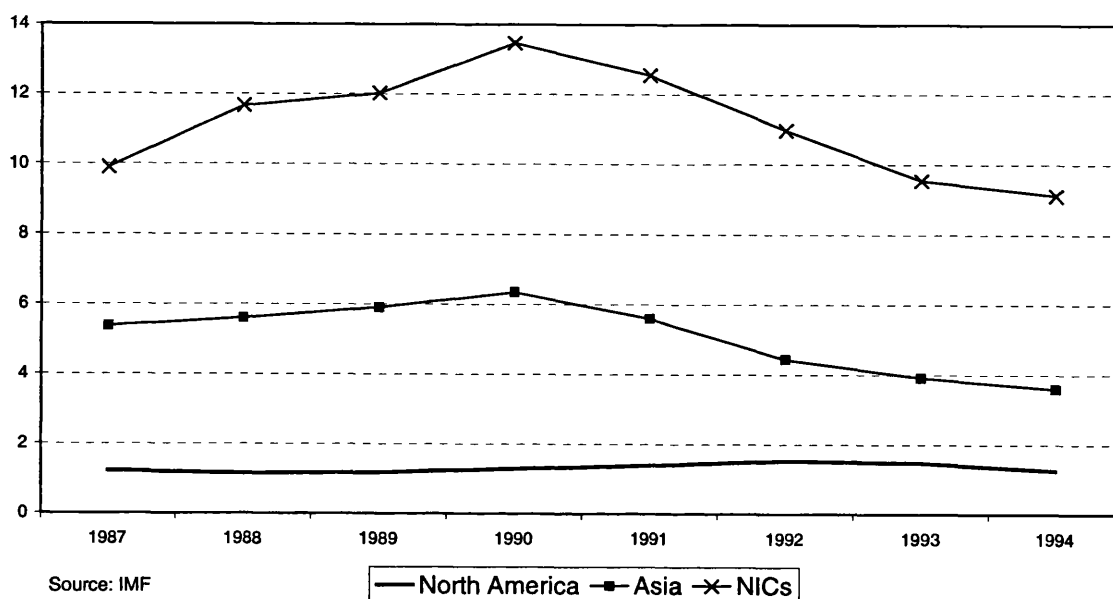
The United States is one of the few countries to correct foreign direct investment figures for valuation changes. The US Bureau of Economic Analysis produces figures on both a book value and a market value basis in the June issue of its *Survey of Current Business*, and the divergence can be sizeable. For example in 1989 the ratio of inward to outward investment was 1.01 on a book value basis, but on a market value measure it was 0.66 (that is to say, the US was a major creditor on FDI). The gap had been largely eliminated by 1992 following a rise in the US stock market which raised the value of foreigners' US assets.

Examining returns overcomes this valuation problem, as an investment made twenty years ago with a nominal value of, say, US\$50 million has a present value of, say, US\$200 million. A similar investment which is ten years old had an original nominal value of, say, US\$100 million, but again has a present value of US\$200 million. However, both will (theoretically) generate the same return. Looking at flows compensates for the impact of revaluation of assets.

There are of course some problems with examining flows and not stocks, especially in the case of those resulting from FDI. One area where potential for distortion exists is in transfer pricing, when the profits earned from an investment are manipulated through the use of transfer pricing and therefore the "official" profit figures could represent an under- or overvaluation of the underlying asset. It is also important to note that the interest, profits and dividends figures examined below include interest on holdings of foreign bonds which represents a large part of income flows. There appears to be less scope for such manipulation in the income from other forms of capital flows, such as foreign bond holdings.

Figure 3.20 shows calculations for Japan's intensity of interest, profits and dividends (IPD) flows with various regions. In this case, the statistics available limit the North American measure to Canada and the USA, while the Asia definition is broad, stretching across as far as Afghanistan. Data are only available since 1987. The figures indicate that there has been a shift in Japan's investment income bias away from Asia and towards North America since 1987. It is assumed that this also implies a similar shift in Japan's investment bias.

**Figure 3.20. Japan's Interest, Profits and Dividends Intensity Index**



Comparing these results with the figures for Japan's merchandise trade intensities provides interesting results. Table 3.6 shows the results for North America (Canada and USA only) and for the Asian Newly Industrialised Countries (NICs: Korea, Hong Kong, Singapore and Taiwan). This offers the interesting observation that while Japan's trade bias towards North America has been declining, there has been a rise in the bias of IPD flows with the region. One explanation could be that the reduction in trade bias has been offset by a rise in the production linkages between Japan and North America. However, given that only 5.6% of Japan's IPD credits are related to either FDI or property investments,<sup>115</sup> with the remainder largely representing interest on holdings of US bonds and bills, such a conclusion is not supportable. It is more accurate to conclude that there is a growing bias towards North America of all capital flows—not just FDI.

<sup>115</sup> Ministry of Finance, *Balance of Payments Monthly*.

	North America		NICs	
	Trade	IPD	Trade	IPD
1987	1.762	1.228	2.065	9.896
1988	1.661	1.152	1.968	11.663
1989	1.652	1.185	1.945	12.023
1990	1.674	1.288	1.923	13.465
1991	1.612	1.395	1.843	12.550
1992	1.599	1.528	1.793	10.979
1993	1.501	1.474	1.645	9.545
1994	1.514	1.252	1.661	9.119

*Source: Author's calculations from IMF *Direction of Trade Statistics*, *Balance of Payments Statistics* and the Japanese Ministry of Finance *Balance of Payments Monthly*.*

Unfortunately, detailed reporting of income flows by region or country is not widespread, so this analysis cannot be conducted for each region, as was the case for merchandise trade flows. Nevertheless, where possible it seems reasonable to use this approach to test for signs of regionalisation in investment flows.

### 3.7 Currency Flows

Data on financial flows are partly discussed above in terms of investment income flows in their various guises. It is also possible to consider exchange rate movements for signs of a regional bias. Frankel attempted to address the question of whether a yen bloc was forming in Asia by looking at exchange rate movements, interest rate dependencies and composition of foreign reserves.<sup>116</sup> He found that most financial centres in Asia were not sufficiently liberalised to be influenced by interest rate movements in other countries, but in the cases where there was a connection, the role of New York was more powerful than that of Tokyo in everywhere except Taiwan. There was, however, evidence of a greater role for the yen in the region, both as a weight in the pegged currency baskets of

<sup>116</sup> Frankel (1991).

some countries, and as a reserve currency. Note also that an increasing proportion of Japan's trade with Asia is denominated in yen.<sup>117</sup>

On a slightly more anecdotal basis, the behaviour of currencies in the first quarter of 1995 merits observation. At a time of instability resulting from various factors including the economic crisis in Mexico, the Japanese earthquake in Kobe and the collapse of the British merchant bank Barings, there was a clear regional bias in exchange rate movements. At times of uncertainty, funds tend to flow to any perceived "safe haven". For most of the post-war period this safe haven has been the US dollar. Indeed the creation of the Euromarkets in the 1960s owed much to the willingness of the Soviet Union to hold "safe" US dollars, but outside the jurisdiction of the US authorities.

By the 1990s, however, other currencies have come to be regarded as safe havens to rival the US dollar. In the first quarter of 1995 the Deutschmark and Japanese yen both appreciated within their regions and vis-à-vis the US dollar. However, at the same time the US dollar was stable on a trade weighted basis. In spite of depreciating against the yen and Deutschmark, the US dollar rose against the Canadian dollar and against Mexican and South American currencies—which still saw the US dollar as their safe haven—with the net trade weighted effect being neutral.

Currency movements are also important in Europe as a single currency is the next proposed milestone in European integration. The European Monetary System represents a clear political effort to integrate European economies and while its merits are still furiously debated, there are clear signs of a currency bloc forming in the EU around the Deutschmark.

Although it is difficult to provide clear statistical measures of the degree of regional integration from the point of view of currency movements, it appears to be the case that economies in the three main economic regions are becoming more closely tied to the currency of the dominant economy in each region. While it is arguable whether currency movements *per se* are causing regional integration, it is possible that closer currency ties are a reflection of integration in

---

<sup>117</sup> According to the Ministry of Finance (1996) in 1986 only 36.5% of Japan's exports and 10% of imports were denominated in yen. By 1994 the proportions had risen to 40.7% and 21.6% respectively. In 1970 less than 1% of trade had been yen denominated.



other areas, such as trade or investment. The issue of exchange rates is discussed in more detail in Chapter 4.

### 3.9 Conclusion Is Regionalisation Increasing?

This chapter has highlighted the problems in calculating whether regionalisation has increased in recent decades: there are statistical inadequacies in all of the measures used. In addition, there are serious flaws in all data (either because of the lack of a suitable time series, or due to the lack of a regional breakdown) apart from merchandise trade flows. These flaws mean that only merchandise trade data can be used in an attempt to produce reliable, statistically-based conclusions, in spite of the possibility that economic integration is occurring at far more levels than simply the exchange of goods. It is hoped that development of a longer time series or more geographic detail will allow some of the areas outlined above to be used to examine regional economic bias in the future.

There are various methods available to calculate the degree of regional trade bias. The most practical one is the regional trade intensity index which allows the examination of trends over time. Changes in the direction of trade are strong enough to outweigh marginal inadequacies in the index. The trade intensity index is frequently misused, but if employed prudently it is superior to the other methodologies discussed.

Although trade data are thought to give a reasonably accurate portrayal of the real world, even they contain some errors or a degree of incompatibility. This is best illustrated by noting that in 1993 adding up the merchandise trade balances of all countries (on an fob / fob basis)<sup>118</sup>, the world had a US\$30 billion surplus, while summing the current account positions of all countries in the world gave a deficit of US\$105 billion,<sup>119</sup> although by definition, the global trade and current accounts must be in balance. Therefore varying degrees of sophistication of different methods should not conceal the fact that all the figures used are to some extent flawed. Errors in the data are not necessarily a problem if the degree of error remains constant, but there is little reason to believe this is the

---

<sup>118</sup> Fob stands for free on board. Using fob figures for imports and exports means comparing like with like, and in theory the difference between the two should be zero.

<sup>119</sup> International Monetary Fund, *International Financial Statistics Yearbook* (1996).

case—the world current account "black hole" has fallen in recent years, from a peak deficit of US\$138 billion in 1990 down to US\$24 billion in 1995. A further problem is that if regional integration promotes more intensive flows of foreign direct investment within a region then these may be substituting for existing trade flows, with the result that the intra-regional trade intensity index could decline in spite of a rise in overall economic integration. This problem is examined in more detail in Chapter 5.

As noted in Chapter 2, political efforts towards promoting regional integration have revived since the mid-1980s. Preferential trade policies are by no means the only influence on trade flows, but there is evidence in Europe that countries joining the core of the European Union have seen an accompanying rise in regional trade bias. Similarly, increased bias in North America coincides with efforts to reduce barriers to regional trade since the late 1980s. However, there is no sign of an increase in bias between the original six European Union members since the enlargement process began.

In the case of Asia, until recently policy has not been oriented towards reduced regional barriers to trade. Movements in trade bias within Asia are dominated by price effects, by the impact of a rising share of world trade and by the changing relationship with North America. As yet it is too early to see any impact of efforts to lower regional trade barriers in the data. A gravity model approach does find evidence of strong Asian regional preferences, but as Polak has pointed out, this is due to a mis-specification of the model rather than the genuine existence of trade preferences. Using trade intensities the preferential bias within Asian has been on a steady decline until levelling off in the past decade.

Introducing a measurement of economic openness and it is seen that preferential trade liberalisation within a region has not been accompanied by an overall decline in trade with the rest of the world. One explanation is that some of the liberalisation measures are non-discriminatory and lead to an increase in overall openness. This is an extremely positive finding, as it implies that so far the renewed trend towards more regional agreements has not come at the cost of reduced trade with non-members.

## **CHAPTER FOUR**

### **REGIONAL INTEGRATION AND FOREIGN EXCHANGE RATES**

#### **4.1 Introduction**

Regional integration is not just about increasing the movement of goods and services between neighbouring countries, under the watchful eye of approving governments. The price at which those transactions take place (i.e. the exchange rate) is also vitally important to both the state and the multinational corporation. That price is determined as a result of transactions in the markets for goods and service, and for capital.

This chapter will investigate the issues related to regionalism and regionalisation surrounding exchange rates and examine the attitudes and behaviour of states and firms. One question is whether the objectives of a government vis-à-vis exchange rates are likely to be in harmony with those of multinational corporations (MNCs) operating across its borders. A further issue is whether the government is paying too high a price in attempting to secure exchange rate stability, if a side-effect is the erosion of control over the economy due its inability to use various policy tools. It will be argued that MNCs are less concerned about exchange rate volatility than is commonly assumed, and that such volatility has little impact on trade flows. As such, governments' attempts to stabilise exchange rates are better explained by political economy factors, rather than economic ones.

It will be shown that changes in regionalisation, as measured by the trade intensity index developed in the previous chapter, are unrelated to exchange rate volatility. Moreover, regional trade agreements have no identifiable impact on exchange rate volatility unless they are accompanied by an explicit agreement to co-operate to promote exchange rate stability. Related to this is the question of whether fixed exchange rates, or even a single currency, bring significant economic benefits to aspiring regional groups. It will be argued that the economic benefits of a single currency are marginal while the costs are unpredictable, which is an indication that political rather than economic explanations need to be sought.

Financial flows have often been neglected in discussions of regionalism. The most comprehensive text on the subject contains minimal reference to

exchange rate movements,<sup>1</sup> while most other studies concentrate on trade or foreign direct investment flows. This is an unjustified omission in a world where the value of foreign exchange dealing in a single week is greater than the value of exports of goods and services in a whole year,<sup>2</sup> so this chapter will analyse the role of exchange rates in regional integration.

## 4.2 Exchange Rate Movements

The exchange rate has been described as "the single most important price in the economy".<sup>3</sup> This is because a movement in the exchange rate alters the price at which all foreign goods trade in the domestic economy and the relative price between traded and non-traded goods. A weakening exchange rate raises the domestic price of imports which will attract resources into import-competing sectors. It also improves the competitiveness of exports, attracting resources into the export sector. This is at the expense of the non-traded goods sector, which sees its relative profitability decline compared to that of the traded goods sector. Some monetarists would argue that the effect on the real economy is temporary, as the rise in prices implicit in a depreciating currency will soon restore the pre-depreciation equilibrium,<sup>4</sup> but there do appear to be a substantial number of examples of an export boom following a drop in the international value of the currency. The experience of Italy and the UK following the depreciation of their currencies against other European countries following the exchange rate crisis of 1992 is a recent example.<sup>5</sup>

---

<sup>1</sup> In the 435 pages of text in Anderson and Blackhurst (1993), only 15 contain a reference to exchange rates.

<sup>2</sup> BIS (1996).

<sup>3</sup> Eichengreen (1994) p. 2. I would prefer to argue that, alongside the interest rate, the exchange rate is one of the two most important prices in the economy.

<sup>4</sup> For example, see Frenkel and Johnson (1976) for a discussion of the monetarist perspective.

<sup>5</sup> According to the IMF *International Financial Statistics*, between 1992 and 1995 the volume of exports from the UK and Italy rose 21.9% and 36.1%. In contrast, France saw export volumes rise 13.5%. Figures are not available on a comparable basis for Germany due to a break in the series.

In theory, the economic impact of exchange rate volatility<sup>6</sup>—as opposed to unidirectional depreciation or appreciation—is ambiguous. The intuitive approach (and one which can be supported by models which incorporate a strong degree of risk aversion<sup>7</sup>) is that a volatile exchange rate is a "bad thing", as it will create a preference towards domestic transactions above foreign ones, resulting in a sub-optimal level of foreign trade.<sup>8</sup> Firms will be more prepared to trade and invest domestically, safe in the knowledge that their revenues will not be affected by arbitrary shifts in the exchange rate. As the economic advisor to the Bank for International Settlements said, "It is hard to imagine that the volatility of such a key price as the exchange rate could have anything other than an adverse influence on economic decision-making".<sup>9</sup> However, this is not borne out by the evidence.

Gagnon has shown that the degree of risk aversion necessary to yield the conclusion that exchange rate variability has a negative effect on trade is "implausibly high",<sup>10</sup> while strong assumptions are also needed in the construction of the model. Without strong risk aversion it is difficult to demonstrate a relationship between exchange rate volatility and the level of foreign trade. Moreover, repeated studies have found no significant relationship to suggest that exchange rate variability leads to a reduced level of trade or investment. For example, Gagnon finds that "for any plausible parameterization of the model the effect of the observed increase in exchange rate variability on trade flows is too small to be statistically detectable".<sup>11</sup> A similar study by the IMF found no link between exchange rate volatility and trade, noting that "the evidence from surveys provides little support for the proposition that exchange

---

<sup>6</sup> Where volatility is defined as short-term fluctuations around an underlying trend.

<sup>7</sup> The idea is that firms prefer to operate in an environment where exchange rate volatility is low to one where it is high, as variability of its foreign revenues will be commensurately lower. This is the case even though exchange rate movements are a zero sum game—i.e. when one firm loses, another gains.

<sup>8</sup> See, for example, Clark (1973) for a presentation of this view.

<sup>9</sup> Alexandre Lamfalussy, opening address at the Financial Times Conference on Foreign Exchange Risk, February 1983, quoted in IMF (1984) p. 1.

<sup>10</sup> Gagnon (1993) p. 286.

<sup>11</sup> Gagnon (1993) p. 270.

rate variability has a major adverse effect on the volume of international trade".<sup>12</sup> Meanwhile, studies focused on Europe have also been unable to provide evidence that trade flows have been damaged as a result of exchange rate fluctuations.<sup>13</sup> Although these findings seem surprising, one possible reason is that given the array of uncertainties facing international business, those related to exchange rate volatility are relatively short-term and unimportant.

The above findings cannot be attributed to innovations in financial markets, such as foreign exchange hedging. Eichengreen and Irwin have examined the sensitivity of trade flows to exchange rate volatility over three periods in the 1920s and 1930s. They find it is statistically insignificant in 1932-34 and 1935-37, while between 1925 and 1927 it reduced foreign trade by an "economically insignificant" 0.13%.<sup>14</sup>

Nevertheless, forward foreign exchange markets are important in placing a value on the cost of the uncertainty. Forward foreign exchange markets provide an insurance policy for the domestic value of foreign currency earnings, and so the cost of the uncertainty can only be as high as the cost of buying a futures contract. This cost is very low, with the spread between bid and offer prices in forward markets only one or two tenths of one percent.<sup>15</sup> In fact it is difficult to hedge foreign exchange risk entirely, due to a degree of uncertainty about the stream of revenue a foreign project will generate, but the bulk of the risk can be offset.

There is also the question of whether exchange rates have been "excessively" volatile, which would imply inefficiencies in the forex market. In a stringent study of eight major currencies, Bartolini and Bodnar find that "major

---

<sup>12</sup> IMF (1984) p. 21. In fact the IMF did qualify its findings due to the relatively short time span that floating rates had been in operation and due to technical questions related to the surveys. Notable concerns were that sample sizes tended to be relatively small, that they included diversified firms which would presumably be more indifferent to currency changes and that the question was not always precisely directed at the effects of volatility. In the end the IMF equivocated that "no strong conclusions should be drawn from the results reported here" (1984) p. 22.

<sup>13</sup> See IMF (1984), Cushman (1988) and Emerson *et al.* (1992).

<sup>14</sup> Eichengreen and Irwin (1995) p. 20.

<sup>15</sup> It is the spread which is the measure of the cost, rather than the full price of the futures contract, as if exporters hedging currency risk in one direction face a premium, those hedging in the opposite direction will see a discount. It is the price of financial intermediation—the spread—which is the true cost.

exchange rates over the post-Bretton Woods period do not appear to violate the predictions of even the most restrictive version of the monetary model".<sup>16</sup> In other words, criticisms of the speculative or random nature of foreign exchange rate movements are not borne out by the evidence, although the conclusions depend in part on the definition of "excessive".

While the evidence from economics is that currency volatility does not adversely affect trade, an international political economy perspective offers further insights. Bhagwati has noted the danger that protectionist pressures will be generated by excessive swings in the exchange rate.<sup>17</sup> Producers of traded goods in the strong currency country will seek relief from their loss of competitiveness by restrictions on imports or assistance for exports, as was seen for example in the United States in the post-1982 Reagan "strong dollar" period. There is an asymmetry to the process, as producers will be slower to accept a drop in the level of protection once the exchange rate overvaluation corrects and there will not be a focused interest group to argue for liberalisation. In addition, there may be a shift of resources into industries which become temporarily profitable during a period of undervaluation, which will then seek government protection when the exchange rate moves back to equilibrium levels.

Fear of protectionist pressures was one of the reasons behind the adoption of fixed exchange rates in the Bretton Woods system, as Nurkse had argued that speculative runs and irrational exchange rate movements had been responsible for disruption to the world system in the inter-war period.<sup>18</sup> The implication is that exchange rate volatility is not necessarily a danger because of the economic actions of firms, but it is a danger because of the political response that can be generated. There is also a view that trade liberalisation is a "bicycle" process, in that it must keep going forward if protectionist pressures are to be prevented. If exchange rate volatility creates swings in competitiveness, then the result could be greater difficulty in promoting further liberalisation, which in turn could allow protectionists to hold sway.<sup>19</sup>

---

<sup>16</sup> Bartolini and Bodnar (1996) p. 24.

<sup>17</sup> Bhagwati (1992a).

<sup>18</sup> Quoted in Krugman (1989).

<sup>19</sup> Bergsten and Cline (1983).

In spite of the concerns that protectionism can result from misaligned exchange rates, it should be noted that trade liberalisation has managed to proceed at the same time that exchange rates have fluctuated strongly. The Tokyo Round was conducted immediately after the transition to floating exchange rates, while the Uruguay Round seemed similarly unaffected by the exchange rate swings of the late 1980s and early 1990s.<sup>20</sup> Moreover, it is possible to ascribe too much importance to the issue; as the IMF notes:

In the final analysis, the openness of markets depends critically on the strength of a government's adherence to free trade principles. Although exchange rate factors can provide industries seeking protection an additional argument for countering deteriorating market shares of the domestic industry, a government's trade policy is likely to be influenced by its assessment of the political risk of not accommodating the demand for restrictions, against the likelihood of retaliatory restrictions by other countries and greater demands for protection from other domestic producers.<sup>21</sup>

Moreover, in spite of the presumed importance of exchange rate movements, Krugman has shown that in the 1980s extreme shifts in exchange rates did not produce violent changes in trade flows. This was because in a range of situations exporters will find that their optimal strategy is to wait and see whether the new exchange rate is enduring before committing resources or withdrawing from the market.<sup>22</sup> Both imports and exports are slower to react to changes in the exchange rate than basic theories would suggest. This observation complements the finding that exchange rate volatility and trade volumes show no identifiable correlation.

A final point is made with reference to the theory of customs unions discussed in Chapter 2. In fact the real issue is not whether currency movements increase or decrease the volume of trade, but whether they increase or decrease the efficiency of resource allocation. The "more trade is good, less trade is bad" analysis is the only practical way of approaching the issue, but it should be borne in mind that it contains potential pitfalls. That is, unless we have information

---

<sup>20</sup> Of course it is impossible to know how the Rounds would have progressed if conducted in an environment of exchange rate stability.

<sup>21</sup> IMF (1984) p. 32.

<sup>22</sup> This process is known as hysteresis. See Krugman (1989).



about the welfare effects of changes in the level of trade, it is not possible to conclude whether a reduction or an increase in trade which results from exchange rate volatility is beneficial. In general it is assumed that a higher level of trade implies a welfare gain, but this is not necessarily the case.

According to the above findings, imprecision of welfare implications is not a major inconvenience, as there has not been a demonstrated relationship between exchange rate volatility and trade volumes, but it does give an indication of the problems faced when analysing such an issue.

### **4.3 Government Attitudes Towards the Exchange Rate**

There are three separate issues facing governments with regard to exchange rates. Volatility and the level or value of the currency are two related issues, while the further question of the desirability of a single currency (which eliminates volatility and fixes the level) is investigated below. The attitude of a government towards the strength of the exchange rate is likely to vary, depending on the focus of economic policy. If fighting inflation is the main concern, then a firm currency may be favoured as a means of reducing imported input costs and slowing the domestic economy. Conversely, if the government is more concerned with boosting economic growth, a weaker currency will improve export price competitiveness, while making imports more expensive in domestic currency terms. There is debate among economists about the effectiveness of such shifts in the exchange rate in generating lasting changes in the real economy,<sup>23</sup> but the post-Plaza attempts to lower the value of the US dollar to improve the competitiveness of the US economy is an example of its appeal to policy-makers.<sup>24</sup> How effective the government can be in controlling the exchange rate is discussed below, but for most countries it is an important policy variable.

Although governments might find it possible to fix nominal exchange rates, by an implicit or explicit peg to another currency or basket of currencies, it is more difficult to fix real exchange rates. For example, the nominal value of two currencies can be linked together, but a differential in the inflation rate in the two

---

<sup>23</sup> See for example, Frankel and Johnson (1976).

<sup>24</sup> Funabashi (1988) Chapter 3 gives an insight into the political processes.

countries will mean a gradual shift in the real exchange rate—that is, how much a given amount of one currency will buy in each country will change. This does not prevent the enduring popularity of pegging nominal exchange rates, although the trend of the past decade has been a gradual move towards floating exchange rates.

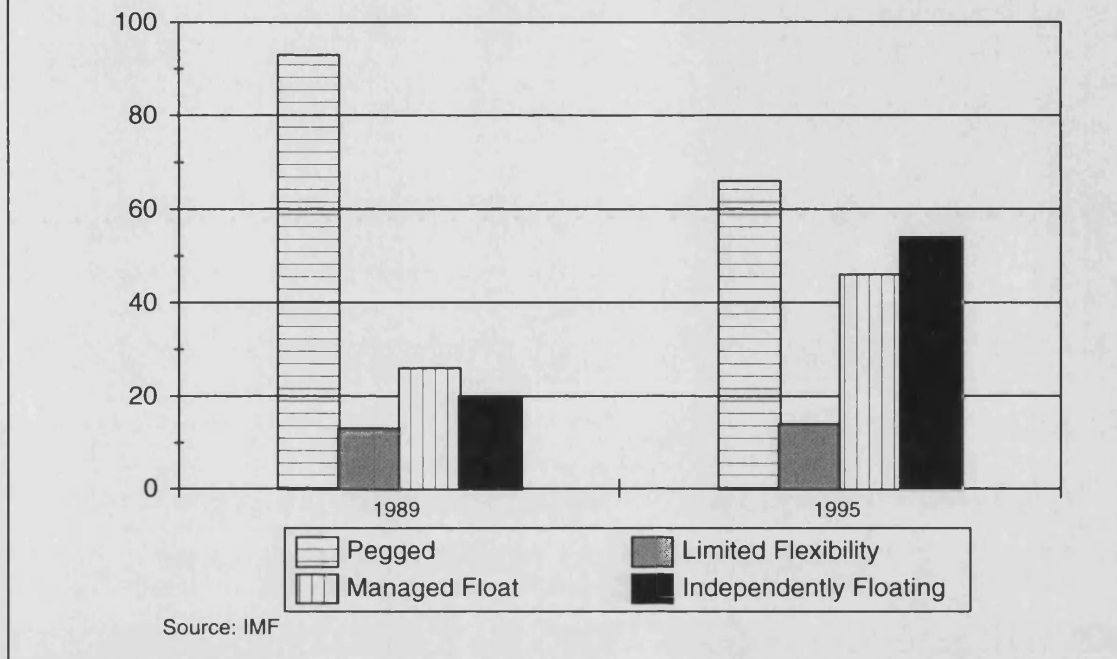
According to the IMF, at the end of 1995, 66 currencies were pegged, of which 22 were tied to the US dollar, 14 to the French franc and 30 to other currencies or to a currency basket.<sup>25</sup> A further 14 had limited flexibility (including those within the EMS), 46 came under the label of "managed float" and 54 were classed as "independently floating".<sup>26</sup> This appears to represent a profound change in the space of just six years: at the end of 1989 a total of 93 currencies were pegged, while only 20 were independently floating (see Figure 4.1). However, it is worth noting that many of the recent converts to floating exchange rates are the newly independent former Soviet republics such as Armenia or Tajikistan, or other developing economies. Of the 25 OECD members, only 11 are listing as floating. Nevertheless, the underlying trend seems clear: in 1982 only 5% of currencies had been floating.

---

<sup>25</sup> IMF *International Financial Statistics*, April 1996, p. 8.

<sup>26</sup> Under limited flexibility the government acts to hold the exchange rate within a certain stated range, while a managed float implies the government intervenes at times, but allows the market a greater role in determining the level of the exchange rate.

**Figure 4.1. Exchange Rate Arrangements**



Even in countries with floating exchange rates, swings in the value of the currency which are not based on economic fundamentals are viewed as undesirable.<sup>27</sup> So although Japan and the US are listed by the IMF as having an independently floating exchange rate, they are ready to intervene in foreign exchange markets if they feel that currency valuations have become damagingly detached from underlying fundamentals.<sup>28</sup>

There is no clear pattern as to when countries choose to peg and when they choose to float. An expected guide would be the degree of trade dependence on a particular country, with a pegged currency offering greater certainty about the value of export revenues. However, while several Caribbean countries (such as Barbados and Dominica) choose to peg to the US dollar, others (Guyana, Haiti, and Trinidad and Tobago) float.<sup>29</sup>

<sup>27</sup> The G7 statement after the April 1997 Washington G7 meeting contained the sentence "excess volatility and significant deviations from fundamentals are undesirable", *Reuters*, 27 April 1997.

<sup>28</sup> In 1995 Japanese foreign exchange reserves rose some US\$95 billion (from US\$95 billion to US\$190 billion) as it fought to reverse a sharp rise in the yen's value against the dollar. BOJ (1996).

<sup>29</sup> IMF, *International Financial Statistics*, April 1996.

Another common motivation for pegging the exchange rate is that it represents a statement of the government's commitment to pursuing policies which will enable the link to be maintained. This usually involves a relatively high inflation country tying its currency to that of one which typically enjoys lower inflation. In order to maintain the nominal link, the real exchange rate must also be harmonised by a stringent monetary policy in the high inflation country. If nominal rates are fixed and then real rates forced into line, the pressures on adjustment in the domestic economy can be severe. In the case of some members of the European Exchange Rate Mechanism (ERM) in the 1980s, attempts to stabilise both real and nominal exchange rates led to a sharp rise in unemployment, which was the consequence of measures aimed at holding inflation rates across Europe down to levels which prevailed in the standard-setting German economy.

A practical problem, if a government accepts the need to fix real and not nominal exchange rates, is that it is implicitly acknowledging that the nominal rate must at times change. While this may seem inconsequential, the implications are profound in terms of the reaction of foreign exchange markets, because for currency traders it is the nominal rate which is important. The threat of a sizeable adjustment to the nominal rate to maintain the real exchange rate is likely to cause a rapid, and quite possibly excessive, change in the nominal rate. Repeated small adjustments might be easier to implement, but their existence undermines one of the reasons for pursuing a fixed exchange rate regime, which is to add credibility to a government's anti-inflation credentials.

Of course it is necessary to distinguish between *trends* in the exchange rate and *volatility* around the trend. While government attitudes to the former will depend on policy objectives, high volatility is seen to bring no benefits. The standard government response is that volatility causes uncertainty and therefore reduces trade, which is detrimental to the economy.<sup>30</sup> Even in countries where foreign exchange dealing is an important part of the financial services sector, such as the UK, policy-makers tend to view volatility related to speculation with

---

<sup>30</sup> This has been a recurrent theme of G7 statements. The G7 statement after the Hong Kong summit in September 1997 read "We agreed that exchange rates should reflect economic fundamentals and that excess volatility and significant deviations from fundamentals were undesirable". *Reuters*, 20 September 1997. Note also the April 1997 statement above.

suspicion.<sup>31</sup> In spite of the argument that speculation is an important part of price formation in financial assets, there tends to be an attitude that earnings from such activities are somehow ill-gotten gains.

Irrespective of the government's attitude towards exchange rate volatility, it is questionable as to whether they can act effectively to reduce it directly. This is discussed in more detail below, together with the mechanisms that can be used in an attempt to influence currency rates.

The discussion of the attitude of the state towards the exchange rate is important in emphasising the complex issues involved. It is not simply a question of whether the state decides that it would be useful to have low volatility in its exchange rate, or to have it tied to another currency. There are definite costs involved, which are discussed in the section on the merits of a single currency, as well as the question of whether the exchange rate is ultimately within the power of the state.

#### **4.4 MNCs and the Exchange Rate**

As with states, there are three distinct issues facing multinational corporations (MNCs) with regard to exchange rates. The first is volatility, the second is the level of the currency and the third is the desirability of a single currency. Unpredicted movements in the exchange rate pose a risk to the revenue flow and the net asset value of a multinational corporation, but it is possible to insure against swings in the exchange rate by hedging in the currency futures market. Thus, for example, an American exporting firm can guarantee the amount of US dollars it will receive for a given amount of foreign currency at the end of its financial year by entering into a futures contract with a financial institution.

In theory, if forex volatility is simply rotation around an underlying stable level, then a risk-neutral MNC should view it positively as it increases the achievable level of profits. This is because producers can pay for imports when their home country currency is strong and repatriate export earnings when their currency is weak.<sup>32</sup> In this case a strong degree of risk aversion is needed to

---

<sup>31</sup> For example, then Chancellor of the Exchequer Ken Clarke said in an interview with the *Sunday Times* 3 April 1994, "Stability of exchange rates is preferable and attractive".

<sup>32</sup> Bliss (1994) pp. 120-121.

explain any anti-volatility stance of producers: they must be prepared to exchange a lower level of expected profit for a lower degree of variability in that profit. A more realistic explanation is that it is difficult to distinguish between short-term volatility and lasting changes in valuations at the time they occur.

However, there are doubts as to how much importance MNCs place on currency risk. As noted above, in a macroeconomic sense there is no evidence of currency volatility having a negative impact on trade, although if MNCs were currency risk averse, then a correlation would be expected. A 1995 survey of 1700 British firms by the Confederation of British Industry found little evidence of the currency risk averse nature of firms. A single currency can be viewed as the ultimate means of eliminating foreign exchange risk, but only 50% of respondents viewed a single currency as being positive for UK business as a whole and a smaller 41% felt that it would be positive for their own business. Moreover, although 19% of respondents replied that the UK should be in the leading group of countries moving towards European Monetary Union (EMU), 12% favoured immediate rejection of EMU and a further 8% felt that the UK should attempt to prevent EMU beginning in 1999.<sup>33</sup> This study suggests there is little support for the assertion that firms have a negative view of foreign exchange risk. Presumably one reason for this is that for firms which do see foreign exchange rate volatility as potentially detrimental to their business, the availability of hedging instruments offers a remedy.

Of course another problem is in distinguishing between volatility and a trend move in an exchange rate. The difficulty in attempting to do so is that the judgement can only be made in hindsight. At the time it happens it is impossible to tell whether a move in the currency is simply a short-term fluctuation, or whether it is the beginning of a new trend of depreciation or appreciation.

For those MNCs which are foreign exchange rate risk averse, one explanation is that they do not face a symmetrical exposure to changes in the currency. In one year, being unhedged when the exchange rate is depreciating would mean larger than expected profits, but if the exchange rate moves the other way the following year the result could be losses which threaten the survival of the company, through bankruptcy or takeover. Apart from in this

---

<sup>33</sup> Taken from the answers to questions 9 and 10 in CBI (1995).

asymmetric situation, if foreign exchange markets are perfectly efficient then there will be no gain from hedging, as the unhedged company will see its currency losses and profits even out over time. The hedged company will be less efficient as hedging has a price. For a currency hedge, if transactions in one direction face a premium due to the interest rate differential (which is the same as the expected movement in the currency), then those in the other direction will face a discount. The two net out, leaving only the spread between the two (i.e. the fees charged by the financial intermediary) as the true cost of hedging.

However, most financial hedging instruments are relatively short term, rarely extending much over one year. Thus for anything other than short-term tactical hedging of currency risk, this is inadequate. Different strategies are needed to guard against longer-term currency movements in order to allow firms to concentrate on their main line of business, without undue concern that a fundamentally sound business strategy will be de-railed by a protracted period of exchange rate misalignment.

As noted above, it is not proven that, as a group, multinational corporations tend to be risk averse and favour low levels of exchange rate volatility. However, it seems reasonable to assume that firms with a high degree of exposure to foreign exchange risk will place more emphasis on reducing it than those firms where it is a more marginal concern, due to the noted asymmetry of risks. Unlike states, MNCs can have only a marginal impact on their environment, in that their actions will have little effect on currency markets in industrialised countries.<sup>34</sup> The question for risk averse MNCs is therefore how best to optimise their strategy in the light of the potential dangers.

For longer-term control, a strategic currency risk management approach is needed. The underlying theme is that of matching the currency denomination of costs and revenues, or assets and liabilities. So, for example, input costs are denominated in the same currency as the market in which the product is sold. Alternatively, funding for a foreign investment project is procured in the capital markets of the country in which the investment is being made, or funds are raised in another market and then swapped into the required currency. The

---

<sup>34</sup> There are some rare exceptions in the financial sector. In 1992 George Soros' Quantum Fund and a handful of other US hedge fund managers were instrumental in pushing sterling out of the Exchange Rate Mechanism, but it can be argued that this would not have happened unless the underlying conditions existed.

currency matching does not necessarily have to be absolute if it defies business logic, but the greater the overlap, the lower the exchange rate risk. It is possible that only a proportion of matching can take place, and that at times it will be more efficient to use connected currencies (such as the Canadian dollar instead of the American dollar, the French franc in place of the Deutschmark), but the net effect is to lower exchange rate risk.

Even a system of matching the currency denomination of costs and revenues, or assets and liabilities, is an imperfect one. The end objective of the venture—profit—will still be denominated in foreign currency and so will still be vulnerable to short or long term swings in the exchange rate. Therefore a multinational corporation can never fully insulate itself from the vagaries of the foreign exchange market.

In the case of risk averse producers, exchange rate uncertainty will reduce the amount of investment in a country which is targeted at exports and increase that aimed at the domestic market. However, the situation changes if cross-border mobility of capital exists. In this case, uncertainty encourages foreign direct investment, as this provides a means for an MNC to diversify its production base and reduce its exposure to exchange rate movements. This FDI is likely to be trade creating, as the output will be shipped to the final market, with lower risk achieved by spreading production across several countries. There may even be a case for over-investment and duplication of facilities,<sup>35</sup> which would allow production to shift from one site to another depending on currency movements.

The efficiency of diversified production facilities will depend on the nature of exchange rate movements. For example, if the exchange rate moves in a random fashion around a stable level, then diversified production sites are likely to be a less efficient means of providing inputs than if they are centred on one country, due to the loss of economies of scale. However, if an exchange rate movement represents a real change in economic conditions, then FDI provides genuine cost diversification, which can be seen as efficient.

If regionalism contains measures to reduce the volatility of regional currencies, so that the bilateral exchange rates within a region are more stable than rates with non-regional countries, this could have a marked impact on risk

---

<sup>35</sup> Helpman and Krugman (1989).



averse companies. The logical corporate structure that would arise from this type of uncertainty is to have independent, co-ordinated production networks within each region. Each would be insulated from foreign exchange rate fluctuations between the regions, and would benefit from relative stability within each region. The observable pattern which should emerge from such a development would be stronger trade flows within regions and stronger investment flows between regions. While there is some evidence that this is indeed a trend in the global economy (see Chapter 3 for details), the causal importance of relative currency volatility is difficult to isolate from the effects of other trade and investment liberalisation measures. Moreover, it has been noted that, as a group, there is no evidence of MNC aversion to exchange rate volatility, so these findings apply to only a limited subset of the whole.

With the above in mind, it seems reasonable to conclude that, as with governments, the favoured regime for a risk averse MNC is one which produces a stable exchange rate and where changes in economic fundamentals produce a smooth adjustment in rates. Although short-term volatility may not be a serious problem, sustained misalignments (such as the US dollar in the mid-1980s) can cause problems. A stable system would allow companies to focus on their area of competitive advantage, such as making cars or providing telecommunications services. However, for the bulk of MNCs, no evidence has been found of their risk aversion, which implies indifference as to the exchange rate system in operation.

Inevitably, some financial institutions have an interest in foreign exchange volatility, as this provides them with the chance to exploit their competitive advantage of trading foreign exchange. However, unlike the trading of equities, forex trading is a zero sum game, in that it is not possible for there to be a general rise in prices. By definition, a rise in the value of one currency must be accompanied by a fall in the value of others. Together with the existence of a sizeable group of companies specialised in currency trading, the conclusion must be that non-specialised companies (such as those making cars or providing telecommunications services) are more likely than not to be the losers if they become involved in speculative foreign exchange trading. The likes of Kashima Oil, which in early 1994 announced a US\$1.5 billion loss from trading foreign

exchange, are the unavoidable casualties of an activity when one company's gain must be another's loss.<sup>36</sup>

MNCs have a clearer attitude towards appreciation or depreciation of a currency than towards volatility, where the evidence fails to support the idea that MNCs as a group are risk averse and favour stable exchange rates. In terms of the effect of longer-run currency trends it is not enough simply to calculate whether the firm is a net exporter or importer. The price elasticities of the goods being bought and sold are also important, but most firms should be able to determine whether they would gain or lose from a weaker currency. In theory, the multinational corporation should be more concerned about real exchange rates than nominal ones, and these should be more stable. That is to say, inflation which raises the costs in a foreign country will also result in a depreciation of its nominal exchange rate, keeping the costs stable in terms of an MNC's domestic currency. However, evidence suggests that relationships based on purchasing power parity levels are poor at explaining exchange rate trends in anything other than the long term.<sup>37</sup>

There is a tendency for firms in the traded goods sector to view a depreciation of their currency positively because it reduces domestic competition from imports or helps to raise the competitiveness of their exports. This microeconomic analysis might well be valid over the short term for an individual firm, but from the macroeconomic viewpoint it is less clear, because of the direct and indirect pressures on costs which result from a weaker currency. Exchange rate depreciation means higher imported input costs in local currency terms, and it also tends to raise the general price level in the domestic economy, increasing labour costs and domestic input costs.

The impact of exchange rate movements on trade and production will depend on the nature of the product. In the case of a homogeneous product, such as semiconductors, the producers are price-takers and they cannot raise prices to pass on the effect of a strengthening in the currency of the country where they produce. In this case, production will move across the world to regions where the costs are lowest. Where some product differentiation exists,

---

<sup>36</sup> *Nikkei Weekly*, 28 March 1994.

<sup>37</sup> See, for example, Aggarwal and Soenen (1989).

such as for automobiles and electrical equipment, then some of the effects of a strong currency will be passed on to consumers in export markets. Depending on the proportion of the exchange rate shift which is passed on to foreign consumers, the exporter will lose market share in foreign markets and trade volumes will decline.

The means of supply to the foreign market will also be important in determining what proportion of an exchange rate movement is passed on to consumers. If responsibility for the exports ends when the goods are loaded on the ship, then the producer may be more prepared to accept a fall in volumes and more willing to raise the price in foreign markets. However, if the exports are related to a large investment in the foreign market—such as through the creation of a network of car dealerships—then the exporter will be less prepared to undermine the investment and the longer term relationship with customers by raising prices.

While these product and firm specific variables, such as elasticity of supply, might be important in explaining a firm's behaviour, it will also be affected by the state of the economic cycle in the main economies. As Table 4.1 shows, the pass through rate of the costs of yen appreciation by Japanese exporters in the January 1994 to April 1995 period was far greater than in the two previous phases of yen strength. This can largely be explained by the weakness of the domestic Japanese economy, which suffered sub-1% GDP growth rates for the fiscal years 1992, 1993 and 1994. Without a healthy domestic profit base due to the protracted domestic recession, Japanese exporters were unable to cut yen prices and squeeze the margins on exports or even export at a loss in order to limit the dollar price increase and maintain market share, as they had in the past. At the same time, their main markets in the US and Asia were growing and were able to accept a higher prices. Note also that the pass through rate was strongest in the latter period of extreme yen appreciation up to May 1988, when the cumulative magnitude of the change meant that only about a third of the change could be met through domestic cost savings or margin reductions.

From	To	Change in Yen/US\$	Absorbed Domestically	Absorbed Abroad
Feb 85	May 87	85.2%	55.2%	44.8%
Jul 87	May 88	20.4%	33.1%	66.9%
Apr 90	Nov 90	22.8%	61.8%	38.2%
Jun 91	Aug 93	34.8%	63.3%	36.7%
Jan 94	Apr 95	33.3%	50.1%	49.9%

*Source: Author's calculations from IMF International Financial Statistics, Bank of Japan Monthly Economic Statistics.*

Any MNC should be able to calculate on a microeconomic basis whether it would gain or lose from currency appreciation or depreciation. Although the response of similar firms may differ, in terms of whether they sacrifice market share to maintain margins, or vice versa, the calculations are relatively clear cut.

The third issue regarding the attitudes of MNCs towards the exchange rate relates to the extreme situation where both volatility and depreciation or appreciation are eliminated through the adoption of a single currency. The concerns of MNCs are not simply related to the dynamic aspect of changes in exchange rates. There are also static costs of transferring funds from one currency to another, which are only eliminated by a single currency and not by fixed exchange rates. In Europe some have gone so far as to argue that "one market needs one money".<sup>38</sup>

However, while foreign exchange costs may be large for tourists or small businesses, for the majority of transactions conducted by large traders the static cost of transferring funds between currencies is already marginal and is still falling. Large firms can transfer funds at a cost of about one or two tenths of one percent of the total, which does not compare with the potential losses from currency movements. Even a positive report on European Monetary Union put the benefits at only 0.3% to 0.4% of GDP (but only 0.1% to 0.2% for the larger countries), which compares poorly to the estimates by Cecchini of the benefits of a single European market, which were put at 2.5% to 6.5% of GDP.<sup>39</sup> As Bliss

<sup>38</sup> Quote from page 9 of the study by Emerson *et al.* (1992) of the Economic Research Division of the EC Commission titled *One Market: One Money*.

<sup>39</sup> Emerson *et al.* (1992) p. 251.

notes "the static costs of currency differentiation cannot be an important part of the case for the cruciality of a single currency".<sup>40</sup>

Thus we have seen that the attitude of multinational corporations to the exchange rate can be divided into three distinct areas. Firstly, we have seen that volatility is theoretically not a problem for an MNC, and there is no evidence of MNCs as a group favouring stable exchange rates, although a sub-set of firms is likely to favour stability. Secondly, it is possible to calculate the effects of longer term currency depreciation and appreciation, which will depend on the cost and revenue base of firms, as well as the nature of the product which they sell. Thirdly, the costs of exchanging funds from one currency to another are relatively unimportant compared to the larger risks associated with currency movements.

There are some parallels between the attitudes of MNCs to the exchange rate and to regional trade arrangements. Firms which favour a strong exchange rate as it lowers the cost of their imported inputs will derive much the same benefit from lower trade barriers. However, the attitude of the state is not necessarily the same as that of domestic firms. If the state is trying to squeeze inflation out of the system then it may favour a strong exchange rate (which lowers imported input prices and depresses economic activity). This would damage the competitiveness of exporting firms which would only have seen some of their input costs fall as a result of the currency appreciation.

#### **4.5 Controlling the Exchange Rate**

The above discussion indicates that states favour stable exchange rates, valued according to underlying economic fundamentals, although MNCs appear less concerned about volatility. In both cases attitudes towards monetary union are less clear. Leaving aside this latter method of permanently fixing the exchange rate by abandoning national currencies, there are three general means of reducing exchange rate volatility.

The first is that the state can intervene to try and influence price setting behaviour in foreign exchange markets. This can occur directly via foreign exchange intervention by the central bank, or indirectly by movements in interest

---

<sup>40</sup> Bliss (1994) p. 116.

rates aimed at affecting capital flows (and thereby moving the exchange rate). In recent years the record of these types of policies is mixed: post-Louvre Accord intervention in support of the US dollar after February 1987 did not prevent its continued slide against the Japanese yen and German mark. Similarly, interest rate hikes and forex intervention could not maintain sterling's position within the European Exchange Rate Mechanism in 1992. Central banks are perhaps more likely to be successful in defending their currencies when they are under pressure to appreciate. Unlike foreign exchange reserves, which can quickly be exhausted in buying the domestic currency to support its price, the supply of domestic currency which can be sold to counter a rise in its price on the foreign exchanges is, in theory, unlimited. The Bank of Japan successfully intervened to drive down the value of the yen against the US dollar in the second half of 1995 by a combination of aggressively buying US dollars and cutting interest rates to record low levels for a major industrialised country.<sup>41</sup> Moreover, once a 105-100 yen per dollar rate had been established by early 1996 the Bank of Japan demonstrated its determination to prevent a renewed yen appreciation. In late February 1996 the yen threatened to break through the ¥103/\$ level and again head into double digit territory. The Bank of Japan intervened massively, buying up to US\$12 billion in just ten days and thereby convincing speculators of its determination to prevent further yen strength.<sup>42</sup>

The problems for governments are ones of magnitude. According to a survey by the Bank for International Settlements (BIS), by April 1995 average daily turnover in foreign exchange markets had reached US\$1,260 billion.<sup>43</sup> This was a 46% increase from the 1992 survey, which in turn had recorded a rise in forex turnover of 38% between 1989 and 1992, preceded by a 116% jump between 1986 and 1989.<sup>44</sup> Altogether this represents a more than trebling of forex trading in less than a decade. Partly due to a build up in the economies of

---

<sup>41</sup> On 9 September 1995 the Bank of Japan cut the Official Discount Rate to just 0.5%. This was some two percentage points below the level which prevailed during the asset price "bubble" of the late 1980s.

<sup>42</sup> *Reuters*, 1 May 1995.

<sup>43</sup> Bank for International Settlements (1996) p. 3.

<sup>44</sup> BIS (1996) Table 2-A. The sample base of the survey has altered over time, making the series of value figures inconsistent, but the percentage figures are calculated using constant sets of countries.

East Asia, central banks' reserves at the end of 1994 were two and a half times the level of end 1985, so over the nine year period the differential in growth rates was not significant.<sup>45</sup> However, the scale is important; by end 1994 the reserves of all countries amounted to US\$1,186 billion, or less than the average *daily* turnover in forex markets. Moreover the sizeable build up in total reserves masks the fact that growth in reserves in G7 countries has been less impressive, rising from US\$161 billion at end 1985 to US\$378 billion by end 1994. Some of the countries which have seen their reserves grow (Taiwan, China and India, for example) are likely to be less prepared to participate in joint foreign exchange market intervention than the G7 members which tend to lead co-ordinated attacks on (what they see as) exchange rate misalignments. The impression is one of government intervention becoming more "market-wise" but of having a decreased chance of changing market direction if it runs against economic fundamentals. It is also the case that if countries decide to float their currencies, with no intervention, then there is less need for large currency reserves.

The effectiveness of using higher interest rates as a weapon to support a weak currency is similarly in doubt. If currency speculators expect, say, a 5% depreciation in a currency within a week, then the interest rate needed to make such speculation unattractive will be more than 1000 percentage points higher than that which prevails in the appreciating country. For example in November 1992 the Swedish krona came under downwards pressure as the markets began to doubt the durability of its exchange rate link to the ECU. Even an increase in the marginal interest rate to 500% was not enough to hold the krona within its target band.<sup>46</sup>

Just as the state has problems in controlling the underlying trend of its currency, it has limited success in reducing volatility by increasing the costs of foreign currency transactions. It is generally recognised that one of the reasons for the massive increase in forex trading in the past two decades has been technological advances which have reduced the spread between the buying and the selling price. For the major currencies such as the yen, the US dollar or the

---

<sup>45</sup> Looking at a longer time period the change is more pronounced. A chart on page 98 of *The Economist* of 13 July 1996 shows the ratio of total official reserves to foreign exchange turnover falling from almost 15 times in 1977 to less than five times in 1980 and then continuing to slide to parity.

<sup>46</sup> Eichengreen (1994).

Deutschmark, the spread is now as low as five basis points (0.05%).<sup>47</sup> Combined with a rise in the underlying level of cross-border business transactions, the institutionalisation of savings and the reduction of government controls on capital flows, this has made feasible forex trading in search of small shifts in the exchange rate.

A logical policy for a state seeking to reduce the level of forex volatility would be to act to raise the costs of trading. Some measures which have been suggested include introducing a transactions tax on foreign exchange trades—a "Tobin tax"—and variations thereof, such as penalising trades which are not related to real economic activity, or a tax on trades which are unwound within a certain time period—say, three months.<sup>48</sup> Others advocate requiring banks with open foreign exchange positions to make non-interest bearing deposits at the central bank, using similar principles to those behind the BIS capital adequacy rules.<sup>49</sup>

Whether such measures can be practicably implemented is less clear. The use of offshore markets, derivatives and foreign subsidiaries are likely to make the imposition of regulations by a developed country very difficult to enforce. Indeed the reduced effectiveness and increased cost of applying capital controls were two of the main reasons for their abolition. Unless a clear consensus on the need to restrict foreign exchange trading exists across the major economies then regulatory arbitrage<sup>50</sup> will ensure that the forex market relocates to the country where it can operate at the lowest cost.

In addition to short-term policy measures aimed at bringing stability to foreign exchange markets, more formal exchange rate agreements have also been used. As discussed below, regional trade agreements are seen to have no impact on volatility, but incorporating explicit co-operation on exchange rates can be effective. In Chapter 6 the view that regionalism offers the state a chance to

---

<sup>47</sup> Bloomberg foreign exchange screen, July 1997.

<sup>48</sup> See, for example, Felix (1995) on the potential for implementing a "Tobin tax".

<sup>49</sup> See Akyüz (1995) pp. 88-89.

<sup>50</sup> Regulatory arbitrage is where firms will MNCs will locate elements of their business in the locations where the costs imposed by the regulatory regime are the lowest. This is not quite the same as saying that firms will locate where regulations are the loosest, as there may be costs associated with overly lax regulation.



regain lost authority over multinational corporations, or markets, will be put forward. In more practical terms, regional agreements on currency stability offer support in trying to control exchange rate volatility. Within the European Monetary System member states are obliged to assist other members if their currency trades at the edge of its range.

The effectiveness of this version of the states' attempts to regain sovereignty appears more dubious than for trade related matters. Exchange rate intervention has been reasonably well co-ordinated since the Plaza Agreement of September 1985, but as noted above, the G7 countries have seen only mixed success when tackling unwelcome movements in foreign exchange markets. More specifically, the European Union acting as a bloc rather than as a more loosely co-ordinated group would be unlikely to tilt the balance significantly in favour of the state when it comes to forex intervention—it certainly proved unable to prevent speculators from breaking apart the European Exchange Rate Mechanism in 1992.

#### **4.5.1 A Capital Markets Regime?**

It is worth side-tracking for a moment to consider whether events in capital markets in recent years offer a new insight into the process of regime formation. The standard definition of a regime is that it is a set of "principles, norms, rules and decision-making procedures around which actor expectations converge in a given issue-area".<sup>51</sup> The regime is generally constructed by the most powerful actor (often labelled the "hegemon") or a set of powerful actors with mutual interests.

Recent developments in capital markets suggest that there is another possibility for regime construction. The past two decades have seen a succession of countries unilaterally liberalising transactions related to capital flows. The nature of the process may have differed, from a "big bang" approach in the UK on the election of Prime Minister Thatcher in 1979, to the more gradual Japanese liberalisation methods, but across a multitude of developed and developing countries, restrictions on capital flows have been steadily eased.

---

<sup>51</sup> Krasner (1983) p. 354.

There have been two forces behind this transformation of restrictions on the movement of capital across borders. The first has been the self-interest of states, convinced in part by the intellectual arguments in favour of liberal capital flows, which see them as contributing to the efficient allocation of resources.<sup>52</sup> The second has been that of the market, where developments have raised the opportunity costs of maintaining capital account restrictions. For example, in the years prior to the end 1994 crisis, Mexico enjoyed substantial inflows of investment capital in response to liberalisation of controls, while India faced a crisis in 1992 as tight controls on capital flows meant that funding its current account deficit was extremely problematic. Moreover, the market has imposed competitive pressures on countries, especially in Europe, with failure to deregulate being seen as threatening the loss of domestic financial activities to deregulated neighbours.<sup>53</sup>

Prior to the 1997 Asian currency crisis, a situation had arisen where more and more states were adopting a liberal approach to cross-border capital flows. Whether or not this meets the definition of a regime noted above is open to question. The "issue-area" is clear, as is the set of principles and rules which apply to capital flows, which would seem to imply that a regime exists. However, to an extent, the decision to pursue open capital accounts is one which is made unilaterally, rather than under the auspices of any regime. There are some parallels with trade liberalisation seen in the 19th century, when unilateral liberalisation was at times the preferred path because of the benefits that it brought to the liberalising nation.

An alternative interpretation is that the state is not acting entirely voluntarily, but is being pressed to liberalise by the foreign exchange market. The costs to the state of continuing to impose capital controls are rising, in terms of being able to lend or borrow at the most favourable interest rates,<sup>54</sup> and this is occurring at the same time that innovations in financial markets are rendering

---

<sup>52</sup> Although the Asian currency crisis which began in mid-1997 has led to some challenging this view, most notably the prime minister of Malaysia, Mahathir Mohamad.

<sup>53</sup> Helleiner (1994) Chapter 7, sees such a competitive response as a major reason for Scandinavian deregulation in 1989-90.

<sup>54</sup> Again, it is worth noting that the damaging effects of foreign exchange movements since 1997 have led some to question whether the efficiency gains from access to foreign capital outweigh the potential damage caused by uncontrolled exchange rate movements.

those restrictions less effective. If a hegemon exists in the case of capital flow liberalisation, then it is the foreign exchange market.

To some extent this is a version of Ruggie's argument, as he sees liberal regimes as a means of reducing transaction costs in the international system.<sup>55</sup> Liberal capital movements result in lower transaction costs for cross-border capital flows. However, the mechanism by which liberalisation is occurring is novel. It is unclear whether there are other areas where a similar logic might apply (broadcasting, perhaps), but it certainly offers an alternative view of regime formation by identifying the market or the intellectual argument as playing the role of the hegemon.

#### **4.6 Exchange Rate Volatility and Regional Integration**

This section considers whether reduced regional exchange rate volatility improves the prospects for regional integration. McKinnon argued that optimal currency areas and fixed exchange rates were most appropriate to countries with high trade to GDP ratios and with high bilateral trade flows.<sup>56</sup> At its ultimate level, exchange rate stability within an integrated region can be achieved by irrevocably fixed exchange rates or by monetary union, the practicalities of which are discussed below with reference to Europe.

In measuring the impact of overall exchange rate volatility in terms of uncertainty in the economy as a whole, it is preferable to use effective exchange rates (i.e. composite measures which are weighted by the bilateral rates with all trading partners) rather than bilateral ones. However, this analysis is more interested in the links between regional trends and exchange rate volatility, which makes a bilateral approach appropriate.

Table 4.2 raises the question of whether there is a correlation between a reduction in exchange rate volatility and closer economic integration. As has already been shown in Chapter 3, since the late 1980s the US and Canada have seen an increase in economic integration in the form of bilateral trade flows, as measured by the trade intensity index. In contrast, the trade intensity index

---

<sup>55</sup> Ruggie (1982).

<sup>56</sup> McKinnon (1963).

between Japan and the US rose through to the mid-1980s as Japanese exports penetrated the US market, but then fell as the yen appreciated against the US dollar and Japanese trade became more oriented towards emerging Asian economies.

However, it is difficult to find a change in the degree of exchange rate volatility which could help to explain changes in trade intensities. In the case of Japan, the first three five-year periods shown in Table 4.2 saw rising exchange rate volatility (as measured by the monthly change in the bilateral exchange rate and the standard deviation of that change) accompanied by increased trade integration. When the volatility of the exchange rate began to fall in the 1990s, the degree of trade intensity also began to fall. Thus, contrary to what might be expected, this example suggests that higher degrees of foreign exchange rate volatility are associated with higher levels of trade integration.<sup>57</sup>

In the case of Canada, the last three periods shown in Table 4.2 have seen no discernible change in the degree of exchange rate volatility, while there was a rise in trade integration in the final period. The two cases do not suggest that a reduction in bilateral exchange rate volatility brings closer trade relations.

	Japan			Canada		
	Average Monthly Exchange Rate Movement	Standard Deviation	Average Trade Intensity Index Method 2	Average Monthly Exchange Rate Movement	Standard Deviation	Average Trade Intensity Index Method 2
1975-79	2.03%	2.41%	1.48	1.01%	0.99%	4.73
1980-84	2.66%	2.18%	1.63	0.98%	0.91%	4.84
1985-89	2.96%	2.31%	1.95	0.94%	0.83%	4.62
1990-94	2.19%	1.79%	1.82	0.99%	0.83%	5.10

*Note:* Exchange rates are nominal, percentage changes are absolute—regardless of direction. See Chapter 3 for methodology of calculations for the trade intensity index.  
*Source:* Author's calculations from IMF *International Financial Statistics, Direction of Trade Statistics*, various issues.

In Europe the situation is rather different in that there were institutional attempts to reduce exchange rate movements, as opposed to *ad hoc*

<sup>57</sup> It is worth noting that, unlike with Canadian-US trade, there was a large imbalance in Japan-US trade flows, movements of which could account for part of the volatility.

agreements such as the 1987 Louvre Accord aimed at stabilising the value of the US dollar. Notably, since March 1979 France and Germany have been linked within the Exchange Rate Mechanism (ERM) of the European Monetary System (EMS), although prior to that the "snake" and "snake in the tunnel" were forms of managed float following the collapse of the Bretton Woods fixed exchange rate system.<sup>58</sup>

In the ERM initially only a 2.25% shift away from the central parity was permitted (other countries joined with a wider 6% band). The only case in which the monthly fluctuation of a currency could exceed 4.5% (i.e. moving from one extreme of the band to the other) was when there was a realignment of the system. Between 1979 and January 1987 there were eleven such realignments, although on only six of those occasions did the French franc / Deutschmark cross-rate alter. After January 1987 there were no further shifts until the general European exchange rate crisis of September 1992. Another exchange rate crisis in July 1993 led to the permitted bands for all but the Deutschmark and Dutch guilder widening to 15% in either direction, leaving only the pretence of institutional stabilisation of the exchange rate.

The institutional factors behind the movement of sterling are less pronounced. In spite of a period of "shadowing" the ERM, Britain did not formally enter the system until October 1990 and then at the wider band of 6%. This situation continued until September 1992 when extreme pressure in foreign exchange markets resulted in sterling crashing out of the ERM.

In terms of economic integration, France, Germany and the UK were members of the European Community through the whole period covered in Table 4.3. However, France and Germany had been founding members and as indicated in Chapter 3, the increase in bilateral trade bias occurred before the period under consideration. However, the UK was a later entrant, joining in 1973, and this is one explanation of the initial rise in the trade intensity index with Germany.<sup>59</sup>

---

<sup>58</sup> Ludlow (1982).

<sup>59</sup> Ending the system of imperial preference while integrating with the European Community led to a marked change in UK trade patterns in the early 1970s. That is, one form of preferential bias was substituted by another. There was also a shift from EFTA to the EC, as discussed in Chapter 3.

There are several noteworthy features in Table 4.3. Firstly, although France saw a definite decline in the volatility of the franc-Deutschmark exchange rate (both the average monthly percentage change and the standard deviation of that change more than halved between the first and last periods), there was no change in its trade intensity index with Germany over the twenty year period. Secondly, although there was only a slight reduction in exchange rate volatility between the UK and Germany, there was a sharp rise in the degree of trade integration between the 1975-79 period and that of 1980-84. In contrast, note that in the 1990-94 period volatility in the exchange rate declined but the trade intensity index was similar to that of the previous decade. As in the US-Canada case, exchange rate movements between sterling and the Deutschmark in the 1970s appear to have had no discernible effect on trade relations.

**Table 4.3. Trade Intensities and Relative Volatility of Exchange Rate Movements of the Deutschmark With the French Franc and British Pound**

	France			UK		
	Average Monthly Exchange Rate Movement	Standard Deviation	Average Trade Intensity Index Method 2	Average Monthly Exchange Rate Movement	Standard Deviation	Average Trade Intensity Index Method 2
1975-79	1.28%	1.24%	1.56	2.16%	1.91%	0.80
1980-84	0.74%	1.18%	1.60	2.21%	2.10%	1.21
1985-89	0.55%	0.69%	1.59	2.05%	1.59%	1.32
1990-94	0.50%	0.42%	1.62	1.55%	1.50%	1.27

*Note:* Exchange rates are nominal, percentage changes are absolute—regardless of direction. See Chapter 3 for methodology of calculations for the trade intensity index.  
*Source:* Author's calculations from IMF *International Financial Statistics, Direction of Trade Statistics*, various issues.

The overall conclusion is that without institutional agreements aimed at currency stability, regionalism has little impact on currency volatility. The Canada-US Free Trade Agreement (CUSFTA) inaugurated in 1988 included no foreign exchange rate co-operation and has seen no measurable change in the volatility of exchange rates, while fluctuations in Europe subsided with the emergence of the ERM. However, as noted in Chapter 3, trade bias has risen in both regions since the late 1980s.

A further observation is that foreign exchange rate volatility is more strongly influenced by formal agreements aimed at exchange rate stability than

by *ad hoc* intervention by governments. However, there are limits to the influence of regional agreements which include exchange rate co-operation. Membership of the ERM did not enable sterling and the lira to maintain their exchange rate levels against other European currencies in 1992. An institutional agreement will only be effective when currencies are not fundamentally mis-aligned.

The above findings cast further doubt on the policy objective of foreign exchange rate stability among developed economies because of the link that is assumed to exist with trade flows. The data in Tables 4.2 and 4.3 show no clear link between the two variables. This supports the earlier finding that foreign exchange volatility had no measurable impact on trade flows. In the final analysis, the conclusion is that policy-makers' attempts to stabilise exchange rates are puzzling, in that even when some success is achieved there are no readily identifiable benefits to trade flows. On that basis, institutional arrangements to stabilise exchange rates could be misguided if the objective is to contribute to higher levels of economic integration.

#### **4.7 Regionalisation and Capital Flows**

Apart from the discussion over exchange rate stability and regionalisation, there is also the question of how regionalism and regionalisation affect capital movements between countries. Do closer political or economic ties mean that the movement of financial flows between countries becomes less (or more) volatile? The answer derives largely from the exchange rate system which operates between the regionalising countries, as well as the nature of the restrictions on capital flows.

As was discussed in Chapter 3, data on capital flows are extremely unreliable. The nature of capital flows is such that it is very difficult to identify accurately the origin and destination of fund movements. A German bank can borrow funds in Japan, switch them into dollars in order to buy the stock of a Mexican company listed on the New York Stock Exchange. This type of flow makes a statistical examination highly complex. However, looking at exchange rates is essentially the same as examining capital flows. Exchange rate movements are effectively the footprints in the trail left by capital moving from

one country to another. Thus the comments made above about exchange rates apply equally to capital flows.

#### 4.8 Single Market, Single Currency

Unlike the theory surrounding customs unions, that concerning monetary union is far less clear. There are a range of economic and political costs and benefits that must be considered in assessing the merits of any particular situation. Few examples of monetary union exist in modern economic history—the cases of the United States in the early 19th century, Germany between 1837 and 1871 and Italy up to 1862 are the main examples within single countries.

Examples of currency union between groups of sovereign states are even less common. The Latin Monetary Union formed in 1866 and the Scandinavian Monetary Union formed in 1875 are the main regional examples.<sup>60</sup> The former was modest in its objectives and relatively short lived,<sup>61</sup> but the latter eliminated differentiations between national currencies until close to the First World War. Both were based around a metallic standard, silver in the former case, gold for the Scandinavian union, and it has been argued that there was no monetary co-operation as a result of the union compared to the situation if each country had unilaterally adopted a gold standard.<sup>62</sup> In the 1990s the debate is focused on Europe, where some argue that the single market cannot function efficiently unless a single currency is also in operation.<sup>63</sup>

As has been discussed above, there is no evidence that exchange rate volatility leads to an inefficiently low level of foreign trade. Therefore, eliminating volatility is a poor motivation for introducing a single currency. A clearly positive argument in favour of a single currency is that it reduces the transaction costs of trading between members of a regional group. However, an EC study showed that the static costs of maintaining national currencies in Europe was between

---

<sup>60</sup> The Latin Monetary Union comprised France, Belgium, Switzerland and Italy, while the Scandinavian Monetary union was between Denmark, Sweden and Norway.

<sup>61</sup> The objective was to harmonise the size of the five franc pieces issued in each country, but the issue of standard silver pieces ended in 1878.

<sup>62</sup> Jonung (1984).

<sup>63</sup> Emerson *et al.* (1992).



1% of GDP (for smaller countries) and 0.1% of GDP (for larger ones).<sup>64</sup> Thus the direct benefits in terms of lower transaction costs of monetary union appear very limited. Krugman is more sceptical of the size of microeconomic benefits from a single currency and claims that any estimates are very loose, asserting "I don't think we even have an idea of the order of magnitude".<sup>65</sup>

In his seminal paper on optimum currency areas, Mundell showed that, in a fixed exchange rate regime, the policy of surplus countries suppressing price rises "imparts a recessive tendency to the world economy on fixed exchange rates or to a currency area with many separate currencies".<sup>66</sup> Although written in 1961, this accurately foresaw Germany's role in Europe in the 1980s. Mundell also showed that with a common currency (as opposed to fixed exchange rates) the result is an inflationary bias, which helps to explain the insistence of Bundesbank officials that all participants in monetary union meet the Maastricht criteria.<sup>67</sup>

Another key point in Mundell's paper is that the relative merits of a single currency versus flexible exchange rates depend largely on the degree of factor mobility. If factors of production can move between countries then this facilitates economic adjustment. If not, then movements in the exchange rate are needed to achieve the same adjustment. While Europe in the 1990s includes liberalised labour and capital markets, in practice the mobility of labour is limited, although capital moves more freely. This is not necessarily a problem if systemic shocks apply equally to all members of the union, but with asymmetrical shocks, individual nations need a means of adjusting.

Bayoumi and Eichengreen have shown that regions of the US adjust more quickly to both supply and demand shocks than do countries in Europe.<sup>68</sup> They find that supply shocks in Europe are larger in magnitude and less correlated than in the US, which suggests problems in forming a monetary union.

---

<sup>64</sup> Emerson *et al.* (1992) Annex A.

<sup>65</sup> Krugman (1995) p. 527.

<sup>66</sup> Mundell (1961) p. 658.

<sup>67</sup> This has been a repeated theme of Bundesbank President Tietmeyer and other officials. See *Financial Times*, 10 May 1997.

<sup>68</sup> Bayoumi and Eichengreen (1993).

Nevertheless there is evidence of a core group of countries in Europe which experience more closely correlated shocks, which is an economic argument in favour of a two speed approach to monetary union. Based on Mundell's analysis it is possible to conclude that the costs of monetary union will be relatively large for the peripheral or less open European countries, due to the large asymmetric shocks and relatively slow speed of adjustment. De Grauwe's summary is that "There is now a broad consensus among economists ... that the *EC-12 is not an optimum currency area*".<sup>69</sup> Similarly, Goodhart has argued that "it is doubtful that the EC is an OCA [optimum currency area] at all".<sup>70</sup>

The economic costs of monetary union come from the loss of ability to pursue an independent monetary policy. Across the main industrialised countries in the 1990s there is still clear evidence of policy-makers cutting interest rates or taxes and boosting spending in response to a slowdown in economic growth. The state apparently still believes that counter-cyclical policy-making is feasible. The idea that the state does not believe its actions will work, but is just acting to allay public pressure that "something must be done" is a little too neat, and ignores the independence of some policy-making institutions.

Moreover, Kenen has made the point that fiscal and monetary policies are complementary and countries need to achieve an optimal policy mix if demand management efforts are to be successful.<sup>71</sup> Without a degree of centralisation of fiscal policy any transition to a monetary union will be painful, due to the lack of stabilising fiscal flows. Maastricht convergence criteria which set limits on budget deficits and public debt to GDP ratios are likely to be a poor substitute for a more federal system which has the ability to provide compensating transfers.<sup>72</sup>

If the problems which require policy action apply to the whole region considering monetary union then there will be no practical difference between a single currency with a single monetary policy and individual national currencies and policies. Similarly, if factors of production are fully mobile then national monetary policies are not needed. However, it seems clear that there are still

---

<sup>69</sup> De Grauwe (1994) p. 87. Italics in original.

<sup>70</sup> Goodhart (1995) p. 453.

<sup>71</sup> Kenen (1969).

<sup>72</sup> Goodhart (1995).

shocks which apply to individual countries (German re-unification being the most extreme in recent years) while European factors of production are not fully mobile. This suggests that there will be real costs from the loss of independent national monetary policies.

An additional problem for the state is that the number of policy tools at its disposal appears to be shrinking. The use of border-level restrictions on trade is largely proscribed by the World Trade Organization, which is increasingly extending into non-tariff areas as well as explicit tariff barriers. Across the industrialised world the automatic stabiliser of the welfare state is coming under pressure as governments try to cut taxes to increase economic dynamism. Meanwhile, for a member state of the European Union, the use of state subsidies is closely monitored, while regional grants are increasingly within the aegis of the EU rather than individual governments. Transfer pricing and mobility of factors of production is raising pressure to harmonise tax rates, another potential policy instrument.<sup>73</sup> A move towards monetary union in Europe would remove independent monetary policy-making, while the Maastricht criteria on budget deficits and national debt remove much flexibility on fiscal policy.

Tinbergen's rule states that as many policy instruments are needed as there are targeted policy variables. On this basis, the policy-makers face a problem: even if monetary union removes exchange rate targeting, the number of policy instruments is shrinking faster than the number of policy variables. While some degree of economic convergence can be expected as a result of the European single market and monetary union, the economies of the member states are unlikely to move in tandem. The consequences of such an imbalance will be an inability to respond to the economic cycles in countries which are out-of-step with the main body of countries. In turn this could discredit the national government which will be largely powerless to act, while also discrediting the central institutions which will lack the flexibility to act.

There is a danger that in pooling their resources in an attempt to regain authority over market forces, the separate states are forsaking their freedom of independent policy-making. This appears to open the way for a sharp reaction against the years of gradual integration, perhaps triggered by a localised

---

<sup>73</sup> Tanzi (1995).

recession. That would be the case whether or not fine-tuning of the economy actually works. In the past, governments were seen to react to economic difficulties by cutting interest rates or raising spending. Effective or not, the pressure of public opinion for remedial action by the government is well documented in the media. If the government cannot act then it is in danger of losing its legitimacy.

To look at the inverse of this argument, consider the explanations put forward as to why the recession in the early 1970s was not met by the same pressure for protectionist tariffs that took place after the Wall Street Crash of 1929. Milner presents an explanation which focuses on institutional changes and pressure stemming from the internationalisation of business.<sup>74</sup> However, another credible explanation is that the policy instruments available to the state had multiplied over half a century, so that more efficient measures were available. For example, rather than raising tariffs to protect a threatened industry—as was the case in the 1930s—in the 1970s policy-makers were able to address pressures for relief from suffering industries by a wider range of policies. In addition to measures such as voluntary export restraints, states could also resort to regional grants, subsidies or the targeting of fiscal spending measures, while the welfare state acted as an automatic stabiliser.<sup>75</sup> That there was a more efficient means of arriving at the desired result may be one of the strongest explanations of why extreme protectionism was resisted in the 1970s.<sup>76</sup>

It is possible to envisage a situation where the constraints on monetary and fiscal action coming from European institutions are stronger and more enforceable than restrictions on trade, despite the strengthening of the World Trade Organization's dispute settlement mechanism in the Uruguay Round. Thus European countries may find themselves in the position where the only effective policy remedy available is related to some form of trade barrier: surrendering control of some policy measures means greater reliance on those that remain.

---

<sup>74</sup> Milner (1988).

<sup>75</sup> In other words, although the "hierarchy of policies" (to use Corden's term) may have remained the same, there were instruments available which had previously been excluded from the set of options.

<sup>76</sup> That is not to deny that non-tariff barriers rose in the 1970s, but the point is that the rise in protection was far less pronounced than in the 1930s.

I concur with Bliss who concludes that "the view that says that exchange rate stabilisation, or a common currency, is essential to a customs union has not found much support from our analysis".<sup>77</sup> From the above, it is far from clear that the economic benefits outweigh the costs of monetary union in Europe. Nevertheless, there is apparently a strong commitment among several members of the EU to form a currency union. The conclusion must be that the motivations for such a step are primarily political rather than economic.

Feldstein identifies three political arguments which are used by advocates of a single currency. Firstly, the establishment of a European central bank is a means of preventing national governments from pursuing inflationary monetary policies. However, as Feldstein points out, this "implies a possibly very large sacrifice of potentially good monetary policy in order to reduce the risk of bad policy being chosen".<sup>78</sup> Secondly, Feldstein sees the desire of most of Europe to take power away from the Bundesbank as being behind the move to monetary union. At present Germany effectively sets monetary policy for the rest of Europe and it has a stronger anti-inflationary bias than many of the other members (i.e. it displays the "recessive tendency" towards European activity identified by Mundell as a likely result of fixed exchange rates).

These two arguments are clearly contradictory, the former claiming that a central bank would be anti-inflationary, the latter that it would prevent an excessively anti-inflationary policy. This leads Feldstein to the conclusion that the dominant motivation of advocates of monetary union is that it is a step on the road to political union, with one money helping to unify essentially different nationalities. It would imply a substantial transfer of power away from national government towards a European central government.

Regionalism (the political process) may benefit from the introduction of a single currency as it would strengthen central institutions and eliminate one symbol of nations' individuality. However, there is little to suggest that regionalisation (the process of economic integration) would be significantly enhanced by all countries within a regional bloc adopting the same currency.

---

<sup>77</sup> Bliss (1994) p. 129.

<sup>78</sup> Feldstein (1991) p. 82.

## 4.9 Conclusion

This chapter has failed to find a link between regional integration and exchange rate volatility. There is little to suggest that lower volatility means closer trading relationships. In spite of the lack of empirical evidence that currency volatility is detrimental to trade and investment, it is viewed negatively by governments, as demonstrated by intervention in foreign exchange markets and the continued popularity of managed exchange rates. However, options for reducing volatility appear limited, with foreign exchange intervention having a chequered record. Only when there is an explicit agreement targeted at foreign exchange rate stability does a regional agreement appear to have a measurable impact on forex volatility.

The ultimate step towards eliminating currency fluctuations is to form a currency union. However, the requirements for this to be an efficient *economic* move are stringent and satisfied by few countries. Nevertheless, in Europe the *political* motivations may override any concerns that an economic cost-benefit analysis does not give a persuasive case for monetary union. Moreover, the motivations for harmonising exchange rates through a pegged system, or of moving to a single currency, appear to be relatively limited. When compared with the potentially large costs involved in terms of loss of policy independence the economic cost-benefit analysis is far from compelling.

Given the continued enthusiasm for EMU among the policy-makers of the European Union, the conclusion must be that attempts to promote currency stability within Europe are politically motivated, not driven by potential economic gains which have been shown to be indeterminate. The political merits of a centralised currency system are a further move of power towards pan-European institutions and the knowledge that stronger federal fiscal authority is a natural corollary if the system is to be effective.

There is no reason to suppose that the arguments which persuade countries that it is in their interests to form a free trade area also apply to forming a currency union. Taken to the extreme, the optimum free trade area is the entire world, while few would argue for a single global currency. The surprising conclusion is that although exchange rate movements receive great prominence in the media and in the minds of policy-makers, they are less important for world

trade flows. Trends towards regionalism and regionalisation can be expected to remain largely unaffected by the nature of the exchange rate regime under which they operate.

## CHAPTER FIVE CAUSES OF REGIONALISATION AND IMPLICATIONS FOR THE INTERNATIONAL POLITICAL ECONOMY

### 5.1 Introduction

This chapter aims to explain some of the regional trends identified in Chapter 3 by looking at how and why the structure of world trade and investment has been changing. Some key features emerged from the statistical examination of trends towards regionalisation. Notably, there has been a marked increase in regional trade bias within Europe and North America since the late 1980s. Moreover, this increase in trade bias has been accompanied by a greater degree of economic openness, suggesting developments have not been detrimental to the rest of the world.

I will argue that there are three forces driving the degree of regional bias upwards, one offsetting force which is slowing its rise, and one force where the effects are indeterminate. Firstly, we can say that, *ceteris paribus*, preferential regional agreements inevitably increase the bias towards trade with regional partners.<sup>1</sup> This increase in bias can be explained in simple macroeconomic terms—preferential regionalism reduces the relative costs of doing business with countries within the region compared to those outside the region. The consequence of such a change in relative prices is that intra-regional trade will increase compared to extra-regional trade. This is the trade creation component identified by Viner. Unfortunately, the amount of increase cannot be calculated without reasonably detailed knowledge of the elasticities involved and a qualitative measure of the value of the preferential agreement, both of which are likely to be imprecise. In recent years non-border issues have come to assume a greater significance and so it is necessary to consider whether "deeper" preferential agreements incorporate different implications for regionalisation than more standard free trade areas and customs unions. One particular issue is whether the focus on deeper integration which is incorporated in the European

---

<sup>1</sup> As discussed in Chapter 3 this bias tends to exist to some degree due to elements such as geographic proximity, transport costs and cultural similarities, but it is the change in the degree of bias which is of greater interest.



Union and the North American Free Trade Agreement contributed to the rise in measures of regionalisation noted since the late 1980s.

One caveat is that many regional developments in recent years have been of the "deeper" variety and only a subset of those are applicable on a regional basis. As the UN has noted, "The elimination of certain non-tariff barriers in a region has characteristics equivalent to the provision of a public good".<sup>2</sup> Several developments have been inherently non-preferential, improving market access for non-members of a regional grouping as well as for its members. As a result the nature of regional liberalisation needs considering before a judgement can be made on whether it is likely to promote regional integration rather than more generally increasing the openness of an economy.

The second force becomes evident by viewing regionalisation from a microeconomic rather than macroeconomic perspective. It is argued that established multinational corporations are increasingly organising production on a regional basis, rather than focusing on single countries, and not extending their production networks to the global level. More widespread adoption of *kanban* (just-in-time) production techniques means that although producing on a global basis may be technologically feasible, it conflicts with optimal organisational structures. Regional production structures mean that components and final products are traded within the region, with mostly raw materials and intangibles exchanged between regions. However, regional organisational structures do not prevent firms from serving global markets. For many production processes, an efficient scale of operation can be achieved on a regional basis. It is in "knowledge" related areas such as research and development, design, finance and advertising where the trade regime is relatively unimportant as long as the fixed costs can be spread over a broad geographic base.

The third force behind rising measures of regionalisation is more of a statistical observation, but is nevertheless important when calculating the degree of intra-regional trade bias. Intra-regional trade in Europe and North America is relatively biased towards intra-industry manufactured goods, while inter-regional trade has a relatively high proportion of raw materials. As a result, a secular downtrend in commodity prices vis-à-vis prices of manufactures, combined with

---

<sup>2</sup> United Nations (1993) p. 8.

an elasticity of demand of less than one for commodities, means that the share of commodity trade in world trade is falling. This has the effect of raising the share of European and North American intra-regional trade compared to inter-regional trade, raising measures of the degree of intra-regional bias.

With these three forces driving regionalisation forwards, there is likely to be an offsetting dynamic at work, because until recent years the rise in regionalisation in Europe and North America was subdued, while it has been stable in Asia. I will argue that this counteracting force is one of globalisation, as more and more domestically oriented firms realise that changes in physical and legal barriers to international trade have been falling, allowing them to become exporters or small scale MNCs. Lower barriers include factors such as the information technology revolution, falling transport costs, reduced uncertainty, looser and more transparent foreign investment regulations and lower tariffs.

One complication to be aware of is that there can be a difference between an increase in the actual degree of regionalisation (in underlying economic terms) and an increase in the selected measures of regionalisation (in statistical terms). For example, the convergence of economic cycles could be taken as an indication of regionalisation, but this is not likely to be picked up in measures of trade or FDI intensities. Conversely, trade-replacing FDI within a region will lower the trade intensity measure, but this does not necessarily imply a reduced degree of integration.

While this chapter attempts to explain the causes of regionalisation trends noted in Chapter 3, it should first be recognised that any such examination is hindered by a lack of detailed information about the flow of investment and intangibles across borders. Most notably there is a problem in the treatment of foreign direct investment (FDI) as it can be either a complement to existing trade flows or a substitute. It could be that FDI flows from one region to another replace existing trade flows, while within a region they are aimed at building regional production networks and so are complementary. On that basis, inter-regional flows would be expected to be aimed at entire processes (i.e. complete transplants), while intra-regional flows would be just parts of processes.

Observing that regionalisation has increased or decreased in recent years is important in contributing to understanding how the international political economy operates, but the implications of regionalisation must also be

considered. In particular, how regionalisation affects economic welfare is a key concern which will be considered in the final part of this chapter. Much of the standard international political analysis is of little assistance in this respect, as it is embedded in the "more trade good, less trade bad" framework.

The objective of this chapter is to attempt to identify forces which might have contributed towards some of the trends noted in Chapters 3 and 4. However, noting what is relevant is much more straightforward than measuring the significance of the factors, especially in the face of inadequate information in some areas and the indeterminate role played by foreign direct investment. The overall complexity is intensified by different interpretations of when a trend represents regionalisation and when it is more correctly labelled globalisation.

## **5.2 Impact of Regionalism on Regionalisation**

The theoretical literature gives us a reasonable insight into the likely reactions of economic actors towards greater regionalism on a macroeconomic basis. The rawest description is that regionalism represents a move between a set of countries to lower the costs of doing business with each other. This may come in several guises, with lower intra-regional tariffs being the most common and most easily identifiable. Other non-tariff features of regionalism, such as mutual recognition of standards, elimination of quantitative barriers, liberalisation of movements of factors of production and greater transparency all have a similar impact on a macroeconomic basis; they lower costs of cross-border transactions.

Moreover, from a macroeconomic perspective it is not necessary to examine statistical or survey evidence to support the idea that lower barriers to cross-border activity result in a higher level of activity. It is necessarily the case that a relatively low cost producer in one country may be prevented from exploiting its competitive advantage due to costs which arise as a result of doing business in foreign markets. These could stem from transport costs, language differences, regulatory compliance, tariffs or any other additional cost which is incurred in delivering the product to the foreign market. The incremental cost of selling in foreign markets falls as border tariffs decrease, or as other non-border differences are reduced by regional trade agreements. That is not to say that every firm, or even every industry, will suddenly find trading more extensively

within the region an attractive proposition. However, it is the case that at the margin there will be firms which now find it profitable to expand into other regional markets, because the cost of doing so has fallen.

How this regionalisation shows up in the data is a greater problem than asserting its existence. If regional co-operation is in the form of lower restrictions at the border then the degree of regional trade bias can be expected to rise. If, however, it comes in the shape of easier establishment of business operations on a regional basis—perhaps through the elimination of negative trade related investment measures—then regionalisation could occur through more intensive intra-regional flows of capital. This could even be at the expense of the measure of the regional trade bias, if the foreign direct investment is of the trade substituting variety.

Graphs in Chapter 3 provided an illustration of trends towards regional bias in recent decades. The most striking features were that until the late 1980s, regional bias had apparently borne little relation to efforts to promote border level preferential bias, while since then moves towards "deeper" levels of co-operation have been accompanied by a rise in the degree of regional trade bias in the EU and North America. However, in the case of Europe, most of the rise in regional bias has been through the impact of new members seeing an increase in their degree of trade bias with the other members. This suggests the need to examine the particular features of deeper integration in order to judge whether it could be responsible for the rise in regional bias seen in recent years.

### **5.2.1 Impact of "Deep" Regionalism**

Deep regionalism relates to co-ordination which extends beyond border level issues. This could include measures such as harmonisation of national standards, unbiased government procurement, uniform protection of intellectual property rights, impartial anti-trust legislation and national treatment for foreign investment.<sup>3</sup>

---

<sup>3</sup> Oman (1994), Lawrence (1996).

Increasingly, these deeper issues were included in multilateral GATT Rounds, with the Tokyo Round containing measures on anti-dumping,<sup>4</sup> and the Uruguay Round covering trade related investment measures (TRIMs) and intellectual property rights.<sup>5</sup> However, the range and depth of coverage of non-border issues is, to some extent, at the discretion of the countries concerned. Attitudes towards (and definitions of) anti-trust policies, environmental protection and public-sector subsidies are likely to differ considerably between countries with different cultural and sociological histories. It is likely that smaller groups of countries with similar economic, political and social circumstances will find it easier to agree on such issues than larger, more diverse groups.<sup>6</sup>

Issues of deeper integration are seen as being closely linked to the rise in regionalism in the EU and North America since the late 1980s, where one objective has been to promote FDI by multinational corporations.<sup>7</sup> However, some of the areas of co-ordination benefit non-regional firms as much as those within the region. Elements such as transparency or the banning of subsidies are difficult, if not impossible, to apply on a preferential basis. Only a subset of measures to promote deeper regional co-operation will raise the degree of regionalisation. Others will result in a non-preferential increase in openness. This can be shown by looking at some examples of deeper regionalism. Unfortunately, most international political economy studies of the issue tend to be satisfied with broad assertions that, for example, NAFTA provides for stronger provisions on TRIMs than the Uruguay Round, without considering the nature or importance of the differences.<sup>8</sup> In contrast, legal studies of the differences between multilateral and regional treaties are strong on facts, but give little consideration to the impact of the differences and tend to be written in a form which is inaccessible to the layman.<sup>9</sup> The following analysis of deeper integration

---

<sup>4</sup> Baldwin (1993).

<sup>5</sup> Evans and Walsh (1994), Lawrence (1996).

<sup>6</sup> Kahler (1995).

<sup>7</sup> For discussion of the importance of deeper integration see, for example, Lawrence (1996).

<sup>8</sup> This is the approach taken by Hufbauer and Schott (1994).

<sup>9</sup> Two exceptions are those of Evans and Walsh (1994) and Parra (1995) who give a detailed and understandable presentation of some of the main issues.

aims to offer greater detail than is available in most political economy studies, in order to explore which aspects of deeper integration are likely to promote regionalisation.

**Subsidies.** If a national government offers subsidies to favoured domestic firms or industrial sectors then this places them at a competitive advantage to firms from within the region as well as those from the rest of the world. Under the Uruguay Round subsidies are divided into "green" and "red" boxes, the former (such as those related to pre-competitive research) being allowed, the latter (such as tax concessions based on export performance) prohibited.<sup>10</sup> "Red" subsidies tend to be related to export promotion and the preferential use of domestic inputs over foreign ones, in violation of national treatment principles. Countervailing duties are permitted in response to "red" subsidies in a similar way that anti-dumping measures are implemented. However the exemptions are largely determined by political considerations, and the use of countervailing duties can be abused.

Among regional groupings the European Union has the firmest stance against national subsidies, with several high profile cases being drawn to the attention of the Commission. These include the UK government's "sweeteners" to encourage British Aerospace to buy the Rover car maker, and French support for the state-owned airline Air France and for the bank Credit Lyonnais. However, outlawing such subsidies does not imply creating a preferential regional bias. British Airways and Lufthansa might suffer from French airline subsidies, but such measures are essentially non-discriminatory in that they affect extra-regional firms as much as regional ones. Whatever regional discrimination that does exist is in the use of countervailing duties, which are not allowed between EU members; of course if subsidies are banned entirely then there is no need for countervailing duties to offset them. Other regions such as North America have not integrated so deeply that the issue of public subsidies is addressed, but nor is such a form of industrial policy as prevalent as in Europe.

---

<sup>10</sup> Evans and Walsh (1994) Chapter 8.

**Government Procurement.** If the state favours domestic firms in its purchasing patterns with the intention of helping them to achieve an efficient scale of production then this is a discriminatory policy which goes against principles of national treatment. One controversial example in recent years has been the Japanese government's procurement policies for satellites and supercomputers which effectively excluded foreign firms until the US forced a lower degree of domestic bias through the Structural Impediments Initiative.<sup>11</sup>

In the original GATT treaty public procurement was explicitly excluded from Article III provisions on national treatment. The Tokyo and Uruguay Rounds contained some provisions on public procurement attempting to bring it within general GATT principles, as well as including services in the deal and applying it at levels below the central government. However, there are monetary limits on which contracts are covered and it only applies plurilaterally to signatories of the agreement.<sup>12</sup>

If a regional agreement is such that a government must not show preference between firms of the region when deciding its procurement policies, then such a deal can generate a regional bias. For example, the European Union leaves open the possibility for governments to maintain a 50% EU content requirement as well as allowing a 3% price differential in favour of EU firms. Similarly, according to NAFTA provisions, bidding for Mexican construction projects and oil industry projects will be opened to US and Canadian firms over a ten year period, but discrimination against non-NAFTA bidders will remain.<sup>13</sup>

In practice, however, outlawing discrimination in favour of domestic firms in government procurement is likely to mean adopting an entirely non-discriminatory policy, and regional discrimination is likely to be the exception rather than the rule. National horizons are still sufficiently narrow that if the objective of benefiting domestic firms cannot be achieved, then the next best option is likely to be the bidder which offers the most competitive tender. As a

---

<sup>11</sup> Although a frequent European Union complaint over the Structural Impediments Initiative was that the ensuing openness was heavily biased towards American producers, so a domestic bias would be replaced by a bilateral one.

<sup>12</sup> For central government only contracts above SDR130,000 are covered, while the threshold is SDR200,00 for sub-central governments and SDR400,000 for public utilities. See Evans and Walsh (1994) p. 62.

<sup>13</sup> Lawrence (1996).

result, government procurement policies will become increasingly liberal on a global rather than regional basis.

**Trade related investment measures (TRIMs).** These are also covered by the Uruguay Round, although the agreement focuses on negative TRIMs (i.e. those that restrict investment) rather than positive ones. The TRIMs agreement applies to goods and is supplemented by the General Agreement on Trade in Services which covers issues such as rights of establishment and treatment of the investment after establishment.<sup>14</sup> The Uruguay Round provisions are relatively weak and negotiations are in progress under the auspices of the OECD to produce a more substantial Multilateral Agreement on Investment (MAI). An MAI is expected to be modelled on the stronger provisions which already exist in regional agreements such as the North American Free Trade Agreement (NAFTA).

NAFTA contains broader provisions on TRIMs than multilateral accords, including tighter restrictions on performance requirements and the extension of dispute settlement to cover disagreements between private investors and states. The NAFTA definition of what comprises an investment is also extremely broad, including "an enterprise; equity or debt securities of an enterprise; interests that entitle an owner to share in the income or profits of an enterprise; tangible and intangible assets acquired or used for business purposes; interests arising from the commitment of capital such as under turnkey or construction contracts; and contracts where the remuneration depends on the production, revenues or profits of an enterprise".<sup>15</sup> The EU restrictions on TRIMs are more advanced than those of NAFTA and they also broaden the scope of protection to include the returns on an asset as well as its capital value.<sup>16</sup>

This is an area which can be discriminatory on a regional basis, as it is feasible to apply closer controls on TRIMs depending on the nationality of the firm. It is difficult to make a qualitative assessment of the differences between Uruguay Round rules and those under regional agreements such as NAFTA, and

---

<sup>14</sup> Evans and Walsh (1994) Chapter 5.

<sup>15</sup> Parra (1995) p. 43.

<sup>16</sup> OECD (1995) p. 41.



even more difficult to assess the role that such differences play in corporate decision-making, but it does offer some support to the idea that "deeper" co-operation implies stronger regional bias. However, this bias is more likely to be evident in the investment figures than in trade data, and as has been discussed in Chapter 3, series on direct investment flows are erratic and unreliable. If the investment is trade-substituting (i.e. aimed at supplying the market in which it is located by replacing exports) then the measures of trade bias would be expected to show a decline.

**Anti-Dumping.** The threat or actual use of anti-dumping duties to restrict foreign trade has become an increasingly popular means of protection.<sup>17</sup> As such, restrictions on the use of anti-dumping action can represent a clear move towards more open trade. Moreover, restrictions on anti-dumping can be imposed on a preferential basis, so this is potentially an area where a regional bias could emerge.

Both the Canada-US Free Trade Agreement (and subsequently NAFTA) and the Australia-New Zealand Closer Economic Relations Trade Agreement (CERTA) include co-operation on anti-dumping measures.<sup>18</sup> Within NAFTA exports cannot be subjected to countervailing duties due to accusations that they are being sold at less than fair value on the basis of a unilateral decision; any anti-dumping duties are made subject to a binding review by a bilateral panel. In the case of the European Union the use of anti-dumping tariffs runs counter to the principles of the single market and cannot be applied to intra-regional trade.

An agreement on dumping was also included in the Uruguay Round, in an attempt to broaden acceptance of restrictions that had been put in place as part of a set of voluntary codes in the Tokyo Round.<sup>19</sup> Nevertheless, countervailing duties based on anti-dumping are permissible under the WTO and their imposition and threat of imposition is a restriction on trade. If a regional agreement lifts the threat of the use of anti-dumping measures from other

---

<sup>17</sup> Laird and Yeats (1990b).

<sup>18</sup> Kahler (1995).

<sup>19</sup> Evans and Walsh (1994) Chapter 10.

countries within the region then it can be expected to have a positive effect on the degree of regional trade bias.

**Intellectual Property Rights (IPRs).** Under the Uruguay Round's Trade Related Intellectual Property Rights (TRIPs) agreement, principles such as national treatment and most favoured nation (MFN) are applied to IPRs. However, the enforcement provisions of the agreement are relatively weak, as a result of the negotiating parties having diametrically opposed views towards IPRs.<sup>20</sup> The majority of IPR holders come from developed countries, which are understandably eager to derive the maximum return from their investment in innovative research. In contrast, developing countries see innovation as a public good and view patent protection as being responsible for inflating the prices of goods they require.

In that protection of intellectual property under the Uruguay Round is based on national treatment and MFN it can be seen as only being applicable on a non-discriminatory basis. However, in practice the main difference lies in the enforcement of IPR protection between countries. Both the EU and NAFTA offer stronger protection on two counts; firstly the legal processes are more clearly defined (and in the case of the EU not controlled by the national judiciary, but by the European Court of Justice); secondly recourse to the law is open to individual companies and not just governments.<sup>21</sup>

Although the provisions of the Uruguay Round are relatively weak, there is evidence that the US is ready to act as a worldwide enforcer in this area. It was US insistence that resulted in the TRIPs agreement being included in the Uruguay Round, while under Section 1303 of the 1988 Omnibus Trade and Competitiveness Act the US can take action against countries which violate IPRs.<sup>22</sup> The implication is that with the US unilaterally policing the multilateral agreement, the level of enforcement will be stronger (although more arbitrary) than it appears on paper.

Conversely, although regional trade agreements between developed countries such as in the EU and NAFTA offer enhanced IPR protection, these

---

<sup>20</sup> See Chaudhry and Walsh (1995) p. 88.

<sup>21</sup> Chaudhry and Walsh (1995).

<sup>22</sup> Evans and Walsh (1994) Chapter 7.

are the same countries that are likely to be holders of intellectual property rights and therefore be prepared to enforce multilateral rules effectively.<sup>23</sup> As a result, coverage in regional agreements between developed countries is likely to add only limited practical protection for IPRs. This implies that the marginal benefits for IPR protection that result from being inside a regional trading arrangement such as the EU or NAFTA are relatively minor.

**Harmonisation of Standards.** Meeting different standards in each national or sub-national market can represent a significant cost for a multinational corporation. Products will need to be redesigned to incorporate special features in order to be acceptable to other countries in the case of differing standards. If standards can be harmonised between groups of countries then the cost of supplying a product within the group will be lower in terms of both design and production costs. A reasonable degree of centralisation is necessary for standards to be harmonised within a region. At the very least an effective bargaining process is needed, and an enforcement mechanism and a central body to set the rules are also likely to be necessary. It can be a controversial area, as it is a relatively high profile one, with consumers in one country feeling their choice or traditions are being manipulated by an extra-national authority.<sup>24</sup>

A move to harmonise standards within a region has similar features to a customs union, in terms of the implications for the costs of doing business across a region. One recent example has been the harmonisation of business law under the Australia-New Zealand CERTA which will reduce the costs of cross-border business between the two countries.<sup>25</sup> However, harmonisation of standards is not an intrinsically discriminatory step, as the same rules will be enforced on all suppliers and the average cost of meeting a single standard in a region is likely to be lower than meeting separate standards in each country. The costs of adherence to the new standards will, in theory, be no higher for established extra-regional suppliers than for regional producers, so there should not be a

---

<sup>23</sup> A 1975 joint WIPO/UNCTAD study found that foreign firms held 84% of patents granted in developing countries. Cited in Evans and Walsh (1994) p. 37.

<sup>24</sup> This is illustrated by sporadic British outrage driven by the popular press against supposed EU rulings on various acceptable weights and measures.

<sup>25</sup> OECD (1995).

danger of trade diversion. As Lawrence points out, deeper is not necessarily better and harmonising on the wrong policy would have a negative impact.<sup>26</sup> However, this is more a question of the appropriate level of regulation than of discriminatory trade policies.

In reality standards can be designed to exclude some producers; for example, if Europe were to impose standards on fuel efficiency for automobiles then it would be likely to discriminate against large US cars. However, such a step would represent an explicitly protectionist policy decision, and is a separate issue from that of whether harmonisation of standards *per se* is applicable on a preferential basis.

**Mutual Recognition.** This is the opposite to harmonisation of standards, whereby if a practice or a product is deemed to be acceptable by one member of a region then the other members must also accept it. The most famous European example is that of the French alcoholic drink, Cassis de Dijon, which in 1979-80 the European Court of Justice ruled must be allowed access to Germany even though its alcohol content fell short of the level required in Germany to be classed as a liqueur.<sup>27</sup> Mutual recognition overcomes the inevitably complex negotiations that surround harmonisation of standards, but it does have the drawback that it can lead to "lowest common denominator" policies, which is sometimes labelled as being a "race to the bottom" in terms of regulations. NAFTA does not include mutual recognition in its free trade agreement, so it is not a possible factor in the closer integration seen in recent years.

Mutual recognition is to a degree discriminatory because an extra-regional supplier will find it necessary to conform to the standards in at least one member country, and these standards may differ from those in its home country, while those within the region will need to make no adjustments.<sup>28</sup> A new extra-regional

---

<sup>26</sup> Lawrence (1996).

<sup>27</sup> Turner and Hodges (1992).

<sup>28</sup> One of the recommendations of the Transatlantic Business Dialogue in Seville, Spain in November 1995 was that the US and the European Union should move to mutual recognition of standards for medical devices, telecommunications equipment, information technology products and electrical equipment, followed by negotiations on other important sectors.

supplier might therefore face some extra costs compared to regional producers, while established suppliers will benefit from being able to sell across the whole region. A move within a region towards mutual recognition is a non-discriminatory policy in that if, say, a Japanese bank is granted a license to operate in the United Kingdom, then it is also entitled to set up branches across the European Union. However, foreign suppliers will find themselves disadvantaged if, as a result of a mutual recognition agreement, they find themselves competing with firms from a country within the region where regulatory standards are lower. Thus it may be plausible to ascribe part of the rise in regionalisation in the EU to the adoption of mutual recognition agreements, because in some situations non-regional suppliers can face additional costs.

**Rules of Origin.** One of the major differences between a customs union and a free trade area (FTA) is the ability of member countries of FTAs to maintain different levels of external tariffs. For this to be effective it is necessary to have legislation in place to prevent imports entering the lowest tariff country of an FTA and then being shipped across the border to a higher tariff partner after a cosmetic alteration. To achieve this, rules of origin are imposed which require a product to be transformed or have a specified amount of value added within the region.<sup>29</sup> It is worth remembering that rules of origin are only necessary in areas where tariffs or quotas exist; free trade would make them superfluous.

Rules of origin are inherently discriminatory and when broadened on a regional basis they can become more so, or less so. For example when the Canada-US Free Trade Agreement was extended to include Mexico some local content requirements were raised. In the case of automobile parts the value added requirement rose from 50% to 62.5%, while tighter limits were also imposed for textiles and televisions.<sup>30</sup> In that rules of origin are intended to enforce the effectiveness of regional tariff preferences, they are aimed at discriminating against countries from outside the region.

---

<sup>29</sup> Palmeter (1993) gives a full explanation of the four different forms that rules of origin can take; substantial transformation, change in tariff heading, value added requirements and specified process.

<sup>30</sup> Gruben and Welch (1994).

**Competition Policy.** As with the elimination of public subsidies or partiality in public procurement, an effective competition policy is likely to benefit non-regional firms as much as those within the region (or even more so, considering that some regionally-based firms would be favoured by weak application of competition policy). Effectively the EU and ANZCERTA both have a regional competition policy. NAFTA contains provisions to prevent the abuse of monopoly power by public monopolies and requires each member to enact a national competition policy (a rule aimed at Mexico or future entrants, as Canada and the US already had one).<sup>31</sup>

The Uruguay Round has little to say on the issue of competition policy, although this is expected to be an area for inclusion in any future Round.<sup>32</sup> An effective regional competition policy has a definite impact owing to the lack of multilateral rules, and its non-discriminatory nature means that it cannot be seen to be a factor behind the recent rise in regionalisation in North America and Europe.

**Transparency.** Clear and open rules governing all forms of economic transactions are a frequent result of procedures being codified by a central authority. This is not particularly relevant to North America, as the US is an extremely legalistic society, although Mexico is much less so. Transparency is also high in the Europe Union, with the member states lacking the freedom to make arbitrary decisions. However, if regionalism were to progress in Asia then the rules applying in what are frequently seen as "extra-legal" societies such as Japan and China would be made explicit.<sup>33</sup> Such a step would certainly not be discriminatory in favour of other members of the region and could even favour extra-regional actors which, perhaps because of cultural differences, currently have less clear information on the business operating environment.

**Summary.** It is clear that shallow regionalism can be applied on a preferential basis: this is the heart of old-style regional trading arrangements. However, there

---

<sup>31</sup> Lawrence (1996).

<sup>32</sup> OECD (1995).

<sup>33</sup> Graham (1994).

is less scope to impose a preferential regional bias with deeper integration involving non-tariff liberalisation. Recall that one of the more surprising findings in Chapter 3 was that trade bias between the original six EU members has not increased since the late 1960s, with an increase in overall regional bias ascribed to the effect of expanded membership. Lawrence notes the success of the EEC in eliminating tariffs and quantitative restrictions on intra-EEC-trade by 1968, with the focus since then on "deeper" liberalisation.<sup>34</sup> This suggests that deeper integration measures have not increased the preferential bias between the original six.

The foregoing examples of "deeper" integration need to be considered in terms of their effectiveness in promoting regional integration by granting regional preferences rather than being a non-discriminatory liberalisation. Aspects of deeper integration, such as improving transparency, banning subsidies and enacting an effective competition policy are difficult, if not impossible, to apply on a preferential basis and therefore cannot be responsible for a rise in regionalisation. Indeed, in some cases they may actually favour non-regional firms if they help to level a previously sloping playing field. The main features of regionalism which can be applied on a discriminatory basis are rules of origin, TRIMs and anti-dumping. Even those elements of deeper integration which are applicable in a preferential fashion are unlikely to be powerful enough forces to explain much of the rise in intra-regional integration seen in the EU and NAFTA since the end of the 1980s. If deeper integration measures were significant on a preferential basis then the EU6 measures of integration in Chapter 3 should have risen in recent decades.

The net effect of such "deep" policy steps may be to offer improved access to the regional economy to foreign multinational corporations, although this will not be as great as the improved access to regionally-based firms. The overall effect is likely to be only a slight rise in measures of regionalisation, so explanations which point to deeper regionalism as being behind the rise in regionalisation appear unsubstantiated by a closer look at the mechanisms.

Even though the tariff reductions in the Single European Market programme, the Canada-US Free Trade Agreement and in NAFTA were

---

<sup>34</sup> Lawrence (1996).

relatively low, their effect could have been stronger than that of the deeper integration which was incorporated in the agreements. For example, NAFTA contained progress on lowering barriers to trade in agricultural products, automobiles, textiles, telecommunications and financial services, while in Europe the 1992 programme helped to implement the provisions of the customs union which had previously existed on paper. As such, the impact of border-level liberalisation may still have been the most important feature of the North American and European regional agreements. In particular, in the absence of other convincing explanations for the rise in regionalisation since the late 1980s which is noted below, one conclusion is that preferential trade liberalisation is the main force at work.

It is also worth recalling that if the world is divided into four regional groups and three show an increase in trade intensities as a result of preferential regional agreements, then the trade intensity measure of the fourth region will also rise. However, this appears to be an unsatisfactory explanation of the rise in trade intensities in NAFTA and the EU, as the diffusion of regional trading agreements throughout the world over the past decade has not been substantial enough to boost other regional trade intensities to the extent that the EU and NAFTA measures rise as a residual effect.

### **5.3 A Microeconomic Perspective**

As discussed above, there is a suspicion that a macroeconomic analysis of regionalisation may not be sufficient to explain recent trends and that answers can be found in a microeconomic perspective. Several observers have claimed that firms are increasingly organising production on a regional basis, rather than looking at the country as a discrete unit and this is behind the rise in regionalisation.<sup>35</sup> Such a trend can cause problems in terms of statistical measurement, as it will affect both direct investment and trade flows, with it being difficult to discern whether the former are complementing or substituting for existing trade movements.

---

<sup>35</sup> For example see UN (1991), UNCTAD (1993) p. 130, Oman (1994) and Kobrin (1995).



This is the core of the observation in Chapter 3 that the links between the political process of regionalism and the economic process of regionalisation tend to be relatively weak, or to put it another way, it is possible to have either policy-led or market-led integration. Microeconomic forces promote *de facto* regional integration in addition to the effects of the *de jure* regional agreements between governments. This occurs as MNCs set up networks within each region and thereby advance integration. Essentially this turns the earlier analysis inside out: rather than regionalisation being viewed in terms of its impact on the world economy, it is the trend towards more internationally mobile MNCs that is resulting in a regional bias to corporate activity.

Oman believes that "from a policy perspective, globalisation is more usefully understood .... as a *microeconomic* phenomenon, one that is driven by the strategies and behaviour of firms".<sup>36</sup> The driving force is not so much deregulation, technology or even financial markets liberalisation, but the impact of new corporate organisation—"flexible" or "lean" production—or "the new competition" which has strained Fordist or Taylorist production systems. The consequence is that firms are meeting the trend of harmonising demand across the world via a series of regional production networks.

One caveat is that although persuasively argued, Oman offers little solid evidence that the majority of firms are adopting these new forms of production and there is a concern that the analysis applies to a limited number of high-profile, headline catching firms, rather than the less visible majority.<sup>37</sup> Although the microeconomic explanation of regionalisation is attractive and credible, it cannot be proved theoretically or statistically and tends to rely on anecdotal evidence such as the observation that a strike at General Motors' Canadian plant in Oshawa would "cripple GM operation throughout North America".<sup>38</sup>

The lack of consistent information on corporate structures and intra-firm flows of tangibles and non-tangibles mean that direct verification of such putative

---

<sup>36</sup> Oman (1994) p. 13. Italics in original.

<sup>37</sup> Oman also claims that regional production occurs because MNCs are keen to match costs and revenues in each region. While this seems intuitively plausible, and might well apply to some firms, in Chapter 4 it was shown that various studies have found no evidence that this is habitually the case.

<sup>38</sup> *Financial Times*, "GM Canada unlikely to avoid strike", 3 October 1996.

behaviour is not possible. The OECD has begun to publish such data in *Activities of Foreign Affiliates in OECD Countries*, but as yet the coverage is sparse.<sup>39</sup> A detailed and consistent time series is only available from the US in reports on the behaviour of US multinational corporations abroad and foreign FDI in the US. The 1995 edition of *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and their Foreign Affiliates* provides limited support for the idea that sales are becoming more regional. Preliminary results for 1993 show that of the US\$1,279 billion sales of goods and services by America majority owned foreign affiliates, US\$138 billion (10.8%) was exported back to the US (8.6% to US parents, 2.2% in unaffiliated US sales), while US\$845 billion (66.0%) was sold in the country of production, with 3.3% of the total being sold to related local affiliates.<sup>40</sup> Only US\$296 billion (23.1%) was sold in third countries. The figures for third countries do not give a regional breakdown, but of the US\$296 billion, US\$168 billion was sold to other foreign affiliates and US\$128 billion to unaffiliated persons. Thus only 13.1% of total sales of US foreign affiliates were intra-firm trade with other third country foreign affiliates (and even then not necessarily in the same region) which indicates that extensive regional production networks are not yet widespread. However, note also that only 48.7% of sales by the affiliates of US parents were in the manufacturing sector and that the proportion of manufacturers' sales made locally in 1993 was 59.7%, compared to the 66.0% average figure for all sectors.<sup>41</sup> The reason is that sales of services such as hotels and retailing tend to be tied to the country in which the investment is made. Moreover, sales by manufacturers to affiliates in third countries was 17.6% of total sales, compared to the 13.1% average and just 8.8% in the case of non-manufacturers.

Total intra-firm trade was 25.0% of the total (8.6% plus 3.3% plus 13.1%) in 1993, much the same level as has been seen over the past decade. However, in the case of manufacturers intra-firm trade stood at 32.9%, comprising 12.3% of sales made to the US parent, 3.0% of sales made to affiliates in the country of operation and 17.6% of sales to affiliates in third countries. Thus there is

---

<sup>39</sup> OECD (1997b).

<sup>40</sup> US Department of Commerce (1995a) Table III.F.2. Author's calculations.

<sup>41</sup> US Department of Commerce (1995a) Table III.F.3. Author's calculations.

evidence that manufacturers engage in substantial intra-firm trade, especially with affiliates in third countries. Unfortunately a break-down of third country sales is not available.

Earlier versions of the same Commerce Department report show that in 1966 sales to affiliated firms in third countries were 9.8% of total sales, rising to 12.5% in 1977 and then slipping slightly to 12.1% in 1987. In 1992 intra-firm third country trade peaked at 13.5% of total sales of US majority owned non-bank affiliates, and then slipped back slightly to the 13.1% level shown in the 1993 data. Therefore, the historic series indicates a trend to move away from supplying either the local market or the US market, in favour of third country sales.<sup>42</sup> However, there was only a gradual rise in the proportion of sales made to third country affiliates between 1987 and 1993.

In the case of affiliates of US firms located in Europe the proportion of intra-firm third country sales was 18.5% of total sales in 1993, with a gentle upwards trend evident over time. On the assumption that third country sales will be predominantly regional, there is some evidence of a regional network in the production structures of US multinationals emerging in Europe.

In terms of foreign affiliates located in the US, the publication *U.S. Direct Investment Abroad: Operations of U.S. Affiliates of Foreign Companies* provides similar details to its sister publication. In 1994 the sales of goods and services by foreign affiliates in the US to the local market were 90.9% of total sales of US\$1402 billion.<sup>43</sup> Of the remaining output which was sold outside the US market, 4.0% of the US\$1402 billion total went to foreign parent and a further 0.9% to other foreign affiliates. It would appear that the sheer size of the US market is sufficient to render the construction of regional production networks unnecessary. However, there has been a clear trend towards more foreign shipments from the US to the foreign parent and other affiliates; the proportion has risen from 3.4% in 1987 to 4.9% in 1994. A substantial part of this increase are the "reverse imports" of US-made Japanese automobiles back to Japan in an attempt to lower the bilateral trade deficit and reduce trade friction.

---

<sup>42</sup> It is also worth noting that movements of exchange rates will have an effect on the data, although sufficient detail is not available to make a reliable assessment of the impact of such a factor.

<sup>43</sup> US Department of Commerce (1996b) Tables E-12 and H-1. Author's calculations.

Encarnation found little to suggest that regional production networks are becoming widespread for the foreign plants of Japanese MNCs, which also sell around 60% of their output to the home market, with another 20% going to third country markets, usually those geographically close to the country hosting the FDI.<sup>44</sup> Again, the relatively low level of such trade indicates that the regional networks envisioned by the likes of Oman are still not pervasive.

Nevertheless, continuing developments in production processes and management techniques point in favour of regional units. Economies of scale are undoubtedly important to multinational corporations in both the manufacturing and service sectors, but their nature has evolved over time. For most industries efficient plant size can be achieved in producing for regional markets,<sup>45</sup> and sourcing strategies are also efficient on a regional network basis. In contrast, for costs such as research and development, finance, advertising and information systems the most efficient scale is typically reached in supplying the entire global market.

The implication is that even if the data show a trend towards a greater regional bias in trade and investment flows, this does not necessarily mean that the key economic trend is that of regionalisation. The distinction is partly definitional; if trade and investment flows show a stronger regional bias, then on one level, regionalisation can be said to be increasing. However, what is not demonstrated by such figures is the globalisation of the international economy which is behind greater regional integration.

At first glance this may appear contradictory, but demand is becoming globalised, while supply is still more efficient on a regional basis. At the same time competition takes place on a global scale, rather than a regional or national one.<sup>46</sup> As a result, firms are globalising to meet demand and compete worldwide, but the productive mechanics of doing so are regional. So while regionalisation is the trend on a physical production basis, globalisation is the trend in terms of strategy or corporate planning. This can be labelled "regional globalisation" in

---

<sup>44</sup> Encarnation (1993) pp. 14-15.

<sup>45</sup> See for example Stopford and Strange (1992).

<sup>46</sup> Ohmae (1990).

that the objective is to meet global demand, but through the means of regional production.

Note that unlike the macroeconomic factors at play promoting regionalisation as a result of intra-regional trade preferences, these microeconomic forces are based on the business logic of the industry and not any stronger economic "truth". As a result it is quite feasible that in the future, technological developments (such as a revolution in transportation systems) could make regional production structures inefficient. As Kobrin notes, "There is no reason why a larger market area should make discrete borders more meaningful or territorial control of economic activity more effective in an electronically networked world economy."<sup>47</sup> A move to either a globally integrated production network or a single site supplying the entire world market via exports is quite possible and would reverse the growing regional bias in trade and investment flows. Such a change would not, however, alter the underlying trend of globalisation in the world economy, in that the objective of meeting demand worldwide would remain, with only the strategy of how to do so being revised.

One effect of such "regional globalisation" would be a growing share in intra-industry trade within regions. Various studies have found that a rise in intra-regional foreign direct investment (FDI) has tended to boost intra-industry trade.<sup>48</sup> One such analysis is a World Bank study of Japanese companies, which used JETRO data.<sup>49</sup> This found a strong relationship between the propensity to export and the degree of foreign direct investment, without suggesting in which direction the causality ran. It also found that small firms have a proclivity to move production to countries within the same region, and those firms also tend to carry out direct investment which complements existing trade patterns. In contrast larger Japanese firms are more likely to invest in Europe and North America, with the investments being of the trade replacing variety (presumably because of the fear of higher trade barriers). Both of these dynamics will raise measures of intra-regional trade intensity, the former as it raises the amount of trade within the region, the latter because it reduces the amount of inter-regional trade.

---

<sup>47</sup> Kobrin (1995) p. 28.

<sup>48</sup> See for example Lee (1989) and Primo Braga and Bannister (1994).

<sup>49</sup> Dasgupta, Mody and Sinha (1995).

As an explanation of the rise in measures of regionalisation noted in recent years the microeconomic perspective has its attractions. However, useful data are only available for US outward and inward FDI and those figures show only a gentle rise in intra-firm trade with third countries, and this is an activity which is still of only limited importance. Anecdotal observation suggests that the popularity of regional networks has increased substantially in recent years, but this could be the result of a tendency to focus on more trend-setting companies. In terms of explaining the rise in regionalisation measures noted in Chapter 3, regional production networks may be partly responsible, but they seem inadequate in showing why the regional trade indices took a jump after the late 1980s.

#### **5.4 Terms of Trade Effects**

Trade among developed countries tends to be of the intra-industry, rather than inter-industry variety. Moreover, intra-industry trade between developed countries tends to be in manufactured rather than primary products.<sup>50</sup> In contrast, trade in primary products is predominantly a North-South process. As previously noted, regional trading arrangements tend to be established between countries at similar levels of development<sup>51</sup> and, historically, the effective ones have been between developed countries.

Combining this observation with the argument that there is a long-term trend for commodity prices to decline relative to those of manufactured goods, then a terms of trade effect on measures of regional trade bias also becomes evident. There is an active debate on whether the terms of trade of developing countries have in fact shown a long-term decline, but the bulk of analysis supports such a view.<sup>52</sup> On a basic level, IMF series show the price of non-fuel

---

<sup>50</sup> See Greenaway (1988), United Nations (1996).

<sup>51</sup> Although Lawrence (1996) p. 68. claims that NAFTA was unusual because it was a regional agreement between two developed countries and one developing one, it is worth noting that Mexico became a member of the OECD in 1994, the same year that the agreement came into place. Moreover, the World Bank ranks Mexico as an Upper Middle Income country, which places it alongside Portugal and Greece.

<sup>52</sup> Among others, Spraos (1980), Sapsford (1985) and Bleaney and Greenaway (1993) have produced convincing evidence of a decline in the net barter terms of trade of primary commodities compared to manufactured goods.

commodities rose by 174% between 1965 and 1994 (i.e. an average of 3.5% per annum), while crude oil prices rose 650% (7.2% per annum) and wholesale prices in industrial countries (a proxy for manufacturing prices) rose by 300% (or 4.9% per annum).<sup>53</sup>

In the European Union and NAFTA, intra-regional trade consists of a relatively high proportion of trade in manufactures, while extra-regional trade is relatively high in primary products.<sup>54</sup> Lower prices of primary products will lower both the value of total world trade and the value of extra-regional trade. It will also lower the value of intra-regional trade, as some trade in primary products occurs, but this will be a lesser effect than on extra-regional trade.<sup>55</sup> In terms of calculations of intra-regional trade bias, if no change in trade volumes occurs the net effect will be to make intra-regional trade appear to be a larger part of the whole, raising the intra-regional trade intensity index. However, such a rise in the measure of regional bias occurs without any genuine increase in economic integration taking place. Moreover, if the result of lower commodity prices is that more primary goods are traded inter-regionally, then it can be argued that the degree of regional integration will actually fall. This illustrates the danger of taking the figures generated by statistical analysis on face value, without any deeper understanding of underlying trends.

In terms of seeking to explain the recent rise in regional trade intensity indices since the late 1980s, terms of trade effects may account for a reasonable part of the increase. From 1988 to 1994 in US dollar terms non-fuel commodity prices fell 5.3% (0.9% per annum), while crude oil prices rose 8.0% (1.3% per annum) and industrial wholesale prices rose 12.2% (1.9% per annum). The implication is that the rate at which the terms of trade of commodity exporters are declining has accelerated since the late 1980s. This might go some way to explaining the rise in intra-regional trade intensities since then.

Specifically taking the example of North American trade intensities, a 10% improvement in the terms of trade (assuming there is no offsetting rise in

---

<sup>53</sup> IMF, *International Financial Statistics Yearbook* 1995.

<sup>54</sup> Whalley (1985) p. 192.

<sup>55</sup> Price elasticities are also important in such an example, and the price elasticity of demand for primary products is typically less than one, which is to say a 10% drop in price does not generate an offsetting 10% rise in volumes.

volumes as a result of the lower prices) generates a rise in the trade intensity index of 0.2.<sup>56</sup> The actual rise in the in the NAFTA trade intensity index observed from the beginning of the recent upturn in 1989 to 1995 was 0.49. However, over the same period the US terms of trade (as measured by the ratio of export unit prices to import unit prices) deteriorated by 0.5%, while Canada's terms of trade deteriorated by 7.0%. The IMF does not publish figures for Mexico, but the Peso crisis at the end of 1994 and relatively weak oil prices during the period in question are likely to have meant a decline in the terms of trade.<sup>57</sup> The implication is that terms of trade changes were not responsible for the rise in the NAFTA intra-regional trade intensity—if anything the effect should have been to lower the regional trade intensity index.

In the case of the European Union an improvement in the terms of trade since the late 1980s has contributed to a rise in the intra-regional trade intensity index. No unit price index is available for the region as a whole, but of the four main economies, three saw an improvement in their terms of trade between 1989 and 1995 while one saw a deterioration.<sup>58</sup> The net effect is that the terms of trade for the European Union have improved since the late 1980s, although it is not possible to put an exact value on the change. Nevertheless unlike North America, terms of trade effects are one of the factors behind a rise in the intra-regional trade intensity in Europe since the late 1980s.

Thus the relatively mundane (at least in international political economy terms) effect of terms of trade changes needs to be considered as well as the other two forces outlined above in explaining changes in the measures of regional bias. Each of the three factors discussed above has contributed to the rise in measures of regionalisation over the past three decades. In terms of explaining the recent sharp rise in the regional trade intensity indices since the late 1980s, preferential tariff and non-tariff liberalisation, combined with terms of

---

<sup>56</sup> This is calculated using the trade intensity index (Method 2) as discussed in Chapter 3.

<sup>57</sup> In any case, Mexico is a relatively small part of the NAFTA total. There is also the problem of double counting in that Canada's terms of trade, for example, includes the price of exports and imports to and from the USA and Mexico, but the underlying finding of a deterioration in the terms of trade is not likely to be affected.

<sup>58</sup> The terms of trade for France improved 6.6%, Italy 7.4% and the UK 3.1% between 1988 and 1994, while Germany saw a 0.3% deterioration.



trade effects in the case of Europe, have been the most influential factors at work.

## 5.5 Offsetting Force of Globalisation

With the three factors outlined above driving statistical measures of regionalisation forwards, it is perhaps surprising that the trade intensity indices shown in Chapter 3 have not increased more rapidly. One possible reason for this is the offsetting force of globalisation which has moderated the impact of regional preferences, organisational structures and shifts in terms of trade.

Just as regionalisation is taken to mean the closer interdependence between the economy of one country and that of one or more other economies in the same geographic region, globalisation is the closer integration of one economy with others on a world scale. As shown in Chapter 3, although regionalisation has been rising in recent years, there is also a long-term trend towards major economies being more open to trade on a global basis. Increased regional integration has not been accompanied by a decline in integration with non-regional countries. Complemented by similar trends in movements of capital, this is the phenomenon known as globalisation. There is some debate as to whether globalisation is reaching new heights or simply returning to the pre-1914 state,<sup>59</sup> but the main point is that it is a trend which is progressing alongside that of regionalisation.

The three above forces discussed above are all leading to a rise in measures of regionalisation in the world economy, but it can also be argued that they are resulting in a stronger degree of globalisation. Firstly, although the rise in regional preferences is primarily to the benefit of countries within the region, there are also benefits to extra-regional firms, because a larger, more coherent market offers greater opportunities to an MNC, irrespective of nationality. As is discussed above in the section on deeper integration, some measures explicitly favour regionally based firms, but others such as restricting government subsidies cannot be applied on a discriminatory basis, so liberalisation within a region can benefit all firms.

---

<sup>59</sup> See Sachs and Warner (1995) and Bairoch and Kozul-Wright (1996) for the two sides of the argument.

In relation to the second point about corporate organisational structures, it appears that some MNCs are producing regionally, while supplying the global market through facilities within each region. While on the basic level this is an increase in regionalisation, it can be argued that the more important trend is that of a rise in globalisation. As is discussed above, regional production does imply a rise in regionalisation in terms of direct investment or trade flows, but in terms of what it means for the world economy the stronger force is that of globalisation. It is not recognised as such because inter-regional flows are in intangibles such as research and development, or other knowledge based assets and as such they are not adequately captured by the available data. Unfortunately the data simply do not exist to illustrate this assertion that globalisation is the dominant force, as such flows of intangibles result in economies becoming more closely linked together irrespective of geographic location.

Moreover, the factors which are behind the rise in regionalisation as a microeconomic trend are also leading to a rise in globalisation. The revolution in communications of recent years means that firms' choices are no longer constrained to what is readily at hand within a region. Information about production and sales in non-regional markets is available to allow even relatively small MNCs to seek scale efficiencies and new customers on a global basis.<sup>60</sup> The avenues of opportunities that have been opened up by information technology mean that some firms will be globalising more aggressively than they are regionalising. Moreover, as firms with a base across one region expand into other markets, globalisation will increase. Such behaviour would counteract the pressures towards regionalisation noted above.

A strong case can therefore be made that trends which appear to show a rise in regionalisation do in fact represent an increase in globalisation. Unfortunately, such an argument cannot be supported (or disproved) statistically due to problems in measuring flows of intangibles and it depends to some extent on whether a narrow or broad definition of the term "globalisation" is adopted.

---

<sup>60</sup> See Table 2-1 in Herring and Litan (1995) for details of falling communication costs.

## 5.6 Impact of FDI

Incorporating foreign direct investment (FDI) flows into the analysis is complex and imprecise for two reasons. On one level, it is useful to distinguish between FDI which is complementary to trade flows (such as establishing car dealerships) and that which is a substitute for trade (such as setting up a car production plant). On another level, the inadequacies of the statistical material make directional and motivational analysis of FDI flows imprecise.

Mundell demonstrated that an efficient allocation of resources within a region could be achieved as a result of movements of factors of production or movements of goods.<sup>61</sup> If perfectly free flows of factors of production already exist within a region, then liberalising flows of traded goods does not enhance economic efficiency (and vice versa). Simply observing that trade creation has occurred, even if it is greater than the degree of trade diversion, does not allow us to be sure that it has raised economic welfare. It could be that movements in factors of production had already allowed maximum levels of efficiency to be reached within the region. It might seem clear to observers of the international economy that neither factors of production nor goods move freely across borders, and the continued provision of regional assistance in the European Union indicates that it does not expect migration to correct regional disparities. However, this does highlight the theoretical dangers of making what might seem to be safe predictions about the implications of regionalisation without being well-informed as to the pattern of both trade and FDI movements.

With trade barriers falling steadily during the post-war period, trade growth has regularly outpaced that of output.<sup>62</sup> However, the growth in FDI has been even faster than that of trade, with FDI outflows quadrupling since 1980 and exports doubling.<sup>63</sup> This is not necessarily what would be expected from Mundell's theory, as trade growth could be seen as a substitute for FDI flows. The fact that they occur contemporaneously indicates that barriers existed to

---

<sup>61</sup> Mundell (1957).

<sup>62</sup> See Maddison (1995) tables G-2 and I-4 for details.

<sup>63</sup> Between 1981 to 1993 FDI outflows grew by a total of 326% (calculated from UN (1995) Table I.1) while world exports grew by 102% in current dollars (IMF *Direction of Trade Statistics*).

both the movement of both goods and factors of production, and both sets of barriers have been declining.

Barriers to FDI have been falling faster in the developing world than among OECD countries in recent years, irrespective of the impact of regional agreements.<sup>64</sup> An explanation of this could be similar to that for the erosion of capital controls on a unilateral basis that was noted in Chapter 4; technological and ideological changes make such restrictions untenable. The consequence is that although regional agreements in Europe and North America have covered FDI flows, the reduction in protection has not been as great as in a range of countries in South America and Asia where the climate for FDI has turned far more welcoming.<sup>65</sup> This is largely because the OECD restrictions were initially at a lower level.

Consider three types of FDI which are commonplace. Firstly, there is FDI which is made in search of lower production costs. This tends to occur within the region of the investing firm, especially when it is a relatively small firm making the investment.<sup>66</sup> It tends to be of the trade-creating variety, involving flows of capital equipment to the low cost producer and of finished goods back to the home country and to other developed countries (often within the region). In contrast, a second form is market seeking FDI which aims to secure market access and which is likely to be a substitute for trade flows. This is most clearly the case when the investment is aimed at guaranteeing market access in the face of the threat of trade barriers. Protectionist threats mean that manufacturing facilities cannot simply be "screwdriver" plants, incorporating minimal value-added, as these would fall foul of rules of origin restrictions. As a result a large part of the sourcing and value-added activities will need to be conducted locally, which makes the investment trade substituting. However, if the output from the plant is to be sold across a region, as is the case with foreign automobile plants situated in Canada or the UK, then the investment will create a change in the direction of trade flows as it replaces previously existing flows. A third form of FDI is driven by a company's aim of maximising the returns from its ownership, location or

---

<sup>64</sup> UNCTAD (1995).

<sup>65</sup> See Kennedy (1992), Ahluwalia (1994) and Parra (1995).

<sup>66</sup> See Dasgupta, Mody and Sinha (1995).

internalisation (OLI) advantages.<sup>67</sup> In this case the effect on trade flows is indeterminate. For example, the internalised transactions could be trade in intermediate goods, which appears in trade figures, or they could be trade in the knowledge-based assets of the firm, such as patented processes, which do not appear in merchandise trade figures.

These complications make an accurate assessment of regionalisation even more difficult. For example, if Toyota sets up a car plant in Spain to make cars to sell across Europe then the trade figures would show a rise in the intra-regional trade intensity index (especially if the production was substituting for cars that had previously been exported from Japan). In terms of actual economic integration, from one perspective there has been a rise in regionalisation, but from another perspective the situation is unchanged, because a variety of European countries are still buying Japanese cars. However, if BMW sets up a similar car factory in Spain, but this time plans to sell the output to the local market instead of exporting from Germany, then the trade intensity index will decline. However, it can be claimed that there has been no change in the degree of European integration—it is simply that FDI flows have replaced trade.

Thus the problem is part functional (what is the FDI for?) and part definitional (what do we mean by regionalisation?). The net result is that unless we can see the whole picture of what is happening to flows of goods, factors of production and intangibles, then confident assertions about the actual (as opposed to statistical) path of regionalisation and globalisation are problematic.

## **5.7 Regionalisation and Economic Welfare**

That regionalisation is an increasing trend in terms of data on trade and investment flows has been demonstrated. This has implications for the behaviour of governments and of multinational corporations which will be discussed in subsequent chapters, but there are also the questions of whether such a trend is positive or negative from an economic welfare perspective, and what principles would help to ensure a positive welfare effect.

---

<sup>67</sup> Dunning (1980).

There are two main areas where regionalisation can detract from economic welfare. The first is the classic Vinerian example, where trade diversion outweighs trade creation. As has already been discussed, Kemp and Wan noted that if trade volumes with the rest of the world are kept constant, then there is not a welfare loss as a result of trade diversion. For this to occur transfers must exist, and Grinols showed how compensation schemes can be constructed.<sup>68</sup> Thus a regional group can result in more intensive intra-regional trade, but without a welfare loss to the rest of the world. So the conclusion that regionalisation is on the increase does not necessarily imply a reduction in welfare for countries outside the regional bloc. However, in the real world there is little evidence of welfare assessments related to trade bloc formation and so trade diversion appears to be a continuing issue.

The second area where welfare losses can take place is that of inter-sectorial distortions and rent-seeking behaviour, which occur when a free trade area is only of a partial nature. The MERCOSUR pact which came into force at the start of 1995 is a good example, in that it provided temporary exemptions for several important sectors, including capital goods. As Corden has previously highlighted,<sup>69</sup> direct allocative distortions will result from differential tariff rates which in MERCOSUR's case range from 0% to 20%. Some of the results outlined by Krueger regarding rent-seeking behaviour are also relevant here.<sup>70</sup> Substantial efficiency losses could stem from any rent-seeking behaviour by interested parties, attempting to maintain the advantage that differential tariff rates gives them.

As was shown in Chapter 2, Makower and Morton, and Lipsey noted two key features which will help to determine whether a customs union will raise efficiency.<sup>71</sup> Firstly, the greater the share of trade between the countries entering into the agreement as a proportion of total trade, the greater are the benefits. More recently, Krugman has argued that free trade areas are more likely to be welfare enhancing if they are created along "natural" geographic lines, which

---

<sup>68</sup> See Kemp and Wan (1976) and Grinols (1981).

<sup>69</sup> Corden (1984).

<sup>70</sup> Krueger (1974).

<sup>71</sup> See Makower and Morton (1953) and Lipsey (1960).

tends to be the same thing as saying they have a relatively high propensity to trade with each other.<sup>72</sup> Secondly, the greater the cost differentials in the two countries, the greater the efficiency gain. So dissimilar, but closely integrated economies will benefit most from a customs union. On this basis, the gains in the case of NAFTA could be expected to be high, while in the case of the European Union the cost differentials are lower, whereas in the case of an Asian bloc, the share of trade is lower. It is also the case that the lower the difference in costs between the new supplier inside the free trade area and the previous external supplier, the lower will be the welfare cost of any trade diversion. These factors imply that free trade areas between developed countries, or between developed and developing countries, are more likely to be welfare enhancing than those between developing countries.

Krugman constructs a relatively simple, but highly informative model examining the number of trade blocs and implications for world welfare. Firstly looking at tariff levels, he assumes that each bloc will impose the optimum tariff. Krugman shows that the larger the bloc, the higher will be the optimum tariff level with the result that "a consolidation of the world into fewer, larger blocs will lead to higher barriers on inter-bloc trade".<sup>73</sup> Combining this finding with welfare considerations, he shows that for any realistic elasticity of substitution between any two countries the optimum tariff level is much higher than can be observed in the real world. This shows that actual trade relationships between major trading blocs are much more co-operative than in the case where optimum tariffs are imposed. One reason for this could be that the policy actions of trade blocs are constrained by adherence to multilateral obligations which prevent them from raising tariffs to optimum levels.

Finally, Krugman shows that in a world where welfare is maximised when there is only one trade bloc (i.e. global free trade exists), the greatest damage to welfare occurs when there are three trade blocs. If the world is approaching a situation where this is becoming a reality (European, Pan-American and Asian) then this could severely reduce world welfare, if the blocs begin acting in a less co-operative fashion and attempt to impose optimum tariffs.

---

<sup>72</sup> See Krugman (1991a).

<sup>73</sup> Krugman (1991a) p. 36.

Issues which were very much in vogue around the time of the inauguration of the European Single Market programme relate to the efficiency gains from regionalisation. Regionalisation promotes efficiency via the stronger competition which results from easier market access for other regional firms. As long as an effective regional competition policy exists, this is one unequivocally positive dynamic as stronger growth within the region does not imply weaker growth outside it—on the contrary, the boost to regional demand will also enable extra-regional suppliers to sell more exports.

As noted above, a large proportion of recent developments towards deeper integration are non-discriminatory in their nature: the United Nations has labelled regional non-tariff barrier liberalisation as a quasi public good in that non-regional parties cannot be excluded.<sup>74</sup> The implication is that deeper integration will contain less trade diversion than more discriminatory tariff based schemes, which would indicate that recent European Union and North American moves are likely to result in fewer "losers" than earlier bouts of regionalism.<sup>75</sup>

The issue of welfare gains is clouded as a result of inward and outward foreign direct investment. The gains from trade creation within a region will go to the firms producing within that region irrespective of ownership. It is quite feasible for foreign-owned firms within a regional bloc to enjoy the gains from trade creation, while the extra-regional affiliates of firms with their home base within the region suffer from trade diversion. Remittances of profits on an inter-regional basis will make the distribution of gains from regional integration even less clear.

It has also been argued that FDI can lead to welfare losses due to the strategic behaviour of multinational corporations. In an oligopolistic industry firms might find it advantageous to over-invest, thereby creating excess capacity that can be used to deter other firms from attempting to enter the market.<sup>76</sup> It could also be the case that uncertainty about a future protectionist slant to the trade bloc could cause firms to over-invest, to give them the ability to meet demand in

---

<sup>74</sup> United Nations (1993) p. 8.

<sup>75</sup> Although in Europe agriculture may be an exception to this.

<sup>76</sup> See Helpman and Krugman (1989).



the event of restrictions on imports.<sup>77</sup> In either case, the welfare effects of such behaviour are negative.

There are also dynamic aspects to economic welfare considerations which can be tangentially important. Few countries embark on policies which result in lower trade barriers or even deeper regional co-operation without engaging in broader economic reforms, usually on a non-discriminatory basis. For example a report for the Australian government noted that trade liberalisation tends to result in other inefficiencies in the economy becoming more apparent, with the end result being an increase in pressure for related reforms.<sup>78</sup> The idea is that lower trade barriers raise competitive pressures within the economy. These make existing restrictive practices more evident and more damaging, leading to pressure for their removal. Alternatively, there is an ideological overlap, with the same arguments used in favour of reducing trade restrictions also relevant for liberalising the domestic economy. The implication is that standard trade-related calculations of welfare effects will understate the overall impact on the economy, as the increase in domestic competition raises welfare gains through dynamic effects.

Another aspect of preferential regional agreements is that they lower the level of political risk for companies operating within their boundaries. As is discussed in Chapter 6, political co-operation reduces the systemic risks (as opposed to business risk) faced by multinational corporations as it makes damaging military or political conflict between the participants less likely. This would indicate that objective measures such as the value of lower trade barriers which stem from a regional agreement will understate the real reduction in costs to MNCs (on the basis that political risk is a cost).

Overall, evaluating the welfare effects of regionalisation is highly complex. The overriding impression is that most static, economic analysis is likely to underestimate the degree of welfare gains, although once again, the interaction of trade and FDI flows makes definitive assertions inappropriate.

---

<sup>77</sup> See United Nations (1993) p. 14.

<sup>78</sup> EPAC (1995).

## 5.8 Conclusion

In this chapter it has been shown that there are several possible explanations for the statistical findings presented in Chapter 3. It is necessarily the case that an increase in preferential trade arrangements results in a rise in regionalisation, although the magnitude is unclear. More importantly, it does not appear legitimate to ascribe the rise in regionalisation noted in North America and Europe since the late 1980s wholly to the "deeper" aspects of the relevant agreements, some of which are difficult to apply on a preferential basis. This had already been hinted at by the findings in Chapter 3 that in the case of the European Union the increase in regionalisation over the past two and a half decades was predominantly due to the entrance of new members, rather than increased bias between the original six.

Changes in corporate organisational structures also appear to be promoting regionalisation as companies establish regional production networks in response to changing technologies. Moreover, the statistical effects of changes in the terms of trade have played a part in raising European trade intensity indices since the late 1980s in addition to any underlying economic transformation. However, in North America weaker terms of trade have exerted a downward pressure on trade intensities.

It is likely that there has been another agent at work, which is that of globalisation, offsetting the power of these three forces. Some of the moves towards globalisation will counteract the forces promoting regionalisation, but in other cases firms can globalise in terms of meeting demand and competition, while regionalising their production systems. The picture is further clouded by foreign direct investment flows because of the differing motivations for, and effects of, FDI. The implication is that microeconomic forces cannot be ignored when examining regional developments.

Having looked at factors which are behind the regionalisation trends discussed in Chapter 3, the next chapter will move on to consider issues behind the trend towards regionalism. However, the MNC is clearly a key player in any discussion of regional integration and its preferences and behaviour will be examined in more detail in Chapter 7.

## CHAPTER SIX CAUSES OF REGIONALISM AND IMPLICATIONS FOR THE INTERNATIONAL POLITICAL ECONOMY

### 6.1 Introduction

In Chapter 2 it was established that the trend towards regionalism had revived in popularity in recent years, while Chapter 3 demonstrated a rise in the degree of regionalisation of Europe and North America. This chapter examines the factors behind the increased popularity of regionalism. In terms of considering why the trend towards regionalism has been so strong in recent years it is possible to examine a range of motivations. As regional arrangements are primarily bodies to deal with trade and investment issues, economic factors can be expected to be the strongest force, but other aspects such as political or systemic factors will also have a bearing. In particular, it is necessary to consider not just why regionalism occurs from a static perspective, but also from a dynamic one in order to explain its growth over the past decade.

Marked variability in the forms of regionalism and the potential for diverging paths in the future raises the issue of differing implications for multinational corporations, as well as for members and non-members of regional trade agreements. Such diversity creates ambiguity as to whether regionalism is compatible with a fully-functional multilateral system. It will be argued that regionalism is not necessarily a substitute or a complement for multilateralism. As Jackson noted in almost the same breath "regional trading blocs can complement the world trading system .... However, regional trading blocs could get out of hand".<sup>1</sup> The World Trade Organization (WTO) takes a less ambiguous attitude towards regionalism than the GATT had done, and safeguards have been reinforced to promote complementarity. Even so, the director-general of the WTO, Renato Ruggiero, stated "Unless regional initiatives are firmly grounded in the principles and rules of the multilateral system, the risk is that they could create divisions between regional areas, a very dangerous trend taking into account the political weight of some of the these systems".<sup>2</sup> This chapter discusses the potential for complementarity between regionalism and

---

<sup>1</sup> Jackson (1992) p. 501, Friedmann Award Address.

<sup>2</sup> Quoted in the *Financial Times*, 7 July 1995 "WTO chief fears wave of protectionism".

multilateralism, as well as examining the views of the institution established to oversee the world trading system. Moreover it will be argued that the international political economy debate on regionalism tends to concentrate excessively on the building block / stumbling block issue, while neglecting micro issues related to the behaviour of multinational corporations.

It is possible to argue that the rise in regionalism implies a concomitant rise in protectionism. This is a complex issue, made more so by the variety of regionalism evident in the world economy. Analysis can be conducted from the viewpoint of the international obligations of a bloc or from its ideological foundation, as well as from an institutional perspective. If there is a structural bias towards protectionism, irrespective of the ideological stance of a trade bloc, then it will undermine the stated benefits from regionalism.

Regionalism affects multinational corporations at three particular levels. The first level is regime based, with greater co-operation reducing systemic risks. While the impact of lower risk premiums could be significant, it is not an element in econometric studies of the gains from regionalism. The second level touches on the controversy regarding the changing balance of power between states and markets, with one interpretation of regionalism as a means of the state regaining lost sovereignty by pooling its power with other states.<sup>3</sup> The third level is the link between corporate behaviour and regionalism which will be examined in the next chapter. This chapter concentrates on the macro and systemic aspects of regionalism and the implications for the international political economy.

This chapter will demonstrate that regionalism can take various forms, incorporate different regimes and have diverging implications for economic integration. The illustration that there is no set formula is interesting in itself and implies that multinational corporations need to have a flexible outlook. Laying out a range of possible developments will assist in the assessment of corporate behaviour in the following chapter.

## **6.2 Why is Regionalism on the Increase?**

An understanding of the motivations for regionalism is needed in order to provide the framework for analysis of the nature of various regional agreements.

---

<sup>3</sup> Gibb (1994).

Regionalism that is driven by defensive factors will have a different structure from that with a GATT-plus agenda based around expanding economic benefits. Several possible explanations can be suggested when a reason for the trend of a growing number of regional agreements is sought. It is also worth bearing in mind the dynamics of the process. That is to say, we do not simply need to consider why regionalism takes place, but also why it has suddenly become more popular in recent years. The various explanations are summarised as follows:

- 1) There is the basic trade creation argument which stems from the benefits of lower tariffs. Moreover, lower barriers within the region will promote efficiency all the more if the members already trade a lot with each other.<sup>4</sup>
- 2) Groupings of countries with similar trade patterns can produce gains from exploiting monopoly or monopsony power, via the optimum tariff.
- 3) Financial incentives can stem from any transfer payments which accompany bloc membership. Transfer payments are a zero sum game so they do not explain bloc formation, but they can induce some countries to participate.
- 4) Changing industrial structures mean there is a growing need for "deep integration" (i.e. a harmonisation of domestic factors behind competitiveness) between structurally similar countries, which is more easily achieved through regional co-operation. Deeper integration reinforces the efficiency gains achieved by border-level trade liberalisation.<sup>5</sup>
- 5) Regionalism can be an important step in undermining domestic interest groups. What Olson has labelled "distributional cartels" resist economic liberalisation and it may be easier to erode their power gradually via regional agreements, rather than suddenly through multilateral ones. On this basis, broad (i.e. multi-sector), regional agreements may be easier to implement than narrow sectorial ones which threaten specific interest groups.<sup>6</sup>

---

<sup>4</sup> This was one of Lipsey's (1960) findings, as discussed in Chapter 2.

<sup>5</sup> Ostry and Nelson (1995). Chapter 4.

<sup>6</sup> Oman (1994), Milner (1997).

- 6) Some issues are inherently regional. Migration and pollution are two areas which are most effectively addressed on a regional basis for geographic reasons. It could also be that some "new" areas such as intellectual property rights, labour standards or trade related investment measures (TRIMs) are best tackled regionally, due to the different values between regions.
- 7) Regionalism can be a political response to economic changes which have already taken place. For example, some argue that attempts to construct some sort of regional institutional framework in Asia have lagged behind the economic integration of the region.<sup>7</sup> Codifying existing practices is relatively uncontroversial and has the effect of reducing uncertainty for regional actors. It could also be the case that there are limits to market-driven integration and eventually policy or regulatory co-ordination is needed.
- 8) Advancement of political objectives, such as democratic evolution or political stability can be assisted by regionalism. The lure of preferential access to large markets is seen as a means of promoting or sustaining democratic processes. For example in November 1995 Turkey's Prime Minister Tansu Ciller warned that rejection of the EU-Turkey customs union by the European parliament would destabilise the whole Middle East.<sup>8</sup>
- 9) Regionalism can reflect attempts by the state to regain power over markets. It can be argued that there are several areas—notably in financial markets—where national sovereignty has been undermined, either by liberalisation or simply by innovation or technical progress. By making policy on a regional basis, states can try to restore their authority.
- 10) Regionalism can be a defensive measure or "insurance policy" to counteract growing regionalism elsewhere. The fear of being in a weakened bargaining position vis-à-vis regionalised blocs is a recurrent theme in the formation of new regional agreements.<sup>9</sup>

---

<sup>7</sup> For example see Yoshida *et al.* (1994). Note, however, that the findings of Chapter 3 do not support the idea that a *de facto* integrated trade bloc is emerging in Asia, although such a bloc may be being created through investment rather than trade flows.

<sup>8</sup> *Reuters*, 22 November 1995.

<sup>9</sup> OECD (1995).

- 11) Regionalism provides a means of offering and securing stronger and more credible commitments to trade liberalisation. Membership of a free trade agreement typically involves less scope for backsliding than the WTO, which has weaker enforcement. International treaties are harder to change than domestic laws, which means that policy stability is more likely.<sup>10</sup>
- 12) It reflects a loss of faith in the multilateral process, with regionalism viewed as an alternative.<sup>11</sup>
- 13) Regionalism reflects the growing number of states pursuing liberal economic policies. "The end of history" type analysis suggests that fewer countries are operating on non-liberal ideologies (most notably with the demise of the Soviet Union)<sup>12</sup> with the result that more countries are prepared to lower trade barriers on either a regional or multilateral basis.

What is clear from the above list is that economic gain is by no means the only motivation for creating regional agreements. Only the first four items are clearly economic issues: relating to the arguments over customs unions, to monopoly power, to transfer payments and to broader allocative efficiency. Of those, only two are explicitly "trade" issues. All others involve a degree of non-economic consideration, including issues relating to political theory, game theory and various areas of international relations, such as policy co-ordination, environmentalism and regime analysis. For example, it would be difficult to argue that the free trade agreement signed in 1985 between the United States and Israel was based primarily on economic motivations. Credible explanations range from promoting US security interests in the region to the power of domestic US lobby groups, but the economic benefits come well down the list.

Moreover, the thirteen points listed above give an indication of what is *relevant* to the formation of regional agreements, but they do not tell us what is *significant*. Some consideration of the details of agreements is needed to identify elements which have a real impact, but this is complicated by the likelihood that the dynamic forces will vary between blocs and even within blocs.

---

<sup>10</sup> Lawrence (1996).

<sup>11</sup> Kobrin (1995).

<sup>12</sup> Fukuyama (1992).

To illustrate this point, consider the North America Free Trade Agreement (NAFTA) between the United States, Canada and Mexico which was put in place in 1994, bringing Mexico into the free trade area already established between its northern neighbours. The motivations of the participants in signing such an agreement differed considerably. For example the US wanted to encourage political stability to the south of its border, to address issues neglected by the Uruguay Round and to tackle illegal immigration from Mexico, a politically "hot" issue in the United States.<sup>13</sup> Meanwhile Mexico, as with Canada before it, was eager to gain reliable and preferential access to the US market, while also "locking in" economic and political reforms, as commitments to the US were seen as more credible than those to the GATT. Mexico also hoped to attract foreign direct investment that would otherwise have gone to the other NAFTA members, or to other low cost countries.

Canada's initial motivation to form the Canada-US Free Trade Arrangement (CUSFTA) was to guarantee access to US markets, and to increase the predictability of the US treatment of Canadian goods and services. The accession of Mexico was attractive to Canada in that it helped to offset the unequal power relationship implicit in bilateral relations. Note that the free trade element of CUSFTA was not in itself significant (although the extension to services was important) as pre-CUSFTA average tariffs on US-Canadian merchandise trade were only 1%. While, from an economic viewpoint, incorporation of services and investment in the free trade agreement were a key feature, the non-economic elements stand out. For example, as a part of the CUSFTA deal the United States agreed to consult with Canada over any piece of domestic legislation that would directly affect its northern neighbour before its passage. In addition, the dispute settlement mechanism was based on a bi-national panel which would ensure that domestic laws had been correctly implemented. Canada had felt that the US administration had previously influenced verdicts.<sup>14</sup>

Bergsten noted that North American trade patterns would not change much as a result of NAFTA unless seven discriminatory areas were tackled on a

---

<sup>13</sup> As pointed out by Mundell (1957), if commodities can move freely across borders then factor price equalisation can occur and there will not be a need for movements of factors of production—in this case Mexican labour into the US.

<sup>14</sup> Kahler (1995) Chapter 3.



multilateral basis. However, in each case if liberalisation occurred only between NAFTA members then trade diversion would be substantial, as it would generate trade with uncompetitive suppliers.<sup>15</sup> Similarly, Whalley asserts that the Canada-US deal contained so many exceptions that it was "less a FTA than a trade agreement".<sup>16</sup> In most other areas trade was already liberal, both between NAFTA members and with the rest of the world. This suggests that whatever trade creation did occur as a result of NAFTA could involve high costs (in terms of world welfare) due to trade diversion. One frequently cited example is the shift in production from Taiwan to Mexico by Zenith which involved the transfer of 600 jobs.<sup>17</sup>

While small countries may join trade blocs as a defensive measure, in order to be insulated from any protectionist movement of the dominant economy in the future, different forces appear to be behind the US involvement in an Asian trade group. In the late 1980s debate in Asia was whether a regional bloc should be Asian or Pacific (that is to say, whether or not it would include North America and Australasia). The creation of the Asia Pacific Economic Co-operation (APEC) forum, including the Pacific Americas and Australasia was a triumph for the US in that it managed to prevent the construction of a purely Asian bloc, which would probably have been dominated by Japan. Such an Asian bloc would have further reduced US influence in the region, while APEC enables the US to balance out Japanese influence and to prevent developments which might harm US interests in the region.

It has been demonstrated that for a small country, in a perfectly competitive world unilateral tariff reduction is always superior to a preferential regional agreement, from the point of view of resource efficiency, as the latter always contains an element of trade diversion.<sup>18</sup> This being the case, the efforts of small Latin American countries to enter NAFTA, or of small European

---

<sup>15</sup> The sectors noted by Bergsten (1991) were textiles (where South East Asia would benefit from non-discriminatory liberalisation), steel (Brazil and Mexico partly, but mostly Europe and Japan), autos (Japan, Korea and Europe), machine tools (Europe, Japan and Taiwan), dairy products (Australia, New Zealand and Europe), sugar (Latin America and Australia) and meat (Latin America and Australia).

<sup>16</sup> Whalley (1993) p. 363.

<sup>17</sup> Hufbauer and Schott (1992) p. 73.

<sup>18</sup> See for example Cooper and Massell (1965), Johnson (1965), Berglas (1979), Robson (1980) or Wonnacott and Wonnacott (1981).

countries to join the European Union (EU), must be explained by considerations such as potential transfer payments or economies of scale or by political factors.<sup>19</sup> For example, internally it may be that the partial liberalisation implicit in a regional agreement is more acceptable to domestic interests than a widespread opening to foreign competition. Externally it could be that there are aspects of belonging to a particular group (such as transfer payments or stronger bargaining powers) which compensate for the decision not to opt for the more economically efficient, but more isolated path of unilateral liberalisation.

In support of this argument, note that there is a clear trend towards unilateral tariff reduction as well as towards regionalism. During the course of the Uruguay Round more than 60 countries notified GATT of unilateral trade liberalisation. Subsequently, 1995 saw unilateral action by countries ranging from Indonesia and Thailand to Australia and various Eastern European countries. This is related to one of the more important attractions of free trade agreements over customs unions, in that an FTA allows a country the option of unilaterally liberalising its own tariff regime without first obtaining the agreement or participation of the others.

It is also worth noting that once Uruguay Round tariff reductions are fully implemented, tariff barriers in developed countries will be so low that the direct trade-related benefits from preferential trade arrangements will be extremely limited. Again this suggests that marginal economic efficiency gains resulting from trade creation due to lower tariffs are not the prime motivation for developed countries joining preferential trade arrangements—the pre-CUSFTA tariff level was only 1%. The post-Uruguay Round implementation average OECD tariff on industrial imports will be just 3.8% while the Generalized System of Preferences sanctioned by the GATT in 1971 which gives preferential treatment to imports from developing countries means that only five countries face MFN tariffs on all of their exports to the European Union.<sup>20</sup> All other countries have preferential

---

<sup>19</sup> Harris (1985) examined various trade policies for Canada and found a welfare gain of 4% of GDP for unilateral elimination of tariffs, 9% of GDP for a bilateral agreement with the US and 9% of GDP for multilateral elimination of tariffs. The acceptance of increasing returns to scale was a key aspect to the results.

<sup>20</sup> The countries are Australia, Canada, Japan, New Zealand and the United States, although it should be noted that imports from these five make up 60% of the EU's imports from the rest of the world.

treatment for at least some of their exports. This raises some interesting questions:

- i) If direct trade-related economic benefits from regional agreements are marginal then why has so much energy been expended on their formation, especially as in the past decade regionalism has been rising, even during a secular trend towards lower trade barriers. Or, implicitly, what are the other benefits which appear important?
- ii) If the real objective of a regional agreement is to raise the level of political co-operation then is it not more effective to concentrate on purely political measures, rather than using the "side door" approach of economic co-operation leading on to "greater" things?
- iii) Given that the motivations to form regional agreements are so diverse, is it possible to construct a framework to analyse their structure and behaviour?

### 6.2.1 Economic Aspects

One answer to the first of these points is that even if the benefits of lowering tariffs within the region are marginal, they still represent a pure efficiency gain. The end result of producing more output from the same set of inputs is attractive to any nation. Note also that the investment in terms of political effort and dislocation effects on previously sheltered domestic industry tend to be one-off costs, while the benefits are enduring.

Several studies also focus on the dynamic gains from regional integration, in addition to the static gains from more efficient resource allocation.<sup>21</sup> That is to say, as well as the one-off allocative efficiency gains, continued benefits will come from economies of scale and increased competition. Baldwin estimated that in the case of the European Single Market the result could be to add between 0.2% and 0.9% to the EC's long term growth rate in addition to the 2.5% to 6.5% one-off gains envisaged by Cecchini.<sup>22</sup> A more general review of studies of the trade and welfare effects of regional trade agreements notes that the

---

<sup>21</sup> See Francois and Shiells (1992).

<sup>22</sup> Baldwin (1990).

results are imprecise but that the welfare gains are small in most cases.<sup>23</sup> As Corden has noted, it might be possible to measure the rates of tariffs, but it is much more difficult to calculate the real costs of protection.<sup>24</sup>

Estimates vary in the case of the Uruguay Round, but a World Bank/OECD study put the increase in world income at US\$213 billion (in 1992 prices) by the year 2002 while the OECD comes up with a figure of US\$274 billion on the same basis. The GATT Secretariat's estimate was for a US\$230 billion (in 1992 prices) rise by 2005. Most of the gains stem from agricultural liberalisation, rather than lower tariffs for manufactures.<sup>25</sup> Gains of this magnitude would represent a rise of about 1.5% in world GDP.

There is a question as to whether minor tariff reductions are a significant enough benefit to developed countries joining regional groupings, considering the expenditure of such a major political effort. However, as noted in Chapter 3, the experience of Canada and the US after 1989, and new members of the European Union over the past two and a half decades suggests that regionalisation can respond to reduced trade barriers. However, in both cases, greater preferential bias followed agreements which resulted in co-operation at levels other than just tariffs which suggests that "deep" agreements can also have an impact on regional integration. As noted in Chapter 5, several aspects of deeper integration are applicable regionally.

Another noteworthy element is that when business leaders from the European Union and North America met in Seville in November 1995 to examine the potential for some sort of transatlantic free trade area, the discussion did not focus solely on tariffs. The final communiqué referred to the findings of four working groups on standards, certification and regulatory policy, trade liberalisation, investment, and third country issues.<sup>26</sup> Discussion of tariff reductions was even a minor part of the recommendations related to trade liberalisation, which also covered issues such as government procurement and intellectual property rights.

---

<sup>23</sup> Srinivasan, Whalley and Wooton (1993).

<sup>24</sup> Corden (1984).

<sup>25</sup> Taken from Evans and Walsh (1994) p. 4.

<sup>26</sup> Transatlantic Business Dialogue, Overall Conclusions, Seville, Spain, 10-11 November 1995.

There is a difference between regional trade agreements which concentrate on lowering tariffs and those which cover non-tariff barriers and other factors related to economic integration. Many regional agreements do not bypass non-tariff barriers. For example, members are only exempted from anti-dumping action in the European Economic Area and in the Australia-New Zealand Closer Economic Relations Trade Agreement. From a purely practical viewpoint, several distortions are outside the scope of regional agreements—domestic support, export subsidies, sanitary or phytosanitary regulation and technical barriers to trade are difficult (if not impossible) to apply on a discriminatory basis. Therefore, while "deeper" agreements can be seen as conferring benefits to members in terms of non-tariff barriers, there are many areas where deeper liberalisation is non-preferential. Moreover, as noted in Chapter 3, the preferential bias of trade between the six founding members of the European Union has not increased since the late 1960s despite efforts to increase European integration.

Another economic aspect of regionalism is the potential to exploit monopoly or monopsony power. However, the systematic abuse of monopoly power by trade blocs is notable by its absence. Whalley calculated the US could see income rise 2% by imposing an optimum tariff.<sup>27</sup> Similarly, McCloskey estimated the UK lost 4% of national income by cutting tariffs in the mid-19th century.<sup>28</sup> Krugman show that theoretical optimum tariff level is much higher than can be observed in the real world, which implies co-operative trade relationships between major trading blocs. Again this suggests that regions are not taking a narrow economic perspective when deciding on tariff policy.<sup>29</sup> Fear of retaliation is one constraint on predatory behaviour by large blocs. This would help to explain, in game theory terms, the trend towards bloc formation or expansion as a defensive measure. In practice the imposition of optimum tariffs by one bloc would be likely to be met by similar tariffs from others, with the end result of lowering welfare for all. The World Trade Organization identifies three policy responses of countries faced with growing preferential agreements.<sup>30</sup>

---

<sup>27</sup> Whalley (1985).

<sup>28</sup> McCloskey (1980).

<sup>29</sup> Krugman (1991a) p. 36.

<sup>30</sup> WTO (1995) pp. 51-54.

- i) Join or associate with regional groups. This could be to enjoy the MFN benefits of being a member of the agreement, but given the frequently low existing tariffs, it is just as likely to be an insurance against suffering from any increase in levels of protectionism in the future. The large number of bilateral deals with the European Union shows the popularity of this strategy.<sup>31</sup>
- ii) Create new regional agreements. This appeared to be a motivation in the regional agreements signed in Africa and Latin America in the 1960s, with the aim that a group of countries could bargain with other regional blocs more effectively than they could as individual countries. This is also a factor in the renewed interest in regionalism in the past decade.
- iii) Support multilateral liberalisation. There appears to be a clear correlation between regional initiatives and acceptance of further multilateral liberalisation. In particular, EC integration (through both broadening and deepening) was the spark for the Dillon and Kennedy Rounds in the 1960s and the Tokyo Round of 1973-79. Although the average German tariff rate rose from 6.4% to 10.4% between 1958 and 1968 due to tariff harmonisation within the EEC, post-Kennedy Round levels were down to 6.6% and the average EEC external tariff was halved.<sup>32</sup> More recently, indications that the US might aggressively embrace regionalism helped to produce support for inaugurating the Uruguay Round.

Economic explanations of regionalism based on tariff reductions are reasonably persuasive in offering at least a partial explanation why countries choose to form trade blocs. It is less clear whether they can explain why there has been a sudden revival of the trend in the past decade—if anything lower unilateral and multilateral tariffs should suggest the opposite. The recent popularity can partly be explained by the "deeper" aspects of economic integration which are evident in some agreements between developed

---

<sup>31</sup> Twenty two of the total of 109 regional trade agreements notified to the GATT between 1948 and 1994 were related to the formation or expansion of the EC or EFTA, or ties between their members. A further 54 of the notified agreements were between the EC, EFTA or their members and other countries or groups of countries. Only one third did not concern European integration.

<sup>32</sup> See Resnick and Truman (1975) or Sapir (1992) for details.

economies. As economies become more integrated, elimination of non-border inhibitors to trade and investment increase in importance.

It is difficult to argue that the trend towards regionalism is knowledge-based, resulting from sudden and widespread acceptance of the economic arguments in favour of regional bloc formation. The basic theory concerning the gains from free trade has changed little since Ricardo's days, while customs union theory has not seen major advances for at least two decades. It is possible that alternative ideologies have weakened with the demise of the Soviet Union, while free market principals have become more widely adopted and as a result there is greater acceptance of both regionalism and multilateralism. While the economic arguments are reasonably persuasive, other explanations are worthy of consideration.

### **6.2.2 Political Co-operation**

It can be argued that political considerations are the real motivation for some economically based regional agreements, but these political objectives are more easily achievable through tangential means which do not provoke the domestic nationalist lobby. However, this portrayal of a "side door" approach can be too simplistic. If, for example, the real motivations of the North American Free Trade Agreement were political, then would not direct political co-operation have been more suitable? An economic deal aimed at political ends will provoke resistance from economic lobbies which might have acquiesced to a purely political agreement as well as from political opposition which discerns the real motivation for such a step. This is similar to Corden's argument about a hierarchy of preferences existing to correct any economic distortion, with the most directly relevant policy being the most efficient.<sup>33</sup> Here the answer seems to be two-fold. Firstly, as the European experience has shown, economic co-operation provides an institutional base for future understandings on non-economic matters. Secondly, at the end of the twentieth century there is increasingly a seamless link between economic and political matters; attempting to define specific issues as falling within the sphere of economics or those of politics or international relations

---

<sup>33</sup> Corden (1984).

is too rigid a demarcation.<sup>34</sup> A broad trade agreement may be the most effective means of establishing a framework which can be used to address most issues between countries.

In that a regional agreement might be a precursor or a complement to military co-operation, it would be expected that this motivation would have weakened since the end of the Cold War. Security aspects of European integration which were strong at the time of its formation in the 1950s are much less of an issue in the 1990s following the political transformation of Eastern Europe. The fact that there has been a burst in regional agreements *since* the demise of the Soviet Union indicates that military concerns are no longer to the fore. The entry in 1995 of Vietnam into ASEAN—the grouping that was initially formed in response to the perceived threat from Vietnam and China—is another illustration of the changing concerns of regional blocs.

As the OECD has pointed out, the end of the Cold War has allowed trade relations between former allies to become more aggressive.<sup>35</sup> This is most notably the case in US-Japanese relations, where reduced American military involvement in East Asia has been accompanied by greater pressure on Japan to open its market to foreign goods.<sup>36</sup> This comes back to the view that some regions are forming trade agreements as a defensive measure against the possibility of a more aggressive trade policy from the US or European Union.

Another interpretation is that the modern state sees regional economic co-operation as a means of re-asserting its authority over the market. There is a popular (although contentious) assertion that the state has gradually lost power to firms or markets in the post-war period.<sup>37</sup> This is illustrated by features such as difficulty in regulating some industries for fear of driving them away (notably finance), an almost uniformly welcoming stance of states towards multinational firms' investment and the growing importance of some issues which can only effectively be tackled on a regional basis (such as environmental protection).

---

<sup>34</sup> In 1996 the US attempted to link the issues of trade and politics, by threatening to discriminate against any firm which invested in Cuba under the Helms-Burton Act, and similarly planned action against firms which invested in countries which the US claimed were sponsors of world terrorism, such as Iran or Libya.

<sup>35</sup> OECD (1995).

<sup>36</sup> Finger and Fung (1994) discuss the structural impediments initiative between the US and Japan.

<sup>37</sup> See for example *The Economist*, "The myth of the powerless state", 7 October 1995.



Regional policy-making implies that firms have less ability to engage in regulatory arbitrage and it represents another dimension to state control to which the firm must be prepared to respond. Even if the state is not successful in extending its power by a pooling of sovereignty, it still creates another institution with which the multinational corporation must interact.<sup>38</sup> Related to this is the observation that the past decade has seen a splintering of many countries and the creation of a greater number of smaller states. Even without a change in the relative power of states and markets this would point to regionalism as a means of restoring the pre-break up status quo, as was seen with the Czech-Slovak customs union which emerged following the split of Czechoslovakia.

Milward offered a different perspective when he claimed that the European Community was not the antithesis of the nation state and the EC "has been an integral part of the reassertion of the nation-state as an organizational concept".<sup>39</sup> In Milward's analysis, the EC allowed the state to offer its citizens a higher level of security and prosperity than would otherwise have been possible, thus helping to retain the support of the people. In essence, in some issue areas the EC is greater than the sum of its parts, so the state benefits from ceding responsibility.

Bhagwati has suggested that one reason why regionalism has revived since the 1980s, after its failure in the 1960s has been the conversion of the United States to the cause.<sup>40</sup> In the 1960s the United States had favoured the multilateral approach, but in the 1980s constructed free trade deals with Israel and Canada, and since then has aired the possibility of a pan-Americas free trade area. However, it is unclear whether the US adoption of regionalism was a reflection of frustration with lack of progress at the multilateral level, or because it was seen as a complement to the multilateral process.

Thus political or international relations based interpretations offer an extra dimension to explanations of regionalism. However, they have difficulty in explaining the increase in popularity in regional trade agreements (RTAs) in the post-Cold War period, when greater security would suggest fewer regional agreements.

---

<sup>38</sup> Oman (1994).

<sup>39</sup> Milward (1992) pp. 2-3.

<sup>40</sup> Bhagwati (1993).

### 6.2.3 Structure and Behavioural Aspects

It is difficult to classify regional agreements neatly, either in terms of their structure or behaviour. However, it is an area which must be considered in any attempt to construct a framework which relates the actions of multinational corporations to regionalism. A typography of the various forms that regional co-operation may take was offered in Chapter 2, ranging from sectorial agreements to full political union. The standard view is that closer economic integration goes hand in hand with stronger, more centralised institutions.<sup>41</sup> Causality is in debate, and in fact it is probably an iterative process, with economic integration a force in favour of eliminating the merits of political segmentation and the consequent differences in national policy, while promoting the development of centralised institutions. The more centralised institution then implements policies which in turn sponsor further economic integration. The underlying theme is that closer economic integration creates the need for, and is a response to, the closer harmonisation of policies which occurs as a result of firm, centralised policy-making.

Regarding structure, greater economic integration has not led to a single, functionally driven, pattern of institutional change.<sup>42</sup> It does not necessarily lead to centralised, rule-based institutions with expanding scope. In fact Kahler goes so far as to argue that there is an "arc of information" with loose, decentralised institutions likely to exist when information is sparse and expensive, as well as when information is plentiful and cheap. This is based on the idea that it is difficult to develop a centralised structure when information levels are low, and it is not needed when levels are high. Centralised institutions will occur when information is moderately accessible at a moderate price. Although intellectually appealing, placing the European Union neatly in this typography is difficult<sup>43</sup> although it could be applied to the ANZCERTA. On the available evidence it

---

<sup>41</sup> See Haas (1964) or Kahler (1995).

<sup>42</sup> Kahler (1995).

<sup>43</sup> In November 1995 the president of the Bundesbank, Hans Tietmeyer argued that monetary union would have to be accompanied by closer political ties if it was to succeed. In February of the same year the UK Chancellor had argued that political and monetary union were separate issues.

appears more feasible to argue that economic integration is likely to be accompanied by stronger institutions, but this not necessarily the case.

The behaviour of institutions is discussed below, where it is argued that there is a danger that regional trade agreements will behave in a protectionist fashion. This occurs through rent-seeking behaviour or through ineffective decision-making processes. Although this behaviour may be predictable, it is not implied by a structural examination of an institution, but derives from the context in which it operates.

### **6.3 Is Multilateralism Fading?**

In spite of the general acceptance that regionalism is a growing force, there is not a consensus as to whether this spells the end of multilateralism. This brings us to the recurrent question of whether regionalism and multilateralism can be complementary. There are four key issues from the point of view of multinational corporations as well as the GATT/WTO. The first is whether the rise of regional arrangements is hindering, or threatening to hinder, the free flow of goods, services and capital between regions. As will be discussed in the following chapter, the answer to this question will play a part in determining the optimal global strategy of the multinational corporation. The efficient structure of a corporation with global activities will differ considerably depending on whether it can trade in an uninhibited fashion, or whether its markets are becoming increasingly segmented. This will be discussed further in Chapter 7.

The second issue is whether regionalism will prevent further multilateral liberalisation. A polemic view is taken by authorities on international trade such as Bhagwati and Panagariya, who argue that regional trade agreements are undermining the multilateral process. For example Panagariya criticises NAFTA for diverting Mexico away from the path of non-discriminatory liberalisation it followed in the 1980s, while the side agreements on labour and the environment have set a dangerous precedent which will impinge on further multilateral discussions. He even goes so far as to assert "Nafta can be judged actually to have harmed the cause of multilateral free trade".<sup>44</sup> Levy uses a more formal interest group approach to show that support for multilateralism can be

---

<sup>44</sup> Panagariya, letter to the *Financial Times*, 10 May 1995.

undermined (and never enhanced) by bilateral agreements when product differentiation and economies of scale exist.<sup>45</sup>

The third issue is whether there is a need for further multilateral liberalisation. It could be argued that such a high proportion of world trade is now covered by the provisions of the Uruguay Round that a cost-benefit analysis of further multilateral deals makes them appear unattractive. However, this approach is short-sighted: it was the changing structure of international trade that made the Uruguay Round necessary, especially the increased importance of trade in services, and growth of non-tariff barriers.<sup>46</sup> It is already apparent that although the Uruguay Round has bolstered the share of world trade that is covered by international agreements (for example by reaching agreement on services trade), many rapidly growing areas of trade, investment and other types of non-equity activity still fall outside the remit of the World Trade Organization (WTO). In future it could be that competition policy comes to be recognised as an important element in trade relations, but it is an area that is not covered by any multilateral agreements.<sup>47</sup> Discussions between the European Union and the United States are looking at "deeper" issues than are covered by the WTO, such as product standards, patents and taxation: these too are likely to be areas for future multilateral debate.<sup>48</sup>

Defenders of multilateralism argue that regional negotiations may be more effective in achieving incremental advances to already laid-out ground rules, but they will be ineffective in drawing up rules for tackling new areas in the international political economy.<sup>49</sup> However, this does not fit well with the evidence which shows regional agreements acting as test cases for widening the multilateral agenda, as was the case with services treatment in CUSFTA and ANZCERTA.

---

<sup>45</sup> Levy (1997).

<sup>46</sup> Although the Tokyo Round had partially covered non-tariff barriers, the Uruguay Round agreement was stronger and more broadly based.

<sup>47</sup> In October 1995 the European Union's Trade Commissioner Sir Leon Brittan advocated the coverage of investment rules, competition policy, the environment and labour standards by any future international trade negotiations.

<sup>48</sup> Transatlantic Business Dialogue, Overall Conclusions, Seville, Spain, 10-11 November 1995.

<sup>49</sup> WTO (1995) p. 56.

The fourth issue is that even if it is desirable to have further multilateral liberalisation, is it practical or feasible? There are serious questions about achieving consensus among such a large and diverse membership,<sup>50</sup> as well as over the speed of negotiations and implementation. For example, the Uruguay Round was launched in September 1986, was signed in 1994 and it is not until 2005 that full implementation of all agreements is required. In fact if the timing is dated back to the Ministerial Meeting in 1982 then the process spans almost a quarter of a century.

In reality criticism of the slowness and complexity of multilateral negotiations is overstated, perhaps as a result of post-Uruguay Round fatigue. Although there were 114 contracting parties to the GATT at the time Uruguay Round negotiations were completed in December 1993, a limited number of countries outside the OECD have real influence. Few developing countries have enough power to contemplate trying to press their own agenda, and if they act together when negotiating (the Cairns Group<sup>51</sup> is an example) then this again reduces the number of actors to manageable proportions. Problems resulting from the number of negotiators is relatively slight compared to issue-based complexities caused by fundamental disagreements between major actors over sectors such as agriculture.

Concern about the length of time involved may also be exaggerated. Uruguay Round negotiations did not begin in earnest until 1988 which was the year of the Montreal mid-term review. They were completed at the end of 1993. Moreover, although liberalisation of some sectors will be slow, most of the effects will be seen by the end of the century. Similarly Schott argues that the substantial component of the Tokyo Round negotiations only took 18 months, although on paper the Round lasted from 1973 to 1979. It is also worth noting that for recent regional agreements, once the deal is signed implementation tends to run ahead of schedule.<sup>52</sup>

---

<sup>50</sup> There were 125 signatories to the Uruguay Round while by the time of the Ministerial Meeting in Singapore in December 1996 there were already 126 members of the WTO.

<sup>51</sup> The Cairns Group represents exporters of agricultural products and comprises Australia, Argentina, Brazil, Canada, Chile, Colombia, Fiji (not a GATT member), Hungary, Indonesia, Malaysia, New Zealand, Philippines, Thailand and Uruguay.

<sup>52</sup> See Schott (1989). The Australia-New Zealand CERTA is an example of this acceleration. Signed in 1983, it provided for a free trade deal by 1995, but this deadline was brought forward to 1990 after a 1988 review.

One concept which is much discussed with regard to the European Union, but is rarely extended to other regions, is subsidiarity. It could be that this offers some insights into the development of the international political economy. For example, there is evidence of subsidiarity at work in Asia. While the WTO and APEC cover many of the areas of general concern to Asia, there is also scope for regional deals such as ASEAN or the Australia-New Zealand CERTA. At the same time, the popularity of "growth triangles" has boomed in recent years. For example, there exist within ASEAN the Southern Growth Triangle of Singapore, the Malaysian state of Johor, and Riau province in Indonesia, as well as and the Northern Growth Triangle of northern Sumatra (Indonesia) four northwestern Malaysian states and southern Thailand. These arrangements are an effort to capitalise on the variety of inputs available within a small geographic region. These are signs that, in Asia at least, regional integration is occurring at whatever level is most effective.

There are several possible directions for the future regulation of international trade. These options will be used in Chapter 7 when considering the strategies of multinational corporations. The main ones of interest are:

- 1) Multilateral negotiations continue at irregular intervals, as has been the case since the intensive burst of GATT Rounds in the first fifteen years after its formation. Bilateral and regional agreements complement multilateral negotiations and help to set the future agenda.
- 2) No further multilateral agreements are signed, although the growth continues of bilateral and regional agreements which deepen integration between signatories without raising barriers to non-participants. Some elements of deeper integration will inevitably be non-discriminatory in nature. This could include a WTO-plus agenda, linking countries with similar attitudes towards further liberalisation, but without any regional basis. Such an approach could even lower barriers at a faster pace, due to the complexities involved in achieving agreements between the diverse participants in multilateral deals.
- 3) Multilateral agreements will be replaced by bilateral and regional agreements, which increase integration between signatories, but which hinder trade and investment flows with the rest of the world.<sup>53</sup>

---

<sup>53</sup> This could be a particularly negative situation for developing countries if multilateral

- 4) Regionalism falls from favour to be replaced by a renewed faith in the powers of multilateralism.
- 5) Both regionalism and multilateralism are discarded in favour of a return to national trade policy. Such a development would be likely to involve a more protectionist agenda.

Combinations such as a continuation of multilateralism combined with protectionist regionalism are disregarded as being inconsistent. These views are, to an extent, clichéd, in that the issues are not as clear cut as they are presented above, but they provide a useful framework for a discussion of the implications for MNCs which will be conducted in the next chapter. Whichever pattern emerges will have implications for multinational corporations, and this will also be discussed in the next chapter. Much will depend on the behaviour and attitude of the three main forces in world trade; the US, the European Union and the World Trade Organization. The latter is, by definition, in favour of continued multilateral liberalisation. At present the evidence on the US and EU is mixed. In the past decade both the European Union and the United States have embraced regionalism to a greater extent than at any time in the post-war period. However, at the same time both invested considerable effort and made important concessions to secure agreement on the Uruguay Round.

The WTO Ministerial Meeting in Singapore in December 1996 failed to give an indication as to whether another multilateral Round will be attempted, but emerging issues such as competition policy, financial services, product standards and non-tariff barriers in general suggest that there is plenty of material which another Round could address. The decision is likely to depend on whether the wider breadth of a multilateral agreement is worth the additional time and effort. Complications stemming from the likely addition of the People's Republic of China to the WTO before another multilateral Round begins could be the decisive factor which makes the EU and United States opt for regionalism, in perhaps a Transatlantic Free Trade Area.

---

obligations are seen, in part, as restricting the ability of the more powerful developed world to exploit its position of strength. A "survival of the fittest" version of competitive regionalism could result in less co-operative trade policies vis-à-vis the developing world.

A final point in favour of multilateralism is the intellectual argument. The wealth of literature and the counterexample of the 1930s are powerful forces supporting a liberal trading system. They suggest that even if little further multilateral progress is made, it will be difficult for countries or regions to act in a way which directly goes against existing multilateral norms.

Note also that pure bilateralism does not seem to be a practical alternative to the multilateral process. For the 126 countries which had signed up to the WTO by the time of the 1996 Singapore Ministerial Meeting to negotiate bilateral treaties with each other would mean 7875 separate deals. Avoidance of the need for, say, Austria to conduct negotiations with Zimbabwe is one of the efficiencies of the multilateral system. That is to say, it reduces transaction costs and or associated problems such as lack of information, moral hazard and irresponsible behaviour.

On balance, it seems that regionalism is not necessarily a substitute for multilateralism, but it would be complacent not to recognise that multilateral conventions might be replaced by regional and sectorial agreements in the future. The potential for substitutability makes the attitude of the GATT/WTO towards regionalism worthy of consideration. It is also possible for regions to have a protectionist bent, rather than a liberal one. As the guardian of the world trading system, the WTO can be expected to highlight areas where regionalism poses a threat.

#### **6.4 The GATT and Regional Trading Arrangements**

As noted in Chapter 2, the attitude in the General Agreement on Tariffs and Trade to regional trading arrangements (RTAs) was ambivalent. Although they go against the basic GATT principle of non-discrimination, RTAs were seen as potentially being a step towards a distortion-free multilateral system. An attempt to ensure this was the case was made in paragraph 4 of Article XXIV which reads "the purpose of a customs union or of a free trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories". An effort was also made to ensure that the political determination existed to create a regional agreement



capable of overcoming protectionist opposition by specifying that the preferential arrangement could not be a limited sectorial one.

Regional trading agreements had to be notified to the GATT to allow inspection to judge whether they conformed to the rules laid out. Although Article XXIV explicitly permitted the formation of customs unions and free trade areas, the GATT rules on regional trading arrangements were criticised for their ambiguity. The vagueness of Article XXIV, using wording such as "duties and other regulations of commerce .... shall not on the whole be higher or more restrictive than the general incidence of duties .... prior to the formation of such union"<sup>54</sup> left the treaty open to manipulation. It is, after all, not the average level of tariff rates which matters, but the effective rate. For example, in 1957 the six members of the EEC calculated tariff levels according to an unweighted arithmetic mean of tariffs existing prior to the signing of the agreement.<sup>55</sup> If the same method were used to extend NAFTA to a high tariff country within Latin America, then it could raise the effective level of tariffs, while still conforming to wording of the GATT, if not to its spirit. Other ambiguities left similar scope for abuse. For example another GATT Article XXIV requirement was that duties and other restrictions "are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories".<sup>56</sup> However, the precise meaning of the word "substantially" was not made clear.<sup>57</sup>

A more practical problem was that it was rare for a working party to deliver its findings before the regional agreement was signed and operational. For example, the working party investigating the Canada-US Free Trade Agreement began work after a delay of two years. This meant that there was no opportunity for interested third parties to raise objections via the GATT before the agreement went into force.

---

<sup>54</sup> Article XXIV, Paragraph 5a.

<sup>55</sup> So if Germany had imported 90% of a product and had imposed a tariff of 10%, while the other five had imported the remaining 10% but had imposed a tariff of 20%, the post-EEC formation average tariff would have been 18.3% (110 divided by 6). The effective tariff rate would have risen however, from 11% (0.9 x 10% plus 0.1 x 20%) to 18.3%. In fact, tariff rates for Germany and Benelux countries generally rose, while they fell for France and Italy. See Sapir (1992) for details of how tariff rates actually moved in Europe.

<sup>56</sup> Article XXIV, Paragraph 8a.

<sup>57</sup> Blackhurst and Henderson (1993).

More seriously, the working parties tended to be inconclusive with regard to Article XXIV. To the end of 1994, 69 working parties had delivered their reports, with a further 15 still in progress and five others ending without completing their examinations. Of the 69 completed, in only six cases did the working party explicitly find the agreement to be GATT compatible under Article XXIV.<sup>58</sup> Of those six, only two are currently active—CARICOM and the customs union between the Czech and Slovak republics. In the remainder of cases there was no consensus as to whether the requirements of Article XXIV were met. Moreover, no notified agreement has ever been found to be illegal by a GATT working party.<sup>59</sup> Thus as the WTO notes "*making no pronouncement on the key matters they were charged to examine has been the rule for Article XXIV working parties*".<sup>60</sup> Furthermore, no amendments to the structure of a preferential arrangement have ever been requested by a working party, no doubt partly because the report is usually issued after the agreement has been in place for some time. This seems to be the clearest indication of weakness in the wording or implementation of Article XXIV.

A 1985 wiseman's report chaired by Fritz Leutwiler found that the provisions of Article XXIV were ambiguous and that there was no real surveillance. The report found that "exceptions and ambiguities ... have seriously weakened the trade rules, and make it very difficult to resolve disputes to which Article XXIV is relevant".<sup>61</sup> The spirit of the article began to be undermined in 1957-58 with the first steps in the formation of the EEC, when there was no consideration of whether the agreement accorded with Article XXIV.

Perhaps the GATT can be blamed too harshly for the weakness of the provisions concerning customs unions and free trade areas. Bhagwati notes that regionalism "was not generally considered, by the architects of the GATT or by the United States .... as antithetical to the GATT and [its] principles".<sup>62</sup> Economic

---

<sup>58</sup> These were the South Africa-Rhodesia Customs Union (1948), the Nicaragua-El Salvador FTA (1951), Nicaraguan participation in the Central American Free Trade Area (1958), the Caribbean Free Trade Agreement (1965) and the Caribbean Community and Common Market (CARICOM) (1973) and the Czech Republic-Slovak Republic Customs Union (1992).

<sup>59</sup> Blackhurst and Henderson (1993).

<sup>60</sup> WTO (1995) p. 17. Italics in the original.

<sup>61</sup> Leutwiler (1985) p. 41.

<sup>62</sup> Bhagwati (1993) p. 28.

theory on the subject was reasonably limited and it appears that, with certain provisions, they were viewed as "a step in the right direction". The inception of the European Economic Community in 1958 was the turning point, in that it sparked interest in preferential trade arrangements elsewhere, and the treatment of the EEC was inconclusive. The GATT failed to reach a decision on whether the Treaty of Rome was compatible with Article XXIV and has not formally examined the issue since then. Moreover, it was difficult to avoid setting the precedent of allowing the formation of the EEC, as any finding which had the result of driving the EEC out of the GATT would also have meant the effective end of efforts to create a multilateral trading system. The US supported the EEC because of the political benefits of a stronger Europe, despite questions as to whether it was GATT compatible.<sup>63</sup> There was little change through to the closing days of GATT, with the US and European Union possessing an effective veto on substantive decisions.<sup>64</sup>

Thus what could be expected to have been one of the main safeguards against the establishment of a restrictive set of regional trading blocs has proved to be ineffective. Without clear rules and resolute enforcement to prevent regionalism from being of an exclusionary nature there is no case for arguing that legal or institutional considerations will ensure that economic integration of one region does not result in lower welfare for the rest of the world.

If the inability to take a firm position on regional trade agreements is a sign of the GATT's lack of power over members, then this could also be related to the weakness of the GATT's dispute settlement mechanism, which authorised retaliation only once—in 1954. In fact this could be interpreted in two other ways; either that GATT intervention was so successful that disputes were resolved without retaliation being necessary, or that the GATT was scared of a collapse of multilateralism and a spiral into a trade war. The process laid out was for: 1) consultation; 2) conciliation; 3) panel review (all designed to achieve a "mutually agreed" solution); 4) membership vote to make official the panel's findings and recommendations and; 5) vote to authorise retaliation.

The weakness of the dispute settlement mechanism was one area targeted for improvement in the Uruguay Round. In practice, it had become

---

<sup>63</sup> Bhagwati (1992a).

<sup>64</sup> Hindley and Messerlin (1993).

almost impossible for the GATT to find against any major members as they were able to block a panel decision which had to be unanimous. A major change in the WTO dispute settlement procedure is that there now has to be a consensus to reject a panel ruling.<sup>65</sup>

As with the firmer guidelines on regional trading arrangements, however, it is not clear that stronger rules on dispute settlement will, in themselves, be sufficient, as rules do not necessarily indicate power. The GATT's problems over regionalism related to its unclear ideological stance on the issue, the imprecision of the wording of Article XXIV and the weakness of the GATT as an institution. While the first two of these problems are within the remit of the WTO, it has limited control over the third.

## 6.5 The WTO and Regional Trading Arrangements

On paper, the attitude of the World Trade Organization towards preferential trade agreements is similar to the GATT. For trade in goods, the WTO adopted existing Article XXIV provisions together with the Uruguay Round Understanding on Article XXIV which clarified some (but not all) of the vaguer aspects.<sup>66</sup> The Agreement on Rules of Origin is also relevant to free trade areas, while the General Agreement on Trade in Services (GATS) has similar provisions to those for goods.

The Agreement on Rules of Origin was an important step which recognised the basic difference between customs unions and free trade areas (FTA), namely that members of the latter are free to decide on their own tariff rate on imports from the rest of the world. As FTAs are the most common form of regional agreement, rules covering a product's origin need to be clear. Rules of origin can divert trade of semi-finished goods or partly processed raw materials, and can also be used by protectionist domestic lobbies.

Less than six months after its foundation, the World Trade Organization produced a study into the effects of regional trading arrangements. *Regionalism and the World Trading System* looked mainly at the systemic effects of growing

---

<sup>65</sup> Yarbrough and Yarbrough (1997) pp. 144-145.

<sup>66</sup> For example, comparisons of pre- and post-customs union tariff rates is to be on a weighted average of the applied rate.

regionalism, but it was less equivocal on the subject than had been its predecessor. In particular, the WTO noted that the debate over trade creation and diversion was only one element to be considered. It stressed that the economies of scale, increased competition and lower consumer prices which stemmed from lower trade barriers were often downplayed in *ex ante* or *ex post* analysis. The WTO also noted the need to consider issues such as investment flows when assessing the impact of trade agreements.

In terms of the actual rather than theoretical effect of regional integration agreements, the WTO recognised that their diversity makes it difficult to analyse the impact on trade flows and trade policy. The WTO also claimed that regional agreements tend to focus on tariffs. It asserted that non-tariffs barriers tend not to be applied preferentially, while domestic policies (such as production subsidies) cannot be applied preferentially. The implication being that the deeper the level of co-operation, the more difficult it is for the agreement to contain a regional bias. On the whole this is correct, although as noted in Chapter 5 it is not difficult to find recent examples of non-tariff barriers being used on a bilateral basis (most notably in US-Japan relations). Some non-border restrictions such as dispute settlement mechanisms, product standards and anti-dumping can be applied preferentially.

In the end the WTO took a more clearly positive view of regional trading agreements than the GATT had done, noting that "it is clear that to a much greater extent than is often acknowledged, regional and multilateral initiatives are complements rather than alternatives in the pursuit of more open trade".<sup>67</sup> This is not just because regional agreements are structured in a way which results in lower trade barriers within the bloc without diverting significant amounts of trade with non-members. It also derives from the readiness of some agreements to accept higher levels of integration than previously existed on a multilateral level, with regional deals on services and intellectual property rights laying the foundation for Uruguay Round measures. The acceptance of clear rules and procedures—which form the basis of a trading system—at a regional level is also viewed positively by the WTO as this provides a framework for extension to the multilateral arena.

---

<sup>67</sup> WTO (1995) p. 62.

The World Trade Organization accepted that regional agreements tend to be complementary with multilateralism. For example, a desire to reduce the relative degree of preference inherent in regional agreements is seen as a factor in leading to other excluded nations pushing for greater multilateral liberalisation. Moreover, downplaying the risk of a rise in protectionism it noted "There have been no fortress type regional integration agreements among WTO members".<sup>68</sup>

Unsurprisingly (on the basis of institutional self-preservation), the WTO did not see regional agreements as a substitute for the multilateral process. The broader application of processes which are already accepted in some regions (such as TRIPs) is seen to depend on the WTO. Similarly, the WTO noted that it "has also been provided with a strengthened dispute settlement mechanism as well as a monitoring function, which together will bring increased transparency and predictability to trade and economic policies".<sup>69</sup>

The treatment of regional agreements under the GATT had met with frequent criticism. The WTO accepted that there were problems with the interpretation of and compliance with the rules at working party level. Moreover, it can be asserted that the GATT's weakness means that any complementarity between regional integration and the multilateral system may not be a result of the GATT's actions. Simply because regional agreements have been compatible with multilateralism in the past does not necessarily mean that they will remain so unless the rules and procedures are strengthened. The WTO also recognised that such weakness is a danger not just in the specific area related to regional agreements, but to the overall credibility of the WTO.<sup>70</sup> However, the Uruguay Round failed to tighten up all the ambiguities in the wording of Article XXIV. The WTO sees three areas where reform could improve treatment of free trade areas and customs unions:

- i) More rapid notification of agreements, so that WTO working parties can recommend changes before the agreement is signed.
- ii) Improving the clarity of Article XXIV, or re-writing it to improve safeguards for third countries.
- iii) Improving the surveillance of regional agreements as it has been shown

---

<sup>68</sup> WTO (1995) p. 2.

<sup>69</sup> WTO (1995) p. 62.

<sup>70</sup> WTO (1995) p. 3.

that peer pressure is a key consideration when drafting or amending free trade areas or customs unions.

The guiding principle appears to be that the WTO views regional agreements as potentially beneficial, but dialogue and monitoring are needed to ensure that they remain complementary to the world trade system. This is a profoundly pragmatic conclusion; if the WTO were to find against regional agreements then it would need to be in a position to offer a clear and workable alternative. In 1995, with the major players still suffering from Uruguay Round fatigue, this was not feasible. The only realistic stance of the WTO was to accept that regionalism was a force, and to try to guide it towards following the basic principles behind the WTO.

## **6.6 Is GATT/WTO Multilateralism Still Regionalism?**

In some ways the distinction between the regionalism of trading blocs and the multilateralism of the GATT/WTO is a false one. To treat the GATT/WTO as representing the entire trading world is an exaggeration: it has always been dominated by the developed world, with many developing countries either excluded or emasculated. Important non-participants in the mid-1990s include the People's Republic of China, Taiwan, Russia and Saudi Arabia, while countries such as Mexico (joined 1986) and much of the rest of the former Eastern Bloc are only recent members. By 1995 China was the world's eleventh largest nation in terms of merchandise exports, the second largest (behind the US) in terms of FDI inflows and in 1994 it was the second largest economy.<sup>71</sup> Excluding China from the GATT and treating it as multilateral is on a par with excluding Italy from the European Union and still claiming it represents all of Western Europe. More generally, with 123 members as of mid-1996 the WTO covers only two thirds of the membership of the United Nations. Nor is this a recent situation. Note that only 23 countries participated in the first GATT Round. Admittedly, at any point in time there have always been several countries which,

---

<sup>71</sup> The 1995 World Bank report *World Tables* placed China's purchasing power parity GDP second behind the United States.

although not members of the GATT, implemented trade policy as if they were, but non-membership confers greater flexibility on policies.

That the decision-making process within the GATT or the WTO is not multilateral is also clear. As Kahler asserts, "the history of international institutions since 1945 demonstrates a record of great-power plurilateralism, even when embedded in regimes of large membership".<sup>72</sup> In effect, the Tokyo Round was a series of bargains struck between major economic powers,<sup>73</sup> while the horse-trading which occurred between the US and the European Community (and even within the European Community) in the scramble to resolve the Uruguay Round in late 1993 is a testimony to the dominant power of these two economic centres. Smaller nations are often invited to participate on a "take it or leave it" basis. An attempt to redress this imbalance in power was behind the formation of the Cairns Group of agricultural products exporters, which aimed at reducing the high effective levels of protection on agricultural products which still exist in many OECD countries.<sup>74</sup> There is a sense that the tide may be turning following the failure of the United States and European Union to secure two seats each on the seven member WTO Appellate Body, but it remains highly unlikely that the WTO will be able to force significant policy change in either member.

It could be argued that the GATT was not just a regional agreement, but also a sectorial one. In 1992 the president of the OECD Development Centre in Paris asserted that "if GATT covers 10% of international economic and financial flows, this estimate will be on the high, rather than the low side".<sup>75</sup> Oxley noted that by some calculations the proportion of world trade regulated by the GATT was as low as 7%, but most estimates put coverage at 50%. The Office of the US Trade Representative calculated that in 1989 two-thirds of trade was within GATT rules, with agriculture, textiles and services the major exceptions. Whichever is more accurate Oxley claims that even with the largely successful conclusion of the Uruguay Round, large pieces of world trade are still not

---

<sup>72</sup> Kahler (1995) p. 17.

<sup>73</sup> Kahler (1995).

<sup>74</sup> Bliss (1994).

<sup>75</sup> Emmerij (1992) p. 10.



regulated by the WTO.<sup>76</sup> Services, trade related investment measures (TRIMs) and intellectual property rights are largely omitted (although the Uruguay Round dealt with some). In addition, textiles and agriculture were excluded from the GATT and it will take until the year 2005 to implement fully the Uruguay Round provisions. Even that will not result in free trade in agriculture and textiles, but will only bring them under the auspices of the WTO. Meanwhile trade in steel, electronics, automobiles and electrical goods does not strictly adhere to WTO principles.

Nevertheless the WTO marks a definite advance on the GATT as now all members are covered by the agreement's provisions, including the five Tokyo Round Multilateral Trade Negotiation (MTN) Non-Tariff Measures and Anti-Dumping/Subsidies Codes (subsidies & countervailing duties; import licensing procedures; standards & technical barriers to trade; customs valuation; and government purchasing policies) as well as the revised (but still weak) anti-dumping code. Previously fewer than 50 countries were signatories to the five MTN codes. This brings the developing world into line with the global trading regime and eliminates "free riding" on the system.

The increasing substitutability of investment for trade (in a practical sense, rather than in the theoretical sense demonstrated by Mundell) also indicates that WTO-style multilateralism may not cover all the issues. Although the OECD has begun to address regulation of foreign direct investment, issues such as competition policy remain outside the scope of any multilateral agreement.

Thus although there is the temptation to treat the WTO as if it is the sole arbiter of multilateral trade issues, in reality its jurisdiction is limited both geographically and sectorially, as well as being restricted to a subset of the range of factors which influence cross-border transactions. While WTO-based liberalisation covers more countries than any regional agreement, it is not fully inclusive and so any WTO prescription remains a second best solution. On this basis, comparisons between a regional world and a multilateral world under the WTO may be false; the comparison is really between two different types of regionalism. From the point of view of the multinational corporation there are three possibilities: operating in countries which are not WTO members; operating

---

<sup>76</sup> Oxley (1990) p. 128.

in sectors which are not fully covered by WTO rules; and operating within the WTO framework.

## 6.7 RTAs, International Relations and International Business

It is a fact of history, and remains true today, that the majority of disputes which result in military conflict are between neighbouring countries.<sup>77</sup> It is also the case that the majority of trade agreements are regionally based; indeed they are frequently formed between countries which have been involved in warfare at some point in the past hundred years. Just as one of the underlying themes of the European Union is that countries with common economic interests are more likely to find non-military means of resolving disputes, so it can be argued that a world consisting of a web of regional trading agreements is less likely to decline into warfare.

Gowa has found that there is a positive relationship between military or diplomatic alliances and trade preferences.<sup>78</sup> She argues that trade brings economic benefits, which inevitably has the effect of raising resources available for military spending, so it must be the case that trade with an ally enhances security, while trade with a potential adversary diminishes it. Gowa finds that since 1905 trade has been more likely within alliances than between them, especially in a bipolar, rather than multipolar world. The implication is that measures taken by alliances to increase economic integration complement the micro effect of greater security on firm behaviour. Unfortunately causality is unclear; that is whether alliances lead to economic co-operation which brings trade preference, or whether it is the greater security which has a direct impact on trading relationships.

Apart from the obvious humanitarian implications of reduced regional conflict, which at least is apparent within the developed and newly developed world, there are implications for business. Any risk assessment by a multinational corporation tends to be conducted, implicitly or explicitly, on three levels.<sup>79</sup> The

---

<sup>77</sup> Waltz (1979) p. 138.

<sup>78</sup> Gowa (1994).

<sup>79</sup> This is the approach carried out by the Economist Intelligence Unit in its Country Credit Risk Appraisal reports.

first level relates to the general microeconomic situation facing a firm, in terms of its cost structure, the degree of competition it faces, and the like. On a macroeconomic basis, factors such as GDP growth rates, income levels, degree of unionisation, quality of workforce, are all issues which will determine the profitability of an investment in a country. However, systemic risks, such as revolution or warfare threaten not just the income stream from an investment, but the value of the investment itself.

A regional trading agreement offers lower systemic risk to the MNC on two counts. Firstly, linking two countries economically through a free trade agreement involves setting up some kind of forum for discussion, which inevitably involves closer political contacts. Mutuality of economic interests also raises the costs of warfare, which involves destruction or appropriation of productive facilities, and consumer hostility even after the resolution of the conflict. The second area of lower systemic risk relates to the impact on each country's domestic policy-making as a result of being a member of a regional trading organisation, with the implicit or explicit responsibilities to trading partners that this entails. For example, the objective of "locking-in" market oriented reforms in Mexico was clearly part of the motivation of the United States in pushing for NAFTA.<sup>80</sup> This provided a more stable systemic environment for US firms operating south of the border.

Thus aside from any benefits which stem from more economically oriented issues such as resource allocation, there are clear gains to MNCs from a reduction of the risk premium which needs to be ascribed to all economies other than perhaps the soundest OECD members. This is largely irrespective of what the regional group actually does in terms of tariff reductions or non-tariff measures; the mere existence of a forum for discussion is sufficient to reduce risk. This suggests that studies may seriously underestimate the benefits of regionalism as they tend to concentrate on the gains from greater trade flows or the more efficient allocation of investment which result from lower trade and FDI barriers. The rise in trade and both the quantity of investment and its locational

---

<sup>80</sup> Although it should be recognised that this represented an about face from the policy which spanned from the debt crisis of 1982 until 1989 when Mexico tried to reduce dependency on the US economy and integrate more with the rest of the world.

efficiency as a result of lower systemic risk must be added to the benefits suggested by more standard econometric calculations.

## 6.8 FDI, Multilateralism and Protectionism

It is also worth noting that there are important forces at work reducing the motivations for creating regional agreements. There has been a secular rise in foreign direct investment in the past two decades, to the extent that in almost every major economy the role of foreign-owned production has risen. With this rise in foreign ownership comes a decline in one political motivation for regionalism, because the benefits become spread more broadly. This complicates interest group analysis which assumes that the lobbying activity of factors of production is aimed at maximising returns only within the individual country they are located.<sup>81</sup>

Most estimates put the share of intra-firm trade at between one third and one half of total trade.<sup>82</sup> Taking the North America Free Trade Agreement (NAFTA) as an example, the impact of NAFTA trade diversion will affect US subsidiaries abroad as well as foreign firms, while the benefits of trade creation are enjoyed by foreign subsidiaries within North America, as well as domestic firms. As a result, the motivations to create a trade bloc will be less clear cut. While the direct benefits to consumers may not alter too significantly, the impact on foreign and domestic firms will be less clear. Foreign firms will lose less through trade diversion and may even gain through trade creation as a result of FDI in the region. Domestic firms will not take all of the gains from trade creation and will also suffer in the form of trade diversion away from their foreign affiliates.

The sectors in which FDI tends to occur makes this outcome not entirely unrealistic. Foreign direct investment into the bloc is likely to be in traded goods or services and is likely to be in the more efficient sectors. (Firms may transfer technology which has become obsolete in their own economy, but not if it is also obsolete in the recipient's economy.) For example, there was substantial inward FDI in manufacturing within the European Community in advance of the Single

---

<sup>81</sup> Levy (1997), Krishna (1998).

<sup>82</sup> See Dicken (1992) p. 49, Dunning (1993a) p. 303, or Oman (1994) p. 83.

European Market in 1992, but very little in agriculture.<sup>83</sup> Thus from the government's viewpoint, the benefits to the economy as a whole from forming regional blocs are diminished by the effect of inward and outward FDI. In terms of corporate political behaviour, it is likely to make domestic MNCs more circumspect in their support of a regional bloc.

A higher proportion of foreign direct investment within an economy also makes overt protectionism less likely. For reasons outlined above, a general increase in tariffs would damage US affiliates abroad, as well as benefiting foreign-owned operations within the US which would experience less competition. Alternatively, targeted protectionism would benefit some US producers, but would damage foreign-owned interests. For example, former US Trade Representative Kantor's plans to impose high tariffs on luxury car exports from Japan to the US in May 1995 provoked a rash of lobbying and threats of legal action by dealer networks for Japanese cars based in the US. Faced with destruction of their livelihoods, the dealers represented an effective counter to the US Big Three auto makers.

Thus it is not just political pressures which affect trends towards regionalism, but also the underlying structure of the economy. Again this raises the point that multinational corporations do not simply observe and respond to regional trends, but they are key forces in shaping those trends, as the sum of MNCs' actions has a direct bearing on policy-making.

## 6.9 Regionalism and Protectionism

There is a view that regionalism is a threat to multilateral liberalisation,<sup>84</sup> but this is not quite the same as asking whether it actually implies a rise in protectionism. It is worth considering whether this is the case, whether regionalism can rise while protectionism falls, or whether there is indeed any close relationship between the two areas. There are two aspects to this issue. The first relates to the nature of the regime;<sup>85</sup> whether there are institutional features which cause it

---

<sup>83</sup> OECD (1997a).

<sup>84</sup> Bhagwati (1992b), Levy (1997).

<sup>85</sup> Krasner defined a regime as a "set of implicit or explicit principles, norms, rules, and decisionmaking procedures around which actors' expectations converge in a given area of international relations" (1983) p. 2.

to lean in a certain direction. This section argues that the mechanics of trade blocs tend to give them a protectionist bias. The second aspect relates to the incorporation of the regional agreement in the world system and how it interacts with non-members. Whether the grouping is "open" or "closed" will also reflect its objectives. A bloc aimed at supporting multilateralism is likely to be open. One which is defensive or aims to gather economic rents is more likely to be closed. In general an ideological stance towards openness can be observed,<sup>86</sup> which counters the institutional bias towards protectionism.

A free trade area lacks negotiating power as it does not have a common approach to import tariffs. Bargaining power is accentuated by forming a customs union, as then a trading partner or bloc will face a similar response across the members. However, ceding absolute control over setting tariffs is a big step for most countries and the only two significant groups in the world which have progressed beyond a free trade area are the European Union and MERCOSUR.<sup>87</sup> None of the other trade blocs in existence has a unified policy, which suggests that it is unlikely that in its present form regionalism will adopt a protectionist slant, as there is no mechanism through which this can occur. Unless members are agreed on trade policy and there is some sort of central body to implement policy, then protectionist action will be impractical.

Henderson has presented a stimulating argument that the issues of protectionism and regionalism are entirely separate.<sup>88</sup> He sees the future of the liberal trading system being determined by issues such as the response of the US and EU to ever greater competition from East Asia, or by a desire to bring labour and environmental standards into the realm of trade policy. To Henderson, the question is not whether more blocs mean more protection, but whether the major trading nations adopt a less liberal attitude towards trade. In a broad sense, this is a reasonable view as few central institutions exist and the degree of protectionism will be determined largely by the attitudes of the major trading nations. However, there are some areas of overlap in the details of

---

<sup>86</sup> For example, the Uruguay Round took place at the same time as the renewed interest in regionalism from the mid-1980s.

<sup>87</sup> Although there is even evidence of recidivism in the case of MERCOSUR, as only six months after its formation Brazil unilaterally announced plans to impose restrictions on car imports.

<sup>88</sup> Henderson (1994).

regional agreements, in terms of effective rates of protectionism and shifts in the terms of trade. There is also a question of whether there are institutional tendencies of regional blocs to lean towards protectionism, as discussed below. So while Henderson argues the issues are "largely distinct",<sup>89</sup> there are links through game theory and functionalist arguments.

The World Trade Organization disagrees with the argument that regional blocs liberalise more rapidly than is possible at the multilateral level. It claims that countries' commitments under the WTO tend to go beyond those in regional agreements, with the added benefit of WTO dispute settlement and monitoring.<sup>90</sup> Moreover the Uruguay Round largely resolved the issue of free riding on the multilateral system, while the WTO includes trade relations with countries which are not members of regional groups and so claims to offer more comprehensive liberalisation. Unsurprisingly, the WTO does not really address the question of whether its role should be reduced to co-ordinating trade relations between the various groupings which would then be able to proceed with liberalisation at whatever pace they see fit.

The WTO's arguments are not entirely convincing. If regional commitments are weaker than those already existing to the WTO then there would be no motivation to create regional trading arrangements (RTAs) unless a collapse of the WTO was envisaged. Most RTAs incorporate some provisions for deeper integration than exists under the Uruguay Round—NAFTA, the European Union and the Australia-New Zealand CERTA all go further than current multilateral obligations. That is not to say that regional deals will cover all non-WTO issues—the CUSFTA notably avoided sensitive areas such as agriculture and subsidies—but they will extend coverage in one or more issue area. Perhaps a more realistic argument against regional trade arrangements is that they can set a negative agenda. Ardent multilateralists such as Panagariya argue that NAFTA diverted Mexico from its policy of unilateral liberalisation and, more generally, Mexican concessions on labour and environment suggest there will be pressure for their inclusion in further multilateral Rounds. Widening the agenda will prove a distraction from focusing on trade liberalisation.<sup>91</sup>

---

<sup>89</sup> Henderson (1994) p. 197.

<sup>90</sup> WTO (1995) p. 56.

<sup>91</sup> Panagariya, letter the *Financial Times*, 10 May 1995.

Chapter 3 showed that for most of the past three decades, rising regionalisation has been accompanied by the greater openness of economies. This allowed trade volumes with the rest of the world to increase, even though regional biases were strengthening. While this can still be seen as a second best solution compared to increased economic integration on a non-preferential basis, it is probably an advance on the situation where both regional integration and economic openness were lower. Thus although it has generally been the case that regionalism has not damaged the welfare of non-regional members, this is a function of the individual structures of the agreements and it is not inherently guaranteed by the process of regionalism.

Furthermore it can be argued that regionalism sets in place structures and institutions which can be used to implement protectionist policies. It was clear in the late 1980s that one of the main reasons for the burst of Japanese direct investment into the European Community was concern over the results of the European Single Market programme and the possible emergence of a "Fortress Europe".<sup>92</sup> Moreover the adjustment costs which stem from the formation of regional blocs will cause firms which are suffering within the region to lobby for relief in the form of protection. Nevertheless, there are relatively few examples of bloc formation resulting in a rise in tariff protection.<sup>93</sup>

Standard trade theories teach us that the larger the economic actor in world trade, the greater the opportunity to improve its terms of trade by imposing an optimum tariff. This would imply that regionalism should lead to higher tariffs between blocs.<sup>94</sup> That this is not an observable phenomenon indicates that protectionism is not a consequence of regionalism, in spite of the economic arguments in favour of higher tariffs. The conclusion is that the link between regionalism and protectionism is not proven. Regional trading agreements (RTAs) appear to create or strengthen the mechanisms for policy-makers to act in either a liberalising or protective fashion. They also raise the potential economic benefits from raising tariffs. However, post-war history shows major

---

<sup>92</sup> *The Economist*, 15 April 1989.

<sup>93</sup> The most significant recent example is provided by the expansion of the European Union to include Sweden, Finland and Austria. Prior to entry, semiconductors had duty-free access to Austria and Finland and faced a 2.3% tariff in Sweden. The EU duty is 14%. The European Union claimed that higher duties in some areas were offset by lower tariffs on other goods, such as cars, but will compensate affected trading partners—primarily the US.

<sup>94</sup> Krugman (1991a).



blocs using their power to push for lower tariffs with trading partners or on a multilateral basis, so a degree of economic enlightenment appears to go along with the RTA and the increased economic muscle.

### 6.9.1 Institutional Bias of Regional Trade Agreements

It is possible to distinguish between the professed ideological stance of a regional bloc and the mechanisms behind the actual formulation of policy. That is to say, there may be institutional factors within a structure which result in a bias towards or against protectionist policy-making. This can manifest itself through a political system that favours rent-seeking behaviour or through ineffective decision-making processes. Under this analysis, two regional trade agreements with identical policy objectives can have differing degrees of success in implementation, depending on their institutional structure.

On issues related to trade and competitiveness, the result can be that internal conflict is externalised. For example, in the 1970s failure to correct distortions in the European market for steel due to state subsidies of inefficient production in the UK, France and Italy meant that the response was to resort to trade restrictions. Voluntary export restraints (VERs) and the formation of Eurofer, a price cartel, occurred because member states were not prepared to accept domestic adjustment costs.<sup>95</sup> Nor could the VERs be seen as a temporary measure to help to ease transition costs—in 1994 the EC Commissioner was again negotiating to cut subsidies to reduce over-capacity in the EC steel industry.<sup>96</sup>

Depending on the institutional structure, the result can be a "convoy" problem, with the group as a whole moving at the speed of its slowest member. The United States, which is perhaps the finest example of full economic and political union, has a similar problem, with protectionist measures repeatedly finding favour. This is a result of the rent-seeking behaviour of domestic producer interest groups combining with the natural stance of Congressmen and Senators in favouring interests local to their constituencies. Thus the US can implement trade policies in violation of free trade principles and which even damage the

---

<sup>95</sup> Cline (1983).

<sup>96</sup> *Financial Times*, 26 October 1994

American economy as a whole.<sup>97</sup> In Japan belief in the doctrine of free trade is more ambiguous, but again the complex political system favours producer interests over consumers.<sup>98</sup> Japan will likely carry these prejudices to any bloc in which it participates.

Conversely, Hufbauer has argued that blocs may be more willing to liberalise than single countries. Indeed he goes so far as to claim that "without the prior formation of the EC, there would not have been a Kennedy Round".<sup>99</sup> For example, Italy and France would not have made so many concessions in the Kennedy Round unless pushed by Germany, which itself would not have liberalised unilaterally. (Although Winters argues that it also resulted in Germany and Benelux making fewer tariff reductions.<sup>100</sup>) Meanwhile, other countries that want to join the bloc will also liberalise, as was the case with the entry of more recent EU members such as Portugal or Spain. Although their liberalisation may be biased towards other European countries, it also involves embracing some of the more general policies of the group, which means greater openness overall. In addition, enlarging a group can dilute the powers of some of the lobbies which have previously had a strong influence.<sup>101</sup>

Whether an institutionalised trading arrangement has a liberalising or a protectionist bias will depend on at least three factors. Firstly, the relative strength of the members; the EU is notably different in structure from NAFTA in that no single country dominates to the extent that it can effectively coerce all other members. Secondly, in a long-established organisation, the interests of members may become subsumed into the interests of the group as a whole.<sup>102</sup> Thirdly, the nature of the regime which is constructed will play a part in determining whether individual members have the opportunity to pursue their

---

<sup>97</sup> In a study of eight anti-dumping duties between 1989-90 in the US, Anderson (1993) found that for each US\$1 gained by the protected industry, the US as a whole lost US\$3.60. The cost per job was US\$113,800 compared to the average salary of US\$14,300 per job in those industries.

<sup>98</sup> For a description of the processes see van Wolferen (1989).

<sup>99</sup> Hufbauer (1990b).

<sup>100</sup> Winters (1993).

<sup>101</sup> Lawrence (1996) suggests that an enlarged EC had the effect of weakening to power of the French agricultural lobby.

<sup>102</sup> Although the difficulties of the European Commission in lowering steel subsidies in 1994 indicates that there are limits to such behaviour.

own interests above those of the group. It is commonly argued that a rule-based regime will be the most effective guard against protectionist forces, but the lack of flexibility and adaptability in such a system could make it less effective than one geared towards negotiation and mediation.<sup>103</sup> This is particularly the case as trade-related institutions must deal with "behind the border" issues, making it difficult to prove that distortions and barriers exist. That is to say, strong institutional design is not necessarily a proxy for a strong regime *per se*.

There is also the observation that by signing regional agreements, trade policy-makers are publicly subscribing to the view that promoting free trade raises economic welfare. It would require some degree of sophistry to argue that free trade is "good" within a region but "bad" outside the region. Of course this is not impossible (as the United States has shown by passing NAFTA and simultaneously "bashing" Japan), but the ideology of negotiators behind regional trade agreements is likely to be that of free trade.

The issue, as it relates to the legitimacy of trading bloc creation, is whether it is possible to create a structure which prevents the rent-seeking and decision-making processes in which local or national interests conflict with the broader objectives of the whole bloc. If the answer is no, then this must dilute the benefits ascribed to any bloc's formation and could even be an argument against the formation of regional trade blocs. When looking at any institutional bias it is also necessary to consider the issue of policy shifting. That is, the tendency of governments to find alternative policies when their first choice policy instrument becomes inoperable, often due to international agreements. An example is the move from tariffs to non-tariff barriers in the 1970s and 1980s,<sup>104</sup> and if an institution is to be effective it must provide a means of preventing such behaviour. Within the European Union it is relatively difficult for such policy shifting to occur, with precedent setting rulings such as the 1979-80 Cassis de Dijon case enforcing equal access for EU members through mutual recognition.

Another caution of viewing regional agreements as always representing a clear step towards liberalisation is raised by Gruben and Welch, who see NAFTA as part of what they label a Hegelian dialectic.<sup>105</sup> In terms of trade policy this

---

<sup>103</sup> Kahler (1995) pp. 11-18.

<sup>104</sup> Laird and Yeats (1990a).

<sup>105</sup> Gruben and Welch (1994).

signifies the process by which innovations in trade liberalisation are countered by innovations in protectionism, and are succeeded by some synthesis temporarily acceptable to both sides. This is followed by more liberalisation, more protectionism and another synthesis. In relation to NAFTA, this is seen by the main part of the agreement which liberalises trade flows being countered by parallel agreements on labour and the environment. Another example is Section 301 of the 1988 Trade Act which gave the US new manoeuvrability. The US used Section 301 (or Super 301 as it was) to threaten and gain concessions from others. Although Section 301 was aimed at opening other markets, protectionists used it to close the US one, by extracting commitments from trading partners to implement voluntary export restraints (VER) with the threat of 301-type action if no restraint was shown.

A similar trend is apparent in the EC, where Laird and Yeats have shown that in 1986 about 54% of all internationally traded goods were subjected to non-tariff barriers, compared to 21% in 1966.<sup>106</sup> The rise in the use of NTBs was particularly acute for agriculture, textiles and steel. This policy shifting is behind the agenda expansion of many regimes—including the GATT/WTO. The GATT's initial concerns were with tariff reduction, but its focus widened to include non-tariff barriers and then non-border issues as other mechanisms were used to affect trade relations.

However, policy shifting also opens the way for abuse. One of the most controversial cases in recent years has been the US ban on Mexican tuna exports due to their toll on dolphins.<sup>107</sup> In 1991 a GATT dispute settlement panel found the US ban to go against its GATT obligations. The GATT saw the US attempting to project its national policies onto another country, via the threat of denying market access. Moreover, Gilbreath noted that after four years, Mexican fishing practices had changed and few dolphins were killed, but the US ban remained, leaving the conclusion that US restrictions were aimed at saving the US tuna industry and not the environment.

More generally the attempt by environmental lobbies to appropriate trade measures to promote their policies is the subject of controversy. Although many

---

<sup>106</sup> Laird and Yeats (1990a).

<sup>107</sup> See Trachtman (1992), Gilbreath (1993) and Charnovitz (1993) for alternative perspectives.

economists and lawyers would argue that "the area of actual conflict between the goals of a cleaner environment and freer trade would appear to fall between the non-existent and the minimal",<sup>108</sup> this is one of the clearest examples of policy shifting. It could even be argued that a similar offset was seen on the formation of the GATT. States were obliged to make political concessions in terms of their trade policy, but this was balanced by the ability to offer political rewards via reciprocity, or to ease the pain via safeguards.<sup>109</sup>

Apart from institutional reasons which can result in formal regional trading organisations leaning towards protectionist policies, there is also an imbalance between the power of the body overseeing world trade, and large trade blocs. Note for example, that in 1957 the European Economic Community (EEC) set external tariffs at the arithmetic mean of the six founder members. In GATT terms, this could be questioned, but if the GATT had found that the EEC was in violation of Article XXIV stipulations on customs unions, it risked self-destruction. Similar concerns surrounded US action against Japanese automobile exports in the spring of 1995: debate focused as much on whether a WTO finding against the US would cause the destruction of the multilateral system, as on whether the US tariffs were justified.<sup>110</sup>

Thus there is potentially a natural bias towards protectionism in formal trading blocs. This bias can only be moderated, and not reversed altogether, by pressure from the WTO. However, the ideological stance of the grouping will help to determine whether or not any natural protectionist bias translates into illiberal policy measures. This tends to be reflected in the "openness" of the grouping, which is discussed below. What is clearly suggested by the above discussion is that the diverse nature of regional agreements can result in radically different outcomes. This is apparent in the post-war history of trading blocs and could explain the apparent lack of a relationship between RTA formation and integration noted previously.

---

<sup>108</sup> Palmeter (1993) p. 55.

<sup>109</sup> Kahler (1995).

<sup>110</sup> *Reuters*, 17 May 1995.

## 6.9.2 Open Regionalism

At the Asia Pacific Economic Co-operation (APEC) summit in Bogor, Indonesia in November 1994 the eighteen members<sup>111</sup> agreed to liberalise regional trade and investment flows by 2020, with developed countries committed to a 2010 target. In what C. Fred Bergsten (the head of the Eminent Persons Group formed to advise APEC) has described as "the biggest trade agreement in history",<sup>112</sup> the declaration at the end of the summit included a commitment to "open regionalism".

The definition of "open regionalism" is somewhat vague. The Eminent Persons Group saw "four nonmutually exclusive elements"<sup>113</sup> to achieving open regionalism:

- i) the maximum possible extent of unilateral liberalization;
- ii) a commitment to further reduce their trade and investment barriers toward non-APEC countries;
- iii) an offer to extend the benefits of APEC liberalization to nonmembers on a mutually reciprocal basis; and
- iv) recognition that any individual APEC member can extend its APEC liberalization toward free trade to nonmembers on a conditional basis (via free trade arrangements) or on an unconditional basis (to all nonmembers, or to all developing countries, in conformity with GATT rules), since there is absolutely no contemplation of creating a customs union that would require members to maintain common trade policies toward nonmembers.<sup>114</sup>

---

<sup>111</sup> By Bogor membership of APEC was Australia, Brunei, Canada, Chile, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Philippines, Singapore, Taiwan, Thailand and United States.

<sup>112</sup> Bergsten used this phrase in a presentation on the results of Bogor, reprinted in Bergsten (1995) p. 2. Given that a model run by the Australian government produced an estimate of a gain of US\$366 billion in annual world output by 2010 if the Bogor agreement was implemented, compared to a US\$112 billion gain by 2002 in the case of the Uruguay Round, this may not be hyperbole. However, Lloyd has argued that "it is not possible to measure with any degree of precision the extent of intra-area trade liberalisation" because of difficulties in calculating the effects of trade barriers, (1992) p. 13.

<sup>113</sup> APEC Eminent Persons Group (1994).

<sup>114</sup> APEC Eminent Persons Group (1994).

Wonnacott interprets open regionalism as meaning "economic relations may be strengthened among member nations, while at the same time the region also becomes more open to trade and investment with other parts of the world".<sup>115</sup> As Bergsten notes, the main question is whether the benefits of lower barriers within a region should be automatically extended to non-members, or whether access should be on a reciprocal basis.<sup>116</sup> In the case of APEC at least, "open regionalism" does not automatically imply extension of regional liberalisation on a most favoured nation basis. In either case, greater integration must not result in higher barriers to non-members. The implicit suggestion is that open regionalism should meet the Kemp-Wan condition of not lowering trade volumes with the rest of the world, but merely not raising external trade barriers is not enough to guard against trade diversion.

The argument in favour of open regionalism is that it provides a means of achieving greater regional integration while allowing, and indeed encouraging, the continuation of multilateral trade negotiations. Nevertheless the main benefits will accrue to bloc members and to non-members able to negotiate access on either a Most Favoured Nation (MFN) or a reciprocal basis. Schott takes the interesting approach that if APEC does not extend benefits to the EU on an MFN basis, this will raise Europe's willingness to begin another series of multilateral negotiations.<sup>117</sup> Others, Bergsten included, see negotiations within APEC as forming the basis for future multilateral Rounds of liberalisation, by covering such issues as investment flows.

Proponents of open regionalism argue that it should complement multilateralism for two main reasons. Firstly, regional pacts often produce deeper liberalisation as agreement is easier to reach than in a large and diverse group such as the WTO. Benefits can be extended to non-members or put on the WTO agenda. Secondly, regions act as test sites for issues that have not yet reached the multilateral arena.<sup>118</sup> For example, provisions on trade in services in the US-Canada and Australia-New Zealand deals were useful in the subsequent Uruguay Round negotiations.

---

<sup>115</sup> Wonnacott (1994) p. 1.

<sup>116</sup> Bergsten (1995) p. 13.

<sup>117</sup> Schott (1995).

<sup>118</sup> Cable (1994).

Bhagwati has suggested that one means of ensuring that the creation of free trade areas and customs unions does not reduce the degree of openness to the rest of the world is to strengthen Article XXIV provisions.<sup>119</sup> This could involve making the level of external protection following the creation of a customs union set at the lowest rate of any of the members before the union was formed. This is a rather different argument, in that it is an attempt to constrain the actions of members of a regional bloc, as opposed to the school of thought which sees regionalism as naturally complementary to multilateral liberalisation. In contrast Bhagwati recognises that it is possible for regionalism to occur on a basis which is damaging to the multilateral system and proposes tightening the rules to guard against it.

Of course it is not only the external tariff rate on the formation of the new bloc which is important, but also the policy-making processes after the bloc has been formed. Most empirical analysis suggests that lower barriers between members tend to be accompanied by some degree of reduction in the barriers to non-members, and external tariffs have declined steadily in Europe since 1958, largely in step with GATT agreements. However, this has been offset by a rise in the proportion of trade subjected to non-tariff barriers, from 21% to 56%. It is possible to make the argument that effective levels of protection within Europe have declined little since the 1960s and may well have increased in sectors such as textiles, agriculture and steel.<sup>120</sup>

Frankel, Wei and Stein suggest other ways to ensure that regionalism is "open" rather than "closed".<sup>121</sup> By making agreements in new areas such as competition policy or the environment compatible with similar arrangements elsewhere, it will be easier to integrate the policies of different regions at the global level. They also argue that regional agreements should encourage the entry of non-members, so if multilateral liberalisation fails to progress, existing blocs can expand as a substitute.

The conclusion is that many observers claim that there is some sort of natural tendency for regionalism to be "open", but there is little real evidence that this will automatically be the case. For example an ASEAN Free Trade Area may

---

<sup>119</sup> Bhagwati (1994).

<sup>120</sup> See Laird and Yeats (1990a).

<sup>121</sup> Frankel, Wei and Stein (1994).



be an attempt to increase bargaining power vis-à-vis Japan and/or the United States; it would therefore be counterproductive to allow entry to either country. The profusion of suggestions about how to ensure openness shows the degree of scepticism. What can be asserted with confidence is that "closed" regionalism needs to be avoided to prevent damage to world economic welfare.

Closed regionalism can be seen as the opposite of open regionalism, and it also has two possible interpretations. The first is that there are explicit limits to membership of the group. The second is a more aggressive stance, with the region actively raising barriers to non-members, although it is difficult to find a recent example of this latter interpretation. Regions which are formed to act as a counterbalance to regionalism in other parts of the world are likely to be closed in terms of their membership. If access to the group is open then it will lose its bargaining power against other countries and groups.

It could be argued that ASEAN is a case of the former type of closed regionalism, in that membership is not open to South Asia countries such as India or Sri Lanka, or to large East Asian economies such as Japan or Korea. However, this is partly because for most of its life ASEAN has been primarily an organisation aimed at delivering military security in South East Asia. In recent years it has begun to focus more on trade issues and this has been accompanied by enlargement of membership.

In the case of the European Union, membership has steadily expanded to incorporate suitable candidates<sup>122</sup> and, as noted in Chapter 3, the EU is the most frequent partner in bilateral trade deals. Common markets of Central America and the Andean Group in the 1960s were closed, in that they were designed at import substitution industrialisation (ISI), but they failed to develop.

Thus as an opposite to open regionalism, protectionist closed regionalism is so rare as to be virtually non-existent. Even if institutional pressures exist which lead a trade bloc towards a protective bias, this is very different from protectionism being an explicit objective. Note also that such regionalism would be in clear contravention of Article XXIV restrictions and that such transgressions by a major economic bloc would indicate a serious breakdown in the world trading system.

---

<sup>122</sup> This is demonstrated by the expansion from six countries pre-1973 to 15 after the 1995 widening of the EU to include Austria, Finland and Sweden.

### 6.9.3 MFN, Reciprocity and Free Riders

An alternative means of ensuring that regional blocs do not violate the founding principles of the GATT is to focus on Article I of the treaty, which refers to Most Favoured Nation status. By extending any liberalisation agreed upon within the bloc to countries outside the bloc, any regional grouping could stay within GATT/WTO rules. Such an approach, if on a non-reciprocal basis, would renew the debate on the importance of "free riders" on such treaties. Bergsten sees reciprocity as being the way forward in the case of the Asia Pacific Economic Co-operation (APEC) forum. Given that APEC is half the world's economy, Bergsten likens an offer of reciprocity from APEC to one from the Mafia "it's an offer you can't refuse".<sup>123</sup>

If an economic analysis is conducted, there seems to be an inherent contradiction in recommending the reciprocal approach for extending the benefits of a trade bloc to non-members. On that basis regional blocs are formed because of the apparent benefits of free trade and investment flows between members. However, the same analysis shows that these benefits are enhanced rather than undermined by including other parties in the liberalising process, even if there is no reciprocal lowering of barriers on their part.<sup>124</sup> It is quite possible to argue, in a neo-mercantilist fashion, that lower trade barriers can undermine economic development, perhaps due to the impact on industrial policy. However, to adopt a free trade form of analysis at the intra-regional level and then what is essentially a variant of mercantilism at the inter-regional level is illogical. It is also possible for trade blocs to resist extending tariff benefits so that they can adopt an optimum tariff and secure economic rents, but in practice this is rarely (if ever) on the agenda.

Presumably part of the attraction of reciprocity is a political one in that it offers rewards to specific sectors. These groups will then become a lobby in favour of trade liberalisation (along with consumers and importers, who will also gain) and will offset the opposition from domestic interests which benefit from the status quo. Regardless of its merits, Jackson argues that reciprocity is an

---

<sup>123</sup> Bergsten (1995) p. 3.

<sup>124</sup> Although unilateral liberalisation is likely to be inferior to multilateral liberalisation, it is likely to be superior to no deal at all.

obsolete notion.<sup>125</sup> In the past it worked well as most barriers were tariffs which could be quantified. With non-tariff barriers coming to the fore, practical considerations imply reciprocity needs to be rule-based rather than value-based, but this makes it difficult to measure the worth of reciprocal deals.

It is also worth noting that reciprocity has not been the norm in trade agreements between the developed and developing world, such as the Lomé Convention which gives preferential access to European markets to developing African, Caribbean and Pacific economies. Indeed, McConnell and MacPherson claim that NAFTA was the first reciprocal deal between a developed and a developing country.<sup>126</sup> Moreover, it is also significant that several countries choose to adopt unilateral tariff reductions, irrespective of regional or multilateral agreements. Various Eastern European countries, Australia, New Zealand and several Asian economies have been lowering tariffs in the 1990s without any demand for reciprocity from trading partners. While reciprocal liberalisation increases the gains, its absence does not negate the attractions of tariff reduction.

Discussion of the "free rider problem" too readily assumes that there really is a problem. The attitude may be an historically based one, with its roots in the US Reciprocal Trade Agreements Act of 1934 when the US sought to lower its trade barriers with commensurate reductions in tariffs by trading partners, to mutual benefit. However, classical trade theory tells us that the free rider problem is mainly a problem for the free rider. If several countries liberalise their trade regimes but one does not, while "free riding" on the liberalism of the others, then the free rider is the main loser. Other countries will gain less from their trade liberalisation than they would otherwise have done had all countries liberalised, but it is probable that their welfare will still rise. The free rider will also benefit from improved access to other markets, but by maintaining import barriers, the free rider's gains are likely to be substantially lower than would be the case with liberalisation.

Wonnacott takes a peculiar approach to address the "free rider problem". Looking at the example of APEC he notes that there are several products,

---

<sup>125</sup> Jackson (1992) p. 507.

<sup>126</sup> McConnell and MacPherson (1994). In fact Mexico became a member of the OECD in 1994, which makes its classification as a developing country rather dubious. The World Bank ranks Mexico as an Upper Middle Income country, which places it alongside Portugal and Greece.

ranging from electronic equipment to textiles, where more than 70% of the entire world supply comes from within the APEC region.<sup>127</sup> By focusing on these areas, argues Wonnacott, APEC would be able to reap the benefits of liberalisation while minimising the free rider problem even with MFN liberalisation. There appear to be three major problems with this analysis. The first is that the analysis is static: even if there is no "free rider problem" when liberalisation occurs, it could soon emerge as an issue once outsiders have access to the market. The second is that looking at benefits from liberalisation of certain sectors cannot be done on a partial basis. It is also necessary to examine the losses from rent-seeking behaviour that will occur as a result of negotiations aimed at liberalising some sectors and maintaining barriers on others. It also seems inherently illogical to argue in favour of MFN liberalisation if the rest of the world is not competing in that product market: if there is no serious producer outside the region then whether MFN takes place or not is irrelevant.

Thus, demands for reciprocity are useful in that they help in the general worldwide lowering of tariffs. However, it is potentially damaging if the result is less liberalisation than would be the case without a requirement of reciprocity. Demands for reciprocity can result in a convoy system with trade liberalisation proceeding at the pace of the slowest party—MFN liberalisation would accelerate the process. Political factors can help to explain attempts to secure reciprocal deals, but it is difficult to justify on purely economic grounds.

## 6.10 Conclusion

This chapter has provided an examination of the trend towards regionalism in the world system. While recognising that an additional dimension is offered by political and structural explanations of regionalism, the basic economic factors must not be neglected. Although tariff reductions may not be significant among developed countries, other improvements in economic efficiency stemming from regional agreements have the potential to provide a one-off boost to output and even to raise growth rates over the longer term.

Economic explanations of regionalism based on tariff reductions offer a partial explanation why countries choose to form trade blocs, but it is less clear

---

<sup>127</sup> Wonnacott (1994).

that they can explain why there has been a sudden revival of the trend in the past decade. Stronger arguments stem from the "deeper" integration which has been evident in many regional deals of late. An interesting interpretation is that the modern state sees regionalism as a means of re-asserting its authority over the market. Thus political explanations based on strategic or military factors are not as persuasive as those related to attempts to regain lost sovereignty. This is important from the perspective of the firm, as it shows the state trying to find new means of imposing its authority on corporate behaviour.

From the point of view of multinational corporations one key issue is whether the rise of regional arrangements is hindering, or threatening to hinder, the free flow of goods, services and capital between regions. An understanding of the motivations for regionalism helps to provide the framework for analysis of the nature of various regional agreements. The answer to this question can be expected to be an influence on the optimal global strategy of the multinational corporation. Presumably the most efficient structure of a global corporation will depend on whether it can trade and invest in an uninhibited fashion, or whether its markets are becoming increasingly segmented.

Whether regionalism and multilateralism are complementary is not proven, just as there is no clear link between regionalism and protectionism. A neglected argument is that RTAs create or strengthen the mechanisms for policy-makers to act in either a liberalising or protective fashion, so whether the structure contains a protectionist bias becomes significant. Although it is the case that RTAs are pressured to be liberal from an ideological viewpoint and in order to accord to multilateral obligations, rent-seeking and institutional factors can point towards protectionism. RTAs also raise the potential economic benefits from raising tariffs although there is more evidence of major blocs using their power to push for lower tariffs with trading partners, rather than exploiting their monopoly position.

The WTO takes a more positive view towards regional trade agreements than the equivocal stance of its predecessor and some (but not all) of the previous ambiguities on the issue have been resolved. However, the interaction between the regional and multilateral development of the international political economy remains uncertain. There are at least three diverging paths available, and each of which would have differing implications for the environment facing cross-border business.

One feature which is often neglected is the role of regional agreements in reducing the risk involved in cross-border investment. This suggests that calculations of the benefits of regionalism may be conservative, as they focus on factors such as the gains from trade, economies of scale or greater competition.

The uncertainty surrounding the direction and implications of regionalism suggests that multinational corporations will not have uniform approaches or strategies. The range of possibilities open to multinational corporations, how they can respond to different regional trends and how they can act in order to attempt to ensure a favourable outcome will be addressed in the next chapter. It is also worth remembering that multinational corporations are the main actors on a regional and global basis, and are the main vehicle through which regionalism can translate into increased regional integration.

## CHAPTER SEVEN REGIONAL TRENDS AND MULTINATIONAL CORPORATIONS

### 7.1 Introduction

This chapter aims to link the behaviour of multinational corporations with regional trends in the international political economy. As a key cross-border actor, the multinational corporation has an influence on the formation of preferential regional agreements, although just how much is discussed below. With no two regional agreements being alike, there will be features of some deals which have particular appeal to certain firms, features of others to which some firms object. Notably the current debates surrounding open and closed regionalism, and deep and shallow integration are of interest. The MNC is, by definition, one of the vehicles through which regionalism has an effect, and it is also the economic actor most affected, which makes the issue a complex one.

Chapter 5 argued that, on a microeconomic basis, the organisational structures of firms have a part to play in determining the degree of regional integration of trade and investment flows. The influence of regionalism on multinational corporations is examined in more detail below, with the different forms that regionalism can take seen to have identifiable implications for optimal corporate structures.

It has been claimed that the subject of regionalism provokes a "big yawn" from US multinationals.<sup>1</sup> However, such an assertion is at odds with both the lobbying and the strategic reactions of firms. Moreover, preceding chapters have shown that regionalism has an impact on both competition and business opportunities facing multinational corporations. As a result, any firms that do respond with a "big yawn" are being negligent.

Much is made of the differences between deep and shallow regionalism, but it will be argued that from the perspective of the multinational corporation it is the act of lowering intra-regional barriers which is important, more than the nature of that liberalisation. The difference between deep and shallow regionalism will have more impact on *how* firms react as opposed to *whether* they do, but whether liberalisation is at or behind the border will not affect underlying business decisions if the overall preferential bias is the same.

---

<sup>1</sup> This phrase was coined by Wells (1992).

Similarly, whether a region is open or closed will be of concern to globally oriented companies. However, this is not because of the popular and, I will argue, over-emphasised debate as to whether regionalism helps or hinders multilateralism. Relations between regions will have an impact on the means of supplying markets, as well as on the decision of whether or not to become involved.

A neglected aspect of the debate on regionalism is how it affects the merits to the MNC of internalising transactions. Some aspects of regionalism (such as stricter enforcement of intellectual property rights) will reduce market imperfections and so lower the benefits from internalisation. However, if an aspect of regionalism is lower transport and communication costs, then this will be an offsetting force in favour of more internalisation. Regional liberalisation could also allow firms to expand or consolidate monopoly positions, depending on the anti-trust provisions in place.

A further issue for MNCs is that regionalism involves a reduction in systemic risks, as well as affecting the micro or macroeconomic environment. Regionalism implies a commonality of interests and closer communication between members which lowers systemic risks to all firms operating within the region.

The lack of homogeneity among multinational corporations means that it is difficult to construct reliable rules as to the reactions and preferences of firms in relation to regional trade agreements. However, I will propose a matrix which attempts to show the implications for multinational corporations of a range of situations. One lesson that literature on international business teaches which is not accounted for in purer economic theory is that apparently similar firms can have different strategic responses to the same situation.<sup>2</sup> Inevitably, among diversified companies the responses are more difficult to predict, as although it is necessary to treat the firm as a unitary actor with a clear list of priorities, the impact of regionalism may be difficult to calculate if the firm is involved in an array of businesses. Meanwhile other firms will have historical or cultural constraints which limit their flexibility, but setting out a general framework is helpful in outlining likely reactions.

---

<sup>2</sup> For example, see Dunning (1993a).



Taking a microeconomic perspective towards the issue of regionalism suggests that for a large number of firms, the main concern is whether regionalism is protectionist. As long as production networks tend to be constructed on a regional basis, the differences between multilateral and regional liberalisation will be limited. The main impact will be on *how* firms supply markets rather than *whether* they do so.

## 7.2 Methodological Issues

There are serious methodological problems in attempting to examine links between a diverse group of multinational corporations and regional groupings. For example Wells has colourfully claimed that the issue of regionalism provokes a "big yawn" from US multinational corporations.<sup>3</sup> However, he provides no single piece of evidence to support such an assertion, either in the form of interviews or surveys. Although Wells may indeed be correct—and he produces statistics which purport to show why US MNCs need not be concerned about regionalism—he makes a leap in logic which is not satisfactory for the purposes of this research. However, other methods also have considerable flaws.

Most notably, subjective studies such as industry surveys tend to be less informative than their proponents claim. There are inevitably temptations to use surveys of corporations' attitudes or behaviour to test how they view trends towards regionalism. I have chosen not to take this approach for three reasons. Firstly, formulating accurate surveys is a highly complex task and clearly false conclusions can be drawn from taking the results of some surveys at face value. For example, a 1996 survey by KPMG of 70 top Japanese industrial companies in the UK found that 53% were earning a lower than acceptable rate of return, while 40% were earning an average rate of return.<sup>4</sup> In spite of the UK economy being at a buoyant stage of the economic cycle, no firms in the survey reported their profits to be high. The accompanying newspaper story was along the lines that Japanese firms were disappointed with the results of their investments in the UK, implying that further capital inflows could be endangered. A more realistic

---

<sup>3</sup> Wells (1992) p. 14.

<sup>4</sup> As reported in the *Financial Times*, 12 February 1996.

interpretation is that no manager of a Japanese-owned operation is likely to give the politically sensitive reply (let alone what it could mean for future wage rounds or bargaining with suppliers) that their UK investment was making a very high rate of profit.

Along similar lines, Thomsen argued that Japanese FDI in the UK was not aimed at bypassing the threat of higher trade barriers which was seen to accompany the Single European Market (SEM) programme, but the motivation was to obtain proximity to the market.<sup>5</sup> This assessment was based on the responses to a Japanese survey on motives for investing within the European Community. Again, it seems unlikely that the firms involved would be open about their motivations if the objective of an investment was to evade future protectionist measures. Japanese firms answering that motives such as "avoid quantitative restrictions", "concern about protectionism" and "avoid infringement of anti-dumping regulations" were factors in their direct investments in Europe were unsurprisingly low. More worthy objectives such as "part of globalisation strategy" or "meet consumer needs" ranked far more highly.<sup>6</sup>

Secondly, there is likely to be a degree of sample bias in any survey on an issue such as regionalism. Relatively few respondents could be expected to be prepared to reply that it is not a subject that they have seriously considered. Moreover, there is also the danger of autosuggestion, as the very act of answering a survey would, for some, probably generate attitudes which had previously not existed.

Thirdly, there tends to be a bias towards larger companies in such surveys. The nature of production networks would indicate that large firms are likely to view regionalism more positively than smaller firms, because the former will believe that they are in a position to benefit from the lowering of trade barriers in other markets, which will more than offset the cost of increased domestic competition. Small firms, however, tend to be more focused on the home market, and as such their cost-benefit assessment will be skewed against measures which increase levels of domestic competition. Nevertheless, surveys are often

---

<sup>5</sup> Thomsen (1993).

<sup>6</sup> See table from JETRO in Thomsen (1993) p. 309.

favoured due to the lack of availability of objective statistics, where breadth of coverage and consistency are a problem.

When it comes to individual firm or industry behaviour the process is less clear. It is not unusual to be able to obtain organisational matrices which show how firms' operations are (on paper) structured. However, publicly available material from MNCs rarely gives detailed information as to intra-firm flows of goods, services and capital between or within different regions. The most that can usually be obtained is a geographical breakdown of revenues. Industry bodies are no more informative than their corporate members.

A less biased process is to impute the attitudes of firms from statistical evidence of their behaviour. However, this is not straightforward and even then the conclusions need to be treated with caution. Data on trade flows show how goods move intra- and inter-regionally, but they give no information as to the nationality of the firms producing the goods.<sup>7</sup> Figures on direct investment flows are less reliable and face similar problems. Moreover, joint ventures, licensing and other strategic alliances are rising in significance relative to FDI and these are even less precisely measured. A third factor, on top of trade and investment flows, is the flow of knowledge or of intangibles. As international production networks are increasingly aimed at achieving maximum exploitation of a firm's competitive advantage in knowledge (in the form of production processes, or the fruits of R&D) then the flows of value-added resources across borders become even harder to trace.<sup>8</sup>

As was seen in Chapter 5, there are clear problems in attempting a statistical analysis of the impact of regionalism on corporate behaviour. Aside from difficulties associated with time lags (are investments made in anticipation of regional liberalisation, or after the fact?), it is not possible to undertake a qualitative examination. If all regions were attempting to promote integration by the straightforward expedient of lowering trade barriers then a rigorous analysis

---

<sup>7</sup> The US Department of Commerce produces reasonably comprehensive data on the behaviour of their MNCs in other countries, and of foreign MNCs within the US, but the degree of regional disaggregation is limited and the data are not available from other countries. The OECD (1997b) has recently begun to publish a broader survey, but as yet is not comprehensive.

<sup>8</sup> It is broadly possible to measure the growth of the fruits of such a flow, which is the return on cross-border non-equity transfers (licenses and the like). UNCTAD (1995) estimates that such flows quadrupled between 1984 and 1992, while exports of goods and services doubled over the same period.

would be possible (although still relatively complex). However, with non-border issues taking an increasingly prominent role the situation becomes less clear.<sup>9</sup> The environmental side agreement to the North American Free Trade Agreement, the social chapter of the European Union and the competition policy of the Australia-New Zealand Closer Economic Relations Trade Agreement can all be seen as important, but an accurate qualitative comparison of their impact is not feasible.

Setting aside attempts to use empirical analysis to illustrate the behaviour of firms, I believe that it is possible to construct a theoretical framework to outline the optimum responses of different groups of firms in a range of situations. The lack of homogeneity among firms means that such a framework is not rigorously testable, but it is at least indicative of likely behaviour. This is explored in more detail at the end of this chapter.

### 7.3 Building Blocks and Stumbling Blocks

The bulk of international political economy analysis on the issue of regional trading arrangements concerns whether they contribute to, or detract from, the overall objective of multilateral liberalisation. However, as indicated above, including the behaviour of the multinational corporation in the analysis makes such a question appear largely irrelevant. The recurring question of whether regional trading arrangements are "building blocks or stumbling blocks"<sup>10</sup> neglects the role played by the multinational corporation in the international system. Views that regionalism can be detrimental to the multilateral system really contain two strands. The first is that large regions will find it advantageous to adopt higher tariff barriers because of the beneficial terms of trade effects. The second is that countries will abandon efforts to liberalise multilaterally in preference for regional liberalisation.

---

<sup>9</sup> Laird and Yeats (1990b) go some way to establishing a methodology for measuring the effect of non-tariff barriers, but it is not clear how well it can be applied to the deeper integration becoming more prevalent in recent years.

<sup>10</sup> Bhagwati (1991), Lawrence (1991b), *The Economist*, 31 October 1992, p. 69, *Far East Economic Review*, 31 January 1992, pp. 32-33 and too many others to mention have used this phrase in recent years.

The first and potentially more serious of these concerns is much the less likely. The network of international trade and production between North America, the European Union and Japan implies considerable mutual pain from a genuine breakdown in international trade. In a situation where several regional groupings exist, if one bloc aims to impose an optimum tariff it must consider the likely reaction of other areas. The welfare gains from improved terms of trade resulting from an optimum tariff can be eliminated by retaliatory action from other regions and so most game theoretical solutions find evidence of a welfare gain only in the short run.<sup>11</sup>

There are also doubts as to how effective a border-level tariff war would be. Among the OECD countries, complex financial linkages mean that the nationality of firms can be difficult to ascertain precisely. Diversified corporations shift their portfolios of subsidiaries and institutional investors switch assets between markets, while the popularity of non-equity forms of investment continues to increase. Even the nationality of exports can be unclear, as indicated by French struggles to restrict imports of cars made by Japanese transplant factories in the UK.<sup>12</sup> As a result, investment flows are likely to be a substitute for those of goods in order to bypass border restrictions. Thus the impact of the slim possibility of a full-scale trade war among developed countries is reduced even further by the effect of cross-border investment.<sup>13</sup>

The second question is whether further multilateral liberalisation will occur now that the focus is on regional groupings.<sup>14</sup> It will be argued below that for a multinational corporation the answer to this question is far less important than many appear to believe. Intra-regional liberalisation allows firms to achieve economies of scale in production, while flows of intangibles across borders mean global economies of scale can be achieved on costs such as R&D, design or finance, irrespective of the state of trade barriers. As a result, if liberalisation—

---

<sup>11</sup> See Södersten (1980) pp. 179-183, Krugman (1991a).

<sup>12</sup> *The Economist* 12 June 1993.

<sup>13</sup> That is not to say that there will not be skirmishes related to certain issue areas, as has been the case between the US, Japan and the EU in recent years, but the chances of an all-out trade war are lower.

<sup>14</sup> In particular Bhagwati and Panagariya have persistently warned of the dangers of being distracted from multilateral liberalisation by focusing excessively on regionalism.

either deep or shallow—is taking place on a regional basis, then inter-regional flows of capital and intangibles will compensate for any lack of liberalisation of inter-regional trade flows.

Barring a return to the "dark ages" of higher trade barriers and expropriation of foreign investment assets it is difficult to envisage a situation where intra-regional flows are constrained to such an extent that the multinational corporation is unable to penetrate developed foreign markets effectively. Moreover, such a reactionary development is not dependent on whether preferential regional arrangements are building blocks or stumbling blocks; it is a function of the relative power of the ideological forces behind mercantilism and liberalism.<sup>15</sup> There is no inherent reason why a trend towards regionalism should lead to protectionism or to slower multilateral liberalisation. If anything, countries are making a statement of belief in liberal trade by joining a preferential trade agreement and it would be counter-intuitive to expect them then to adopt an opposite stance to outsiders.

A political economy approach based on the lobbying behaviour of firms within the region can deliver the result that preferential agreements swing corporate preferences against multilateral liberalisation.<sup>16</sup> However, as Krishna acknowledges, this approach does not make allowances for capital flows in response to trade policy shifts.

The building block—stumbling block debate can be a distraction from another important aspect of regionalism, which is how it affects the structure of international business. Whether to export to a region or produce within it, whether to establish regional networks or independent production sites, whether to internalise transactions or conduct them in the market, and whether systemic risk is falling or rising are all issues of direct concern to multinational corporations. Asking if regionalism will help or hinder multilateralism is of peripheral importance compared to these more directly relevant concerns, and attitudes to the issue will depend largely on whether comparisons are being made with a multilateral ideal or with the current situation.

---

<sup>15</sup> Henderson (1994).

<sup>16</sup> Levy (1997), Krishna (1998).

## 7.4 MNC Views on Regionalism

Regionalism is important to multinational corporations from several perspectives. Firstly there are the opportunities which open up as a result of lower barriers within a region, offset by the increase in competition which is implied. Secondly, there is the question of whether a regional grouping will be open to outsiders or closed. The answer to this issue will help to determine whether production networks should be predominantly regional or global in their orientation, as well as giving an indication of the level of competition within a region. This relates to a fundamental view of how the international political economy operates. If the MNC sees the world as one dominated by principles of free trade, with nations working co-operatively to lower impediments to mutually beneficial economic exchange, then this suggests one strategy. Another strategy altogether would be suggested by a view of the world which was oriented around a neo-mercantilist perspective, with the main economic centres vying with each other for economic and political power. Thirdly, there is the issue of how regionalism affects decisions over whether or not to internalise transactions within the firm, rather than conducting them in the market, as regionalism will tend to reduce market imperfections while also cutting the cost of internalisation. Fourthly, there is the question of whether regionalism lowers systemic risk to MNCs, as a consequence of the closer political co-operation which is implied. These factors are discussed in more detail in the four sub-sections below.

It seems intuitively likely that firms in the same industry will have similar views on regionalism. In reality the responses are likely to differ for five reasons. Firstly, it is quite possible for firms in the same industry to use production processes which involve different degrees of capital and labour intensities. For example, Japanese automobile assemblers in the United States have been noted for using more capital intensive processes than their US rivals.<sup>17</sup> They are therefore likely to react differently to a trade agreement which will change the relative price of factors of production.<sup>18</sup> Secondly, out of several firms in an

---

<sup>17</sup> See Womack *et al.* (1990).

<sup>18</sup> According to the Heckscher-Ohlin framework, trade liberalisation will lower the price of the factor of production which is scarce compared to that which is abundant. Thus in the US, free trade agreements will reduce the wages of unskilled labour (the relatively scarce factor) compared to the cost of capital. Leamer (1992) guesstimated that the wages of unskilled US workers would

industry, at any point in time some will be in a stronger competitive position than others; again the automobile industry is a good example. Lower intra-regional trade barriers can be seen positively by the strong companies because of the opportunities offered in other markets, while at the same time being viewed negatively by less competitive companies which fear for their survival if domestic competition intensifies.<sup>19</sup> Thirdly, firms in smaller markets may view regionalism more favourably than those in large markets, as it could help the former to reap economies of scale, while the latter may already be operating on an efficient scale.<sup>20</sup> Fourthly, Dunning has shown that firms with similar endowments of ownership, locational and internalisation assets can have differing strategic responses to the same event.<sup>21</sup> A final complication is that the spatial perspectives and time horizons of firms can vary. For example, it is possible that a firm will oppose a move to closed regionalism with higher external barriers within one economic area even though it directly raises short-term profits. This could be because it fears greater losses as a result of similar action in other regions or even a trade war, or because it is concerned that sheltering behind trade barriers will damage the longer term growth and competitiveness of the region.

As a result of the different options it is not possible to make entirely confident predictions of corporate attitudes and responses to a range of scenarios for the evolution of the international trading system. Nevertheless, it is possible to make "best guess" assessments of behaviour under given circumstances, while recognising that there will always be exceptions.

A more predictable response should be available by looking at different degrees of competitiveness in industrial sectors. If all firms in a sector face identical costs and operate under perfectly competitive conditions across a region, then lower tariffs will not raise the degree of competition and producers will be indifferent to the move. If the producers are oligopolists, but again face identical cost structures, then the firms' attitudes will be determined by how they

---

fall by US\$1000 per year after a NAFTA agreement because of competition from Mexico.

<sup>19</sup> Such a reaction was evident in France in response to the Single European Market.

<sup>20</sup> Milner (1997).

<sup>21</sup> See Dunning (1993a).



view their opportunity of expanding their oligopolistic power across the region, possibly via a series of mergers or strategic alliances, compared to the threat of losing a dominant position in their domestic market.

The assumption that the firm has enough information to assess its competitive position realistically is also open to debate. A firm which has achieved regional dominance within a preferential trade area might feel that it can transfer such a success into world markets opened up by multilateral liberalisation. However, if its regional success has been dependent on high rates of protection for the region as a whole, the result could be a lack of competitiveness in world markets and a loss of market share within the region as tariffs are lowered as part of a multilateral deal. Whether firms have the information and the internal mechanisms in place to base their strategy on an impartial analysis of their competitive position is an interesting question, but for the purposes of this research it must be assumed that on the whole this is the case.

There is a question as to how far multinational corporations are concerned with the trend to regionalism in the world economy. That is to say, to what extent is regionalism a factor which is considered by MNCs when addressing strategic issues. As noted, Wells has argued that American multinationals are uninterested in regionalism. However, the roll call of MNCs represented at the Transatlantic Business Dialogue in Seville in November 1995 seems to indicate that it is a subject which is high on the agenda.<sup>22</sup>

Regional trading agreements address a range of issues, the foremost of which is that of tariffs. Other areas which are important include non-tariff barriers, equality in local content requirements and harmonisation of standards. These elements are all assuming greater importance, as higher fixed costs such as R&D or investment in plant and equipment create the need to sell worldwide immediately in order to generate profits before competition arrives.<sup>23</sup> That is to say that even though tariffs have fallen to levels where there are limited implications of duties levied at the border, there are increasing effects from other constraints on trade. As discussed in Chapter 5, all of these restrictions on cross-

---

<sup>22</sup> The four co-chairmen of the conference were the CEOs of Xerox, BASF, Goldman Sachs (Peter Sutherland, who oversaw the finalisation of the Uruguay Round) and Ford.

<sup>23</sup>Dunning (1993a).

border business must have an impact on the operations of multinational corporations. The effect could be either positive or negative, but it must be an input into the decision-making processes.

Regionalism has an impact at two levels. Firstly, it will help to determine *whether* or not a multinational firm attempts to gain access to a market. Secondly, it will affect *how* a firm services the markets it decides to target. The distinction is important, as the former will affect the degree of competition within an economy, and the associated welfare gains. The second is more of a decision on whether to utilise domestic resources and export the products, or whether to export the capital and then use foreign inputs.

In the light of these distinctions, it is interesting to look at some of the major issues related to regional trading arrangements; whether they are "open" or "closed", and whether they involve "deep" or "shallow" co-operation. In addition, whether regionalism reduces or increases market failure is another aspect worth considering as it will have a bearing on the degree that transactions are internalised within the firm. The impact that regionalism has on systemic risk is another issue which tends to be neglected.

#### **7.4.1 "Open" and "Closed" Regionalism**

It will be recalled that open regionalism refers to intra-bloc liberalisation without raising external barriers, or explicitly excluding new members. It can also mean extension of regional liberalisation on an MFN basis, but this is not necessarily the case.<sup>24</sup> In contrast, closed regionalism implies limits on membership, higher external barriers, or no MFN extension of internal liberalisation. The main factors for consideration are the extent and nature of intra-regional liberalisation, and the issue of whether regionalism is open or closed. Whether regionalism is open or closed, and how it is perceived by firms, will be an important input into the decision-making process in terms of location of production facilities.

If a regional grouping is "open" on a reciprocal or an MFN basis, and is generally supportive of lower trade barriers internally and externally, then the trade and investment patterns of MNCs will be largely determined by issues of

---

<sup>24</sup> APEC Eminent Persons Group (1994).

micro-efficiency together with consideration of the barriers that exist at that time. Large multinational corporations with efficiently sized production capabilities in all major geographic regions are likely to be more interested in reductions in intra-regional barriers than inter-regional ones. Regional production is likely to be the norm, simply because for many industries this allows firms to reach an efficient scale of production while still being close to the final market.<sup>25</sup> However, there will still be considerable inter-regional, intra-industry trade, as dictated by Fordist-type economies of scale and by product differentiation issues. Under open regionalism there is no real threat of production systems being interrupted by prohibitive policy measures.

However, the calculations change if there is a perception that the regional bloc will adopt a protective stance. If MNCs believe that a regional arrangement is established with a protectionist intent then they will need to adopt strategies with a stronger bias towards self-contained production facilities in each region. Intangibles can still flow across regional barriers, but there will be greater pressure for physical investment in each region.<sup>26</sup> As discussed above, organisational factors are already prompting firms to operate on a regional basis as for many this provides the optimal trade-off between gaining economies of scale in output and having the flexibility needed for new forms of production. The threat or expectation of protectionism merely reinforces this trend.

Such a development could also raise the possibility of a regional grouping adopting a protectionist stance, because if firms have production capacity in each region they will not be particularly alarmed by the threat of higher barriers. Some may even favour any hindrance to imports into a region, as it implies a lower level of competition for the goods they are already producing within that region, and this would raise the possibility of a fragmentation of the trading world. Whether MNCs are so pragmatic in their lobbying behaviour has not been demonstrated, but it would appear to be a rational response on a short-term, micro basis.<sup>27</sup> The suspicion is that broader concerns about the health of the

---

<sup>25</sup> Oman (1994).

<sup>26</sup> Kobrin (1995).

<sup>27</sup> One example is that of Toys R Us which raised objections to Japan's restrictive Large Scale Retail Law when first setting up operations in the country. Once established, however, it was quick to seek recourse in the law when Akachan Honpo, a domestic competitor, was seen to be bypassing some of its provisions. In January 1996 MITI ruled that Akachan Honpo had been

international economic system will lead multinational firms to adopt a generally anti-protectionist position, irrespective of the gains available in a particular market.

In practice it is likely that the nature of the firm will determine its attitude towards open and closed regionalism and this is discussed in more detail below. Moreover, while a firm's response to whether regionalism is expected to be open or closed can be predicted, the direction of regionalism is less predictable. Many feared that the European Single Market would be a form of closed regionalism, as shown by the spate of investment in trade-substituting European resources by Japanese and North American companies in the late 1980s, but in the event it has complemented multilateral liberalisation efforts.<sup>28</sup>

Open or closed regionalism has more impact on the means of supplying goods to the market than on the decision of whether to supply. A credible threat of protectionism is likely to generate an inflow of FDI and prompt firms to establish regional networks, while open regionalism allows more globally oriented strategies. The issue of deep and shallow regionalism has parallels with that of open and closed regionalism.

#### 7.4.2 "Deep" and "Shallow" Regionalism

In terms of its impact on regionalisation, the differences between deep and shallow integration have been discussed in detail in Chapter 5. The rise in the degree of regional bias evident since the late 1980s in the EU and North America which was noted in the earlier statistical examination accompanied moves towards a "deeper" level of co-operation, although how preferential such integration can be is open to doubt. However, it appears that deeper agreements have an impact on corporate behaviour and this is supported by the emphasis on deeper issues in the Transatlantic Business Dialogue held in Seville in November 1995.<sup>29</sup>

---

violating parts of the retail law. *Nikkei Weekly*, 29 January 1996.

<sup>28</sup> As noted in Chapter 3, there has been an increased opening of the EU in the wake of the Single European Market, which has offset the increase in regional bias.

<sup>29</sup> Only one of the four working groups was concerned with the issue of trade liberalisation. The other three looked at standards, certifications and regulatory policy, investment and third country issues. Transatlantic Business Dialogue (1995).

Exactly why deeper integration should be of such interest to MNCs is clear from a consideration of the remaining barriers to cross-border business. The most significant of these come in the form of elements of public policy which result in a bias in favour of domestically located firms, or more generally, in non-tariff restrictions which raise the costs of serving foreign markets compared to a firm's home market. Reforms which lower subsidies available to domestic firms, eliminate pro-domestic bias in the government procurement process, enact an effective competition policy, enforce intellectual property rights or raise the transparency of decision-making processes can all be seen as reducing the advantage of firms based in the market vis-à-vis outsiders. Such liberalisation increases the potential for MNCs from outside a country to compete with domestic firms. However, as noted in Chapter 5, it is difficult for such reforms to occur on a regional basis: a domestic bias is rarely replaced by a similar favouritism towards regional firms.

Harmonisation of standards or mutual recognition reduce the costs of supplying another market, as the number of changes which need to be made to a product to ensure it conforms to a different regulatory regime will be reduced. For example, in the summer of 1996 the US and EU signed a Mutual Recognition Agreement covering testing and certification of electronic products which will allow goods to be accepted into both markets when approved by one of the testing bodies.<sup>30</sup> For some products, such as pharmaceuticals, the process of gaining approval to sell in other markets can be prohibitively expensive, so "deep" agreements which raise accessibility will have real effects on MNCs' strategies.

Examples of deeper integration which can be applied on a regional basis include rules of origin restrictions, anti-dumping policy and trade related investment measures. In terms of the relative importance of the different types of deeper co-operation, those which can be applied on a discriminatory regional basis are a subset of the whole. So although deeper integration increases opportunities for regionally based firms the most, it also raises the overall level of competition from firms outside the region as well. As noted in Chapter 3, the initial six EU countries saw no increase in their regional bias after the late 1960s,

---

<sup>30</sup> EIU *World Trade Outlook*, 3Q 96

in spite of moves to deepen integration, such as the Single European Market. In part this was due to the increase in bias towards new members, but the increased external trade to GDP ratios suggest that developments such as deeper integration also benefited non-regional countries.

In terms of the attitudes of MNCs, the distinction between deep and shallow regionalism is akin to that between open and closed regionalism. Both deep and open regionalism represent a lowering of barriers to trade and investment within a region, but such liberalisation is also likely to involve greater opportunities for firms based outside the region. The increased freedom of flows between regions will therefore affect global strategies. In contrast, shallow and closed regionalism are more explicitly discriminatory in favour of regional firms. Each different form of regionalism will alter the most efficient means of supplying the regional market as, for example, shallow regionalism tends to affect trade flows, while deeper regionalism liberalises both trade and investment flows. How each of the possibilities affects corporate structures is analysed below.

### **7.4.3 Internalisation**

In addition to the changes in relative costs associated with regionalism, there is the question of how internalisation arguments are affected. Coase showed that firms will internalise transactions up to the point where the cost of the internal transaction is the same as performing it in the market.<sup>31</sup> In particular, a firm tends to internalise transactions when licensing its ownership specific advantages to a local firm is inefficient, due to problems in placing a value on its worth, in monitoring performance or in enforcing the contractual obligations of the licensee. Appropriation of intellectual property and damage to brand name or reputation are other risks that a firm can face when deciding to externalise the transaction<sup>32</sup>. In addition, the ability to exploit differential corporate tax rates via transfer pricing is an incentive to internalise transactions.

If a regional agreement contains provisions for stricter enforcement of intellectual property rights and centralised legal institutions (such as the

---

<sup>31</sup> Coase (1937).

<sup>32</sup> Dunning (1993a).

European Court of Justice) then this will reduce the costs of externalising the transaction. In addition, if closer regional co-operation leads to a harmonisation of corporate tax rates—as appears to be taking place in Europe<sup>33</sup>—then the scope for increasing profits through transfer pricing will be reduced, again lowering the benefits from internalising transactions. More generally, if a regional trade agreement succeeds in reducing market imperfections within the region, then it is likely to lead to less internalisation and more licensing or subcontracting. However, the main market imperfection is for knowledge, and apart from intellectual property rights (IPR) protection, regionalism has little to contribute in this area.

It is also important to remember that the decision on when to internalise depends on where the border lies in terms of the balance between the cost of market transactions and the cost of internalisation. It could be the case that regionalism lowers the costs of performing a transaction in the market, but at the same time it makes internalisation cheaper. Lower transport and communication costs resulting from European liberalisation of the telecommunications market or "eighth freedom" air traffic routes<sup>34</sup> would make internalisation more efficient. If such savings are strong enough to outweigh the reduction in market imperfections, then it is quite feasible for regionalism to result in a rise in internalisation.

A UN report attempts to demonstrate a rise in internalisation within Europe, by showing that for US firms located in Europe vertical integration has risen more rapidly than horizontal integration.<sup>35</sup> However, in order to do so it assumes that all dealings with affiliates are vertical transactions and are internal to the firm, and all horizontal transactions are external. This seems to be an inadequate base from which to make the assertion that internalisation has been rising in Europe, as horizontal transactions can involve a higher degree of internationalisation than vertical ones. In addition, the UN has argued that "The theory of regional economic integration has little to say about whether it will increase or reduce market failure in intermediate product markets. But it does

---

<sup>33</sup> See Tanzi (1995) Ch. 7.

<sup>34</sup> See Hanlon (1996) pp. 76-78.

<sup>35</sup> UN (1993) Ch. IV.

suggest that firms engaged in intra-regional trade will be better able to take advantage of the economies and reduced uncertainty associated with the common governance of interrelated activities; and this would suggest that, to protect and advance this governance, firms may prefer to own their assets rather than lease the right of their use to other firms".<sup>36</sup>

Relative costs are likely to differ between industries and even between firms within the same industry. The structure of highly knowledge-intensive firms will remain unaffected by regionalism as internalisation will remain the optimal strategy, but other firms are likely to find it more profitable to move to more intensive use of licenses and subcontracting (US and Canadian firms might find this approach more attractive in Mexico due to the stronger IPR protection incorporated into NAFTA).<sup>37</sup> For others, regionalism could tilt the balance in favour of a greater degree of internalisation (European supermarkets could find it more efficient to buy from affiliates within the region as a result of improved information flows and cheaper transportation costs).

Overall, the structure of firms will be affected by issues related to regionalism which alter the relative attractiveness of internalising transactions. This is a different issue from that of preferential arrangements which are important because of the effect on market access *per se*. Internalisation issues relate to how a firm best structures itself to serve a particular market.

#### **7.4.4 Systemic Risks**

It was noted in Chapter 6 that if governments are coming together in a co-operative fashion to establish mutually beneficial preferential regional agreements then the danger that those governments will engage in hostile diplomatic, military or commercial behaviour is reduced. Commonality of interests reduces the potential for disputes, as does the closer communication and understanding implicit in establishing a forum to discuss trade relations. The lower systemic risk which is a consequence of such co-operation is of benefit to all firms operating within the region.

---

<sup>36</sup> UN (1993) p. 33.

<sup>37</sup> Chaudhry and Walsh (1995).



Most analysis of the impact of regionalism on MNCs tends to focus on the implications for micro and macroeconomic risk. That is, factors such as the change in the degree of competition, or a boost to the growth rate of an economy, can be analysed. However, systemic risk is of broader concern, covering issues such as conflict or expropriation which could endanger not just the profitability of a project, but also the value of the entire investment.

Whether firms which are based outside the region will have such an enthusiastic position is less clear, as there is a chance that greater co-operation within a region will also lead to a unified policy in foreign relations or in trade negotiations. The implication is that a region bargaining in a unified fashion will have more power to coerce other countries and regions, possibly to the detriment of their MNCs.

## 7.5 Impact of MNCs on Regionalism

The role that multinational corporations have to play in regionalism is frequently neglected. For example, Panic has noted "the absence of virtually any reference to multinationals ....[in] the official reports generated by the European Single Act".<sup>38</sup> Similarly, Ostry claims that formal links between the GATT and business groups were non-existent.<sup>39</sup> This does not necessarily mean that MNCs are not influential; merely that their activities are not given prominence in official documents. There is little doubt that industrial lobbying can at times be effective in achieving trade policy goals. The record of the farming lobby in Europe in protecting its privileged position is perhaps the most impressive, but is certainly not unique.<sup>40</sup> Meanwhile, other firms are committed to liberalisation of the international economy, with British Petroleum stating that "as an international company, BP's commercial success is crucially dependent on .... the maintenance and enhancement of the GATT-based multilateral trading system".<sup>41</sup>

---

<sup>38</sup> Panic (1991) p. 204.

<sup>39</sup> Ostry (1990) pp. 3-4.

<sup>40</sup> See Grant (1993) pp. 37-41.

<sup>41</sup> Quoted in Stopford (1992) p. 37.

For firms to be able to lobby effectively they must, of course, have a clear idea about the costs and benefits attached to the various forms of regionalism. While there is some debate as to whether or not MNCs are unitary actors in terms of whether they have an ordered and consistent set of objectives,<sup>42</sup> the impact of different trade regimes on corporate profitability must be roughly calculable and a firm will be able to direct whatever political influence it possesses accordingly.

Krishna shows that firms within a region are most likely to lobby in support of trade diverting agreements.<sup>43</sup> In non-diverting agreements, the gains in the partner country are offset by losses domestically, but in a trade diverting agreement, the losses are borne by non-participants. The establishment of the preferential agreement then becomes a barrier to multilateral liberalisation, as the beneficiaries seek to protect their position.

There are two aspects to the issue of whether MNCs can have an impact on the course of regionalism. Firstly, are interest groups able to garner specific concessions regarding the structure of any trade agreement? Grossman and Helpman show that it should be easier for governments to gain support for regional deals if some sectors are excluded.<sup>44</sup> The second issue is whether governments respond to pressure from business organisations when deciding whether or not to pursue a trade agreement? That is to say, do firms have the power to influence either the shape of an agreement or whether it exists at all?

In Europe, regional agreements behind the formation of the European Union and its precursors have always had an implicitly political agenda and as such, whether such agreements should be attempted can be expected to be relatively independent of corporate lobbying.<sup>45</sup> Milner has argued that regional agreements result from government attempts to balance consumer interests with

---

<sup>42</sup> Pugel and Walter (1985) found that US Fortune 1000 firms were able to adopt a single position on trade policy, irrespective of their degree of diversification.

<sup>43</sup> Krishna (1998).

<sup>44</sup> Grossman & Helpman (1995).

<sup>45</sup> Business groups have tended to support European regionalism, but whether they have had a real effect on developments such as the Single European Market programme is less clear. See for example Moravcsik (1993).

those of the corporate sector,<sup>46</sup> but European integration has also been part of a broader regional political agenda. Moreover, one Commission official has noted that the most appreciated lobbyists are those "which can speak on behalf of a cross-section of interests throughout the Community",<sup>47</sup> which would seem to weigh against industry-specific interest groups. The existence of lobbying offices based in and around Brussels indicates that firms and industries can (or believe they can) garner specific concessions regarding the structure of any agreement, but outside of long-favoured sectors these appear minor.

In North America the process may have been more business oriented, and the NAFTA negotiating process was noted for support from US business groups, such as the National Association of Manufacturers, the Business Roundtable and the US Chamber of Commerce.<sup>48</sup> In the Asia Pacific Economic Co-operation forum the role for business was formalised through the creation of the Pacific Business Forum in June 1994, while in the rest of the world most regional agreements have been either predominantly political in nature (such as ASEAN) or a response to regionalism in Europe and North America, and as such, political forces are likely to dominate. Thus, while it would be naïve to claim that lobbying groups have no effect whatsoever on the form that regionalism takes, it would also be overly brave to argue that they are the main dynamic behind the political force of regionalism. To put it another way, a government will enter into a trade agreement with the end objective of raising welfare in its economy, or as a result of one or more of the factors discussed in Chapter 6. The corporate sector—and especially larger multinationals which tend to be more politically astute—is the main mechanism through which the gains from regional integration are transmitted into the domestic economy, so it is likely to enthuse about such a deal. Although consumers should also benefit, they are likely to have less clear opinions on the effect of regionalism on employment, incomes, prices and consumer choice, and are less well organised into lobbying groups.

---

<sup>46</sup> Milner (1997).

<sup>47</sup> Hull (1993) p. 86.

<sup>48</sup> See Fishlow and Haggard (1992) p. 24.

Oman has claimed that MNCs were not as enthusiastic supporters of the Uruguay Round as could have been expected.<sup>49</sup> However, this could simply be a consequence of a cost-benefit analysis of the returns from active lobbying, rather than a reflection of a lack of interest.<sup>50</sup> How effective firms are in influencing the course of regionalism is a debatable issue. Milner argues that governments respond to “their *domestic* political situations” when formulating policy, balancing consumer interests and corporate lobbying.<sup>51</sup> Milner finds that regionalism can be a politically attractive middle ground, as it offers benefits to both consumer and corporate interests, while limiting the loss of tariff revenues.

Most studies find some degree of correlation between lobbying and responses from political institutions.<sup>52</sup> Steagall and Jennings found that members of the US House of Representatives who received campaign funding from political action committees related to organised labour tended to oppose NAFTA (as did the unions), while those who depended on business for contributions tended to vote in favour.<sup>53</sup> Similarly, by mid-1993 90% of the 40 largest Congressional recipients of funding from labour interests had declared their opposition to NAFTA.<sup>54</sup> In his polemic, Choate went so far as to argue that Japanese lobbyists are the third political force in US politics,<sup>55</sup> but looking at the North American Free Trade Agreement raises doubts as to the effectiveness of special interest groups in securing favourable concessions for their sectors. As with most other regional agreements, NAFTA is notably non-discriminatory in its treatment of industrial sectors, with interest groups such as the Latino Consensus being bought off with the offer of financial assistance rather than

---

<sup>49</sup> Oman (1994) p. 28.

<sup>50</sup> Olson (1965) has argued that the rational attitude is not to participate in organisations which seek collective benefits available to participants and non-participants alike, but to free-ride on the process.

<sup>51</sup> Milner (1997) p.77.

<sup>52</sup> See for example Helleiner (1977), Brock and Magee (1978), Ray (1981), Takacs (1981) and McKeown (1984).

<sup>53</sup> Steagall and Jennings (1996). There is a “chicken and egg” situation here, in that it is not possible to know whether a Congressman received contributions as a result of his position on NAFTA, or whether he developed a position on NAFTA in response to contributions received.

<sup>54</sup> Heritage Foundation report quoted by Conybeare and Zinkula (1996) p. 5.

<sup>55</sup> See Choate (1990).

trade concessions.<sup>56</sup> North American interest groups with a long history of securing preferential treatment such as textiles, agriculture and automobiles continue to enjoy advantages under NAFTA, but these are due to be phased out over time, leading to more equal treatment of industrial sectors.

Considering NAFTA in more detail provides an illustration of the processes at work. The decision to extend the Canada-US Free Trade Agreement was made primarily for political economy reasons, with the US eager to underwrite Mexican economic reforms and to put a brake on labour migration into the US, in addition to the straight economic gains which result from greater trade and competition.<sup>57</sup> US participation was not primarily a result of American business lobbies hoping to benefit from improved access to the Mexican economy, although both large and small business groups did support the agreement. Although the final structure of NAFTA, especially the side agreements on labour and the environment, was influenced by lobbying, it is notable for what is included, more than what is omitted. Politically sensitive sectors such as agriculture, textiles and automobiles will all see trade liberalised over the 15 year implementation period, while the service sector agreement follows a negative list approach, specifying what is to be excluded rather than included.<sup>58</sup> It appears that "traditional" lobbies in the US were relatively unsuccessful in distorting NAFTA to their advantage, although there are some concerns that active use of anti-dumping provisions will give *de facto* discrimination in some areas.<sup>59</sup> Even the side agreements on labour and the environment were implemented as much as a result of the political agenda of President Clinton as a consequence of interest group pressure. Moreover, the NAFTA dispute settlement mechanism, as with the Canada-US FTA, was de-politicised with disputes being resolved by international panels whose decisions are final, which takes the implementation of trade policy out of the hands of individual politicians who are inevitably exposed to pressure groups.

---

<sup>56</sup> Minor exceptions were granted in areas such as ball bearings, beef, oranges, peanut butter, cucumbers and wheat. Conybeare and Zinkula (1996) p. 7.

<sup>57</sup> Bliss (1994).

<sup>58</sup> OECD (1995).

<sup>59</sup> Although one of Canada's motives for signing CUSFTA was to constrain the US use of anti-dumping. Yarbrough and Yarbrough (1997).

Other regional groupings have similar examples of how interest groups can affect the structure of the agreement, ranging from the anomalous treatment of automobiles in MERCOSUR to the privileges enjoyed by agriculture in the European Union. Even so, the overriding impression among trade agreements worldwide is their internal consistency in that most regional agreements treat one industrial sector much like any other. More significantly, although some sectors will still garner preferential treatment, it will tend to be less than, rather than greater than, that which existed prior to the regional agreement. With agreements between developed countries broadening to include trade in services, the lack of exceptions and distortions illustrates the failure of special interest groups to secure significant specific benefits. Agriculture remains a frequent exception, but even here the trend is towards liberalisation, in this case supported by Uruguay Round commitments.<sup>60</sup>

Therefore, any consideration of the actions of MNCs in relation to regionalism should not overstate the role of interest group pressure. Inevitably governments will draw on support from business as a means of presenting evidence that a regional agreement will be of economic benefit, but there does not appear to be undue influence. If MNCs cannot directly shape regionalism to their benefit, then they must inevitably consider business responses to tackle the new challenges and opportunities that regionalism presents.

## **7.6 Impact of Regionalism on MNCs**

Regionalism can alter the degree of competition within an economy by granting entry to imports or investment from firms located elsewhere within the region, while it also increases opportunities for home country firms to expand into other markets in the region. Therefore it is an issue which must be of concern to all firms within an economy, whether or not they have exposure to foreign markets, because regionalism provides a threat as well as a business opportunity.

Firms are affected in a number of ways by regionalism. For firms with their home base within the region it will necessitate a re-evaluation of the profitability of exporting to the more open markets within the region, compared to dispersing

---

<sup>60</sup> The Uruguay Round provided for tariffication of barriers, together with a reduction in overall tariff levels.

production activity around a region through foreign direct investment flows. It may also require a response in the firm's domestic market as a result of the higher levels of competition. Apart from such business responses, regionalism can alter the optimum organisational structure adopted by a firm, which is to say that not just opportunistic or tactical reactions, but also strategic concerns must be addressed.

Chapter 3 discussed trends in regionalisation in recent years, at least part of which is a result of lower barriers to trade and investment within regions. The combination of increased trade and investment integration which resulted from preferentially lower regional barriers, together with the impact of regional production networks were seen as two of the main factors behind the rise in regionalisation. It appears that far from the "big yawn" that Wells claims is the response of US multinationals to the issue of regionalism, the reality is that firms react in a predictable, dynamic and rational fashion.

Lowering tariff and non-tariff barriers is likely to raise the volume of trade. Similarly for investment flows, an easing of restrictions on cross-border investment is likely to raise the size of such flows. In support of such an argument, regional and multilateral liberalisation in recent years have seen flows of both trade and investment grow more rapidly than output. Between 1981 and 1993 FDI flows quadrupled, while trade flows doubled and output rose under 50%.<sup>61</sup> In spite of the theoretical substitutability between the movement of commodities and factors of production,<sup>62</sup> growth in trade flows has occurred at the same time as an even more rapid increase in foreign direct investment flows. The implication is that this was a response to the removal of distortions to flows of both goods and factors of production. On the assumption that some such barriers remain,<sup>63</sup> their further erosion can be expected to provoke a similar response.

---

<sup>61</sup> UN (1995) Table I.1, *IMF Direction of Trade Statistics*, *IMF International Financial Statistics*.

<sup>62</sup> See Mundell (1957).

<sup>63</sup> This seems a reasonable assumption given that the post-Uruguay Round average OECD tariff will be 3.8%, while discussions of an Atlantic Free Trade Area have focused on non-tariff issues.

The question of what regionalism means for corporate structures is more complex and will depend to a large extent on the form that the regional bloc takes. The unique features of each regional trade agreement that exists in the world imply that behaviour in one region cannot simply be transposed directly onto another, but some general rules apply. For example, a shallow, protectionist bloc requires a different approach from a deep, open grouping, because of the implications for investment flows on the one hand, and the degree of competition on the other.

There is a debate over the most suitable structure for a corporation with business interests around the world. Analysts such as Perlmutter or Bartlett and Ghoshal have attempted to formulate typographies for various organisational structures.<sup>64</sup> However, it seems that the ultimate arbiter of the optimal structure of a multinational corporation is a combination of firm and industry specific features together with the nature of the international political economy, and as such it can be expected that regionalism will affect corporate structures. Analysts in the area of international business often appear to formulate prescriptions for corporate structures with little reference to the operating conditions facing the MNC. While it is clear that microeconomic conditions, such as the degree of competitiveness or the rate of technical progress will vary from industry to industry, it is just as clear that the same macroeconomic conditions face each industry. Thus I believe that the question is not "what is the optimal structure for the cross-border corporation?", but more "what is the optimal structure for the cross-border corporation given its view of the international political economy?" or "what is the cross-border corporation's optimal structure given the nature of the international political economy?". In addressing these questions, the nature of regionalism must be considered as it will affect the attractiveness of the different choices.

In industries where Fordist-type economies of scale are still the main determinant of competitiveness (for example aerospace, automobiles and shipbuilding), single site manufacturing will be most efficient from a production cost viewpoint. However, other costs can also be important, such as transport

---

<sup>64</sup> Bartlett and Ghoshal (1989) distinguish between multinational, global, international and transnational firms, depending on their organisational structure, while Perlmutter (1969) categorises MNCs as polycentric, ethnocentric, regiocentric or geocentric.



costs and border controls. In the case of aerospace, the existence or threat of protectionist barriers will need to be relatively high to justify establishing separate production facilities in each major region, because of the loss of economies of scale this would entail. However, in the case of automobiles the calculation is more finely balanced and the 1981 voluntary export restraint agreement between Japan and the US, together with the later fears of a "Fortress Europe" which surrounded the Single European Market programme tilted the balance in favour of regional production sites for Japanese automobile makers.<sup>65</sup> Thus, where the cost of border restrictions<sup>66</sup> exceeds the benefits of economies of scale from single site production, firms will find regional production more efficient. As Thomsen has noted, "global firms are not global factories".<sup>67</sup>

Whether a regional production operation should be established on a single site basis, or whether a network within the region is more efficient is another question which the cross-border firm must address. Rules of origin permitting, an integrated region will allow firms to ship inputs across the region just as they would in a large country. This means that decisions on location can be determined more by microeconomic business logic, with less need to account for man-made restrictions. In this case the structure of the production network will be determined by the balance between the need for just-in-time type processes and the production cost differentials across the region.

According to the Stolper-Samuelson model, a deal which liberalises trade and increases both imports and exports will be of benefit to the abundant factor of production.<sup>68</sup> This will be used relatively more intensively than before, while the scarce factor will be used less intensively, implying that the relative price of the former will rise. For this to occur factors of production need to be mobile. If factors of production are completely immobile and sector specific, then when trade liberalisation occurs both capital and labour in import competing industries will be harmed. The analysis below concentrates on the reactions of individual

---

<sup>65</sup> Emmott (1993).

<sup>66</sup> This could be the cost of actual tariff barriers, or the product of the probable size of such barriers and the risk of their imposition.

<sup>67</sup> Thomsen (1994).

<sup>68</sup> Stolper and Samuelson (1941).

firms, with the implicit assumption that there are considerable barriers to a firm re-inventing itself as a totally different entity, which is to say that factors of production are assumed not to be perfectly mobile between sectors. In this case if, say, a semiconductor fabrication plant becomes obsolete due to competition from imports which result from a regional trade agreement, it cannot simply close down one day and re-open the next day having re-trained its workers and reconfigured its capital equipment to produce automobiles.

Chapter 6 noted several possibilities for the future of international trade regulation. In the matrix shown in Table 7.1 these are combined with a range of corporate structures to provide an outline of the likely impact of different situations on different types of firms. The five main alternatives for the development of the international trade system are summarised as:

- i) Multilateral negotiations continue at irregular intervals, complemented by regional agreements.
- ii) Bilateral and regional agreements replace further multilateral agreements. The regional deals are open and contain deeper elements which are non-discriminatory.
- iii) Bilateral and regional agreements replace further multilateral agreements, but they hinder trade flows with the rest of the world.
- iv) Regionalism fades, to be replaced by renewed multilateralism.
- v) Both regionalism and multilateralism are discarded in favour of a return to protectionist national trade policies.

The various scenarios affect firms in different ways, which in the real world can be assessed by a straightforward cost-benefit analysis. In a general sense it is only possible to construct a framework for inferring the likely corporate response, but the categories below should be broadly applicable:

- a) Exporters based within the region. These are labelled "global" firms by Bartlett and Ghoshal as they build cost advantages through centralised global-scale operations.<sup>69</sup> The response of firms with a large export business will depend on the nature of the regionalism or multilateralism.

---

<sup>69</sup> Bartlett and Ghoshal (1989).

Options i), ii) and iv) all involve a form of reduction in intra- and inter-regional barriers which implies further opportunities to expand into foreign markets, with decisions on the location of production facilities becoming less influenced by trade restrictions. Option iii) of closed, protectionist regions is more of a threat to firms which rely heavily on exporting for delivering their goods to the final market. If closed regionalism provokes a retaliatory response from other regions then there will be greater pressure to set up production facilities within each region.<sup>70</sup> An outflow of FDI to other regions could be evidence of this type of defensive measure.

For firms which are producing in one country and exporting to others within the same region, liberalisation of the type outlined in i), ii) and iii) may bring pressures for a reorganisation of activities to reflect the comparative advantage of the different members of the region. This is particularly the case within a customs union compared to a free trade area, as the former involves the elimination of regional border controls, so the bureaucratic costs of crossing national frontiers fall along with the tariffs. In this case, unless economies of scale in production are dominant, firms could gain from moving some plants to other sites within the region where they can benefit from the particular comparative advantage of that location. This type of adjustment will raise FDI flows, while the effect on trade is indeterminate; if the company adopts a strategy which involves intra-firm trade of intermediate goods, then trade volumes will rise with FDI. However, if the investments are aimed predominantly at adding value for sales in the region's various domestic markets, then trade will decline.

- b) Exporters outside Region. For firms exporting into a region which is pursuing a preferential arrangement the calculations are somewhat different from those for firms based within the region. The main difference is that there will be more pressure to adapt from exporting in order to supply regionalising markets, towards an approach which places greater reliance on regional production. This is most notably the case in the event

---

<sup>70</sup> The flood of FDI from Japan and the US into the European Community ahead of the 1992 Single European Market is a recent example of such behaviour.

of closed regional blocs, but it also applies when the trade diversion effect is likely to be strong. If economies of scale in production are the key competitive advantage of the firm then the trade-off between the higher average unit output costs implicit in regional production could still outweigh the reduction in competitiveness stemming from exporting to preferential regional groupings.

If restrictions on FDI are prohibitive, then foreign firms may need to license the technology to domestic producers, although this tends to be the less favoured choice.<sup>71</sup> Option v) would be the most damaging development, as even if firms were able to invest within protectionist countries in many cases it may be difficult to produce enough output to allow an efficient scale of operation. Exporters with knowledge intensive products would be forced to transform themselves into what Bartlett and Ghoshal label multinational corporations, with investments behind trade barriers.<sup>72</sup>

c) FDI intensive MNCs. These are labelled as "multinational" or "international" firms by Bartlett and Ghoshal. The former build a strong local presence through sensitivity and responsiveness to national differences by owning a portfolio of national entities, each with a high degree of autonomy. The latter aim to exploit the parent company's knowledge and capabilities through worldwide diffusion and adaptation and are somewhere between "multinational" and "global" firms. Firms which have production sites across a range of countries (i.e. "multinationals" in Bartlett and Ghoshal's terminology) are likely to be less adversely affected by the protectionist scenario v). If restrictions on trade result in a reduction in competition within markets where the MNC has established production facilities, the result will be a more dominant position and probably higher profitability. However, from a broader macroeconomic viewpoint the net result could be slower growth which would offset some of the gains from more monopolistic pricing.

---

<sup>71</sup> Buckley and Casson (1985).

<sup>72</sup> Bartlett and Ghoshal (1989).

The three possibilities which envisage further intra-regional liberalisation (that is i), ii) and iii)) are likely to result in a reorganisation of operations across a region. For "multinationals" plants will already exist in many of the countries of the region, but these will be geared towards supplying the home market. Stronger regionalism will make it more efficient to integrate the operations of these diverse production facilities and as a result they will trade more with other affiliated firms within the region. Under this scenario regional production networks are likely to become more prevalent.

In the event of a return to active multilateralism, in theory the response could be a global version of that outlined above for regions. However, technological and communications barriers still remain, which means that global production networks are not necessarily the most effective mode of organisation. Similarly, neither are regional networks necessarily able to reach optimum efficiency, and multilateral liberalisation will allow firms to set up production networks on whatever scale suits their business. Inevitably some firms will find that autonomous nationally-based operations are most efficient, while for others a broader integrated network of production sites (on a sub-regional, regional or super-regional basis) will be preferred.<sup>73</sup>

- d) Efficient domestic utilities. For these firms (often privatised monopolies) the favoured option will be either i) or iv) because this implies lower imported input prices due to improved access, which is likely to directly raise profitability. Regionalism is a lower priority as it will create few new markets and is likely to have a more limited effect on input prices. In the case of utilities, whatever foreign expansion that does take place is likely to be in the form of FDI aimed at serving individual markets and as such will enjoy limited benefits from lower trade barriers.<sup>74</sup> However, an easing

---

<sup>73</sup> Foodstuffs is a sector which tends to favour the former approach, while for automobiles and computers broader geographic networks tend to be more efficient.

<sup>74</sup> Although it is worth noting that France is an exporter of electricity.

of restrictions on the movement of capital, whether delivered by either regionalism or multilateralism, could enable firms to exploit their knowledge or organisational advantages in other markets. The main danger is from new entrants to the home market if monopoly profits appear to be available, and this will again be via the FDI route, most likely via takeover activity, as has been the case in the UK water and electricity supply industries. This threat will be a constraint on pricing behaviour.

- e) Inefficient domestic utilities. Such firms (perhaps part state-owned or heavily regulated monopolies) will also benefit from any lower input costs which result from a regional or multilateral deal. However, if liberalisation includes admitting foreign investors into the domestic market then this will threaten price levels and market share. The inefficient domestic utility will first use its often considerable political influence to oppose such access. If that fails it will be forced into rationalisation, and perhaps some form of alliance with the more efficient foreign firm. The world telecommunications and power generation industries are currently seeing this form of behaviour. Any of the options i) to iv) above would prove painful for the inefficient monopolist if they included provisions for greater investment inflows. If the firm is a price-setter, then the benefits from lower imported input prices will be marginal compared to the losses resulting from the introduction of effective competition and so it will favour option v) which minimises competition.
- f) Domestically oriented small and medium firms. For many small and medium firms greater openness will imply greater competition in the domestic market, often from larger, more efficient foreign firms. Some smaller firms will lack the diversity or adaptability to allow them to overcome such intensified competition and will close or be absorbed by larger operations. When participating economies are at a similar stage in development, regionalism tends to imply competition from firms with a reasonably similar cost base, while multilateralism offers improved access to firms from other regions which may face lower cost structures and i)

and iv) are therefore the options which would result in the greatest strain on domestic firms.

For small firms with a relatively low export sensitivity, the favoured trade policy will be v) above which limits the degree of competition they face and will allow small firms to expand in market areas vacated by foreign imports due to the higher border tariffs.<sup>75</sup> In contrast, if the small and medium firms are regionally competitive and involved in foreign trade, then a regional deal could present them with the opportunity to exploit their advantages on a wider base. For most, however, that wider base is likely to be available within the home market without the need to look abroad.

---

<sup>75</sup> This can be seen in the support of agricultural interests for trade barriers in many developed countries.

	a) Exporters Within Region	b) Exporters Outside Region	c) FDI Intensive MNCs	d) Efficient Domestic Utilities	e) Inefficient Domestic Utilities	f) Small & Medium Domestically Oriented Firms
i) Multilateralism Complemented by Regionalism	Expand into newly opened markets worldwide, especially within region.	Expand exports and consider FDI within integrating regions to avoid trade diversion.	Integrate production on regional basis, but with considerable intra-regional trade.	Lowers costs and allows higher profits, but threat of new entrants constrains profits.	Effect of lower imported input costs is positive, but offset by threat of competition if FDI is allowed.	Threat of competition from new entrants. Some close or are absorbed by larger operators.
ii) Open Regionalism Replaces Multilateralism	Export to regional and worldwide market, and consider production sites in other regions.	Consider FDI within integrating regions to avoid trade diversion effects.	Opportunity to reorganise production on regional network basis, with less intra-regional integration than above.	Indifferent unless it lowers input prices or gives access to invest in regional markets.	Threat from entry by more efficient firms within region. Need for strategic alliances.	Milder threat of competition from new entrants. Some close or are absorbed by larger operators.
iii) Closed Regionalism Replaces Multilateralism	Exploit price advantage of exports within home region.	Create production capacity inside closed regions if possible. Loss of economies of scale.	Strong focus on regional networks. Inter-regional flows mainly in intangibles.	Negative if it raises input prices. Compensation if opportunities emerge to invest in regional markets.	Negative if it raises input costs, especially if it also liberalises FDI flows in the region.	Even milder threat of competition from new entrants. Some close or are absorbed by larger operators.
iv) Multilateral Liberalisation Replaces Regionalism	Export more aggressively worldwide.	Export more aggressively worldwide.	Integrate production on worldwide basis, with substantial intra-firm trade.	Lower costs of imported inputs raise profits unless new competition emerges.	Effect of lower imported input costs is positive, but likely to be offset by threat of competition if FDI is allowed.	Threat of competition from new entrants. Some close or are absorbed by larger operators.
v) National Protectionism Replaces Regionalism and Multilateralism	Segregated markets damage exports and mean few economies of scale if FDI is substituted for exports. More focus on home market.	Segregated markets damage exports and mean few economies of scale if FDI is substituted for exports. More focus on home market.	Higher profits within protected markets due to gain in competitiveness over imports. Pressure to establish more autonomous production units.	Higher imported input costs. Little chance of FDI.	Positive if it reduces competition and allows monopoly pricing, in spite of higher input costs.	Reduction of competition offsets losses from less dynamic economy.



As discussed above, I do not believe that it is possible to conduct credible empirical tests on such a framework.<sup>76</sup> No broadly based data are available in sufficient detail, and selected case studies could be put forward to support or undermine the matrix, depending on the firms chosen. Moreover, I do not believe that it is necessary to conduct such testing. The matrix of the impact of regionalism on MNCs is of interest not because it necessarily represents the actual behaviour of identifiable firms, but because it represents a range of implications of regionalism. Nor is it necessarily possible to conduct an examination on a sectorial basis, as it is quite likely that domestically oriented firms and export oriented multinationals will co-exist within the same industrial sector of an economy, each with different attitudes and responses to regionalism.

This matrix above implies that similar firms will be affected in a similar fashion by the form that regionalism takes, and as a result are likely to react in a similar way. However, Dunning has introduced the issue of MNCs' strategy into the picture, suggesting that even apparently similar firms facing similar situations can react in different ways due to diverging corporate strategies.<sup>77</sup> This brings a further complication and is another reason why a case study approach is not attractive.

The debate about corporate structures is more of a question of *how* firms service markets than *whether* they choose to do so. Unless the direction of trade policy is reversed so that a reduction of competition becomes a genuine possibility, the main issue is whether firms choose to export to meet demand or whether they set up local production facilities, perhaps as part of a wider network.

Apart from the organisational adaptations imposed by regionalism, there are also strategic pressures at work which are leading multinational corporations to integrate their activities on a global basis, irrespective of the regional dynamics. The view propounded by Levitt was that homogenisation of demand across the world makes it decreasingly necessary for the multinational corporation to pursue a different strategy in individual countries.<sup>78</sup> Therefore,

---

<sup>76</sup> Some examples have been offered to illustrate the points made above, but they do not amount to a "proof" of the propositions put forward in the matrix.

<sup>77</sup> Dunning (1993a).

<sup>78</sup> Levitt (1983).

even if the world does deteriorate into restrictive regional trading blocs, elements of the MNC's strategy will not change as the underlying market it services is unaltered. What has changed is the optimum vehicle by which each market is serviced. Homogenisation of demand signals the end of the multinational company which pursues different strategies and sells different products from country to country. In this case, firms will be increasingly be treating the world as a single unit and selling standardised products.

As yet, genuinely global firms are few and far between. Most are domestically oriented with some foreign operations, indicating that Ohmae's vision of a "borderless world"<sup>79</sup> is still some distance away. Even though Levitt has been criticised for taking the argument to an extreme level,<sup>80</sup> it applies to an increasing number of industries, which suggests that optimal structures depend on the nature of the product as well as on the view or state of the world. Nevertheless, this additional dynamic adds a further complication to any consideration of the reaction of firms to regionalism. Similarly, the tendency for governments to reduce tariff and non-tariff barriers contemporaneously with other domestic liberalisation clouds the issue without altering the underlying cost-benefit analysis.<sup>81</sup>

## 7.7 Conclusion

This chapter has attempted to show that regionalism is a trend which has a definite effect on the business conditions facing both multinational and domestically-oriented companies and as such is not an issue which should be met with complacency. In particular, the form that regionalism can take is important—whether it is "deep" or "shallow", "open" or "closed".

Moreover, regionalism has a part to play in a firm's decisions on where the border lies between internalising transactions, or conducting them in the market. Regionalism is likely to reduce market imperfections, which argues for less internalisation. However, it is also likely to lower the costs of internalising

---

<sup>79</sup> See Ohmae (1990).

<sup>80</sup> See for example Douglas and Wind (1987).

<sup>81</sup> EPAC (1995).

transactions, so the overall effect will vary from firm to firm. On a broader level, the reduced systemic risk implied by the commonality of interests and increased communication involved in regionalism will be of benefit to all firms in the region.

To what extent firms can influence regional agreements to reflect their trade policy preferences is open to question. Historically, there has been a correlation between lobbying for protectionism and the granting of preferential treatment. However, a notable feature of recent regional agreements has been the extent of their internal consistency, with relatively few concessions made to specific interest groups. Corporate support for the passage of the overall agreements may have been politically useful, but does not appear to be a key element in their inception or ratification.

Looking at the issue of regionalism from a microeconomic perspective makes the popular "building block—stumbling block" debate appear to be of limited relevance. For a large number of firms, there are limited material differences to whether multilateralism and regionalism proceed side by side, or whether one continues and the other ends, as long as regionalism is not protectionist. Whether regionalism and multilateralism are complementary or in conflict is of more interest to the question of how firms supply markets than whether they do so. The scenarios which provoke a different corporate response are those which involve a retreat towards protectionism and this is a deeper policy issue than whether or not regionalism and multilateralism are compatible.

Having attempted to bring the multinational corporation into the debate on preferential regional agreements, the conclusion will bring the pieces together to summarise how the international political economy of regional trading arrangements interacts with the behaviour of the multinational corporation.

## **CHAPTER EIGHT**

### **CONCLUSION: THE POLITICAL ECONOMY OF CONTEMPORARY REGIONAL INTEGRATION**

#### **8.1 Introduction**

This research has addressed several issues related to the international political economy of regional integration. It is a subject which has been written about increasingly in recent years, but there have been all too few rigorous studies of the facts or their implications for the international political economy. This work has examined several areas for evidence of how the advance of preferential regional agreements will alter the structure of the international system.

Firstly, a range of evidence was analysed for signs of closer integration in the three major regions. As noted in Chapter 3, there are inadequacies in each of the approaches used to measure regional bias. There are various ways of adapting the trade intensity index, developed by Brown,<sup>1</sup> which measures bilateral trade bias, but each of those methods (and indeed Brown's original method) contains drawbacks. As long as the flaws are taken into account (and in particular attempts are not made to draw inter-regional comparisons) then it is possible to use trade intensity indexes to illustrate trends in regional trade bias over time. The more complex, and for a time more popular, method of constructing gravity models to explore factors behind regional bias is also found to contain serious flaws.

By using time series analysis I have used regional trade intensity indexes to display trends over the past three decades in a way that is not possible in analysis which relies on comparing discrete points over time. The potential for short-term distortions to the data, through fluctuations in prices or in exchange rates, makes such a time series analysis more useful when looking for underlying trends. Merchandise trade data show that flows of goods have become more regionalised in Europe and North America, with an acceleration of the trend apparent since the late 1980s. In the case of Europe, since the late 1960s the rise in overall trade bias has been the result of increased bias between existing members and new members, rather than between the founding six members.

---

<sup>1</sup> Brown (1949).

One concern is that the quality of non-merchandise trade data is not good enough to allow a similar analysis for trade in services or flows of investment. Given the potential substitutability between capital and trade flows and the growing importance of trade in services, this means that some caution is needed when interpreting the results of the statistical analysis of Chapter 3.

Regional trading arrangements are classical international political economy territory because of the complex web of motivations for the creation of such structures. Economic factors alone provide a powerful reason to form a preferential regional bloc, but other explanations are useful to show why countries follow this path rather than opting for unilateral liberalisation. Non-economic factors such as increasing bargaining power, attempting to redress the balance of power between states and firms, and reducing systemic risk can all be significant.

Most debate on the subject of regionalism focuses on the question of whether it will aid or hinder multilateralism, but Chapter 7 offers a different perspective by moving away from the standard "building block / stumbling block" type of analysis. I have argued that multinational firms which are organised on a regional or sub-regional basis will not have strong preferences over whether regionalism is the sole vehicle for liberalisation, or whether it is complemented by multilateralism. Taking a micro perspective gives another dimension to aspects of regional and multilateral liberalisation that are relevant to international business and it also allows the construction of a framework which helps to analyse the effects of a range of possible scenarios.

## **8.2 Why is Regionalism a Growing Issue?**

Even before considering the implications of increasing regionalism, it is useful to note the reasons for the revival of interest in the subject. The existence of economic gains from freer exchange is often underplayed, but remains a powerful force behind the creation of regional trade agreements. However, additional perspectives are needed to explain why regional liberalisation is chosen in preference to unilateral action and why the popularity of regionalism has increased in recent years. I have argued that the multilateral lowering of tariffs in recent decades implies that direct trade-related gains are likely to be

less of a motivation for regional agreements than in the past, so other explanations are needed for the revived popularity of such structures. Non-tariff liberalisation is one area where a regional approach is favoured ahead of a unilateral one, because in several areas this comes down to agreement on policy harmonisation, where unilateralism is not a realistic option. The renewed interest in preferential regional arrangements may be a consequence of the fact that they are no longer as clearly focused on border-level tariff reductions, and encompass a range of "deeper" restrictions on cross-border exchange.

One interesting concept is that regionalism is being used by governments in an attempt to regain some of their lost influence over the market. For this to be effective there needs to be a degree of policy co-ordination at the central level above simple tariff reductions, which makes the European Union the only region where this idea can be examined in detail. However, regionalism also implies a shrinkage in the number of policy instruments available to governments, so although they might gain from acting in a co-operative fashion with other countries in the region, they also suffer costs in terms of loss of independence of trade policy, as well as less freedom in formulating monetary and fiscal policy.

The effectiveness and the merits of using regionalism to stabilise exchange rates was examined in Chapter 4. Although various studies have found no evidence of exchange rate fluctuations damaging trade flows, currency stability remains a policy objective of many governments. It was shown that preferential regional agreements do not help to reduce foreign exchange volatility unless they involve explicit institutional agreements targeted at the exchange rate, as in the case of Europe. However, exchange rate stability is not an end in itself, and without benefits to other targeted economic variables it is of limited worth. In particular, there is no evidence that reduced currency volatility increases regional trade bias.

As the world regionalises into a relatively small number of groups it might be the case that it is not so much that membership of a group necessarily brings benefits in terms of market access, but that failure to join a group implies costs due to isolation and lack of bargaining power. This could help to explain developments such as the Enterprise for the Americas initiative, as well as renewed regionalism in Latin America.

Another issue which is frequently absent from the debate on regionalism is how it affects systemic risk. The neglect of such a consideration is perhaps due to the difficulties in quantifying any impact, but it seems clear that if nations within a region have established a forum for co-operation then the dangers of trade or military conflict damaging the interests of multinational corporations operating within the region are lessened. A further issue is whether an institutional bias, either in favour of, or against protectionism, is likely to develop within a formal regional grouping. This seems to depend in part on the structure of the central institutions and the nature of decision-making within the regional group, and so the result is likely to differ between regions.

One concern in approaching the subject of regionalism on a global basis is that the motivations of countries in joining regional arrangements will vary considerably, as will the nature of the agreements themselves. This makes it difficult to construct a framework to analyse the structure and influence of regional arrangements, but in a general sense Chapter 7 presented a matrix to illustrate the likely impact of different trade regimes on different types of firms.

### **8.2.1 Regionalism and Intra-Regional Trade**

Regionalism must lead to more regionalisation, *ceteris paribus*, because at the margin the lower costs of doing business inherent in an effective regional agreement will cause a bias in favour of regional trade. However, measuring this regional bias is fraught with difficulties. Flaws in using the trade intensity index to measure bilateral bias, increased problems when projecting the methodology to the regional level, and drawbacks in the use of gravity models were discussed in detail in Chapter 3. There is no consensus in the literature on which approach is most suitable, and statistical inadequacies are commonly overlooked.

Bearing in mind the problems in the approach, I have calculated regional trade intensity indexes to show trends in regional trade bias. I introduced the innovation of constructing a time series of trade intensity indices over the past three decades to enable trends to be identified which can be missed or misinterpreted by studies that compare the situation at discrete time intervals. Such a process also allows short-term volatility—caused by factors such as

currency or commodity price fluctuations—to be distinguished from longer term structural trends.

Chapter 3 demonstrated that there has been a rise in regional trade bias within both Europe and North America in recent decades. However, the rise in bias within Europe has not included an increase in the degree of preferential bias between the original six members since the late 1960s. Increased regional trade bias between the current 15 members over the past three decades is a result of a rise in bias between the core and the newcomers, and between the newcomers. Looking not just at the bias of trade, but at the overall openness to trade of countries shows whether regional economies are becoming more closely integrated. This is the case in Europe and North America, where both general economic openness (in terms of trade to GDP ratios) and regional bias have increased.

Another problem in a statistical analysis is that the focus tends to be on merchandise trade flows, as elsewhere the data are poor. Information on foreign direct investment flows are too sparse and too volatile, data on trade in services are not sufficiently detailed, while figures on transactions of intangibles are even less informative. As a result it is useful analyse the factors behind the statistical trends an attempt to identify the forces involved.

In welfare terms the relative consistency of regional agreements is a positive feature. Allocative distortions on the scale of those created by the European Union's Common Agricultural Policy are marked by their absence from other regional agreements. Lobbying by industry bodies might have an effect in determining the overall success of regional initiatives, but they have mostly been ineffective in securing significant sectorial concessions. That is not to say that regional agreements do not contain areas of distortion, but that the distortions on a regional basis tend to be lower than those which previously existed on a national basis.

Regional trade agreements also have an impact on efficiency due to their consequences for market failure. Trade liberalisation should mean that structural market failure is reduced, as government intervention in the economy is constrained and the power of firms to pursue anti-competitive strategies is limited. Whether this will continue to be the case is uncertain: in airlines and telecommunications at least it appears that there is scope for domestic



monopolies and oligopolies to be replaced by international ones as a result of M&A and strategic alliances. On another level efficiency gains could be improved, as the commitment to liberalisation inherent in joining a regional trade agreement is often transmitted to domestic policy-making, with eradication of domestic regulations frequently accompanying border-level liberalisation.

### **8.2.2 Regionalism and Extra-Regional Trade**

One finding from Chapter 3 was that in spite of a rise in regionalisation, regions had also experienced a broader opening of their economies. This meant that trade with the rest of the world continued to become more important, even as the positive trade bias within the region increased. It is likely that some of the very measures which led to an increase in regionalisation also led to a rise in economic openness in a more general sense.

As noted in Chapter 5, much of the deeper liberalisation which has been taking place is non-discriminatory in nature. Co-operation on issues such as anti-dumping and TRIMs can be applied discriminatorily, but improved transparency, curbs on subsidies and effective competition policy are essentially non-discriminatory. The consequence is that although the intra-regional and extra-regional bias will change as a result of deeper integration, so does the broader domestic versus foreign bias, with the effect being more open economies. This is one reason why regionalism does not look likely to result in the creation of a small number of economically independent groupings. Moreover, it reduces concern about the potentially protectionist implications of the growth of regionalism. The elements of deep regionalism that cannot be discriminatory do not pose a threat to multilateralism.

From one perspective, a rise in regional independence would imply that concern about an end to multilateral liberalisation is misplaced because it is decreasingly relevant to more regionally-oriented companies. However, the rise in regionalisation identified in the trade data is not necessarily a sign of greater regional independence because it tells us nothing about the quality of flows between regions compared to those within regions. If it is the case that intra-regional trade flows involve intra-industry trade, while inter-regional trade flows involve the exchange of inter-industry products and knowledge-based resources

(and this seems a rough approximation, in relative terms) then regions have not become more independent.

This continued interdependence could be one reason why regions continue to be more co-operative than is sometimes feared. Part of the "building block—stumbling block" debate is founded on the concern that trade relations will become more abrasive. Indeed, a world split into three regions is seen as the most dangerous in terms of the motivations for regions to impose optimum tariffs (and the welfare losses resulting from such action). However, the continued decline of inter-regional barriers at a time when the theoretical gains from optimum tariffs are increasing illustrates the co-operative nature of trade relations.

There is a need for the debate to progress beyond the question of whether regionalism will benefit or hinder multilateralism. A more relevant issue is what form of liberalisation is most important for multinational actors: I have indicated that many MNCs are likely to be indifferent between open regionalism and multilateralism. Moreover, with border-level trade barriers among developed countries already at extremely low levels, it is deeper integration which is becoming the more important concern, and such agreements are frequently non-preferential.

### **8.3 Regional Globalisation**

The most striking suggestion from an examination of regional issues is that globalisation is a stronger force than regionalisation in the international political economy. This is often manifested through regional behaviour, in what I have labelled "regional globalisation", which makes the analysis complex, but the key dynamic is that of multinational corporations attempting to expand into fresh markets irrespective of regional peculiarities.

The assertion that globalisation is more important than regionalisation cannot be proved through statistical analysis, but it is a consequence of an examination of the microeconomic motivations of the actors. Moreover, continued multilateral liberalisation means that the marginal effect of regional liberalisation is decreasing. Data on trade flows show members of major regions moving closer together, but regionalisation of trade does not necessarily imply

that globalisation is diminishing. As noted, the data covering foreign direct investment are poor and offer no information on whether such flows are substituting for existing trade flows or creating new ones. An increasingly important failure in the statistics is that the flows of intangibles, such as knowledge, are measured imprecisely, if at all. As the shape of the international political economy transforms, a fresh approach to compiling statistics on the part of national governments would aid analysis of cross-border linkages and dependencies. With the exception of the United States, statistical information is still wedded to economic structures of decades ago, when merchandise trade flows were dominant, FDI flows existed but were poorly explained, and other flows were largely absent or ignored. For the sake of effective policy-making a better understanding of the integration of the international political economy is necessary.

The formation of preferential regional arrangements means that firms are able to globalise their operations via the construction of regional production networks. These typically offer a large enough scale of operations to obtain production economies of scale, while the existence of similar facilities within separate regions allows economies of scale for fixed costs such as those involved in research and development, marketing or finance. The implication is that in most issue areas, liberalisation on a global scale is not necessary, with regional liberalisation being sufficient to allow efficient operations. Thus, regionalism is not so much a substitute for global liberalisation, but an alternative to it. The one caveat is that there is no inherent reason why a regional (or sub-regional) scale of production should continue to be optimal. At the end of the 20th century it is simply the point at which the need for economies of scale in production meets with the organisational pressures of modern management techniques such as just in time production. It is quite feasible that future developments will render the region an obsolete unit and will require integration of a larger area. Note also that regionalism does not alter the fact that economic and political space do not coincide, so the continuing struggle by states to re-assert control over the market may have to extend from the regional level to the global level.

Therefore, although it might seem that global integration can proceed as a result of the combination of regional trading agreements with the organisational

strategies of multinational corporations, there is no inherent reason why closer integration will continue to be propelled by these two forces. At present if regionalism moves faster than multilateralism then it has its advantages, but in the future it could be that global production is necessary for economies of scale, in which case multilateralism will increase in importance again.

Rather than the well-developed debate on the relationship between, and relative merits of, regionalism and multilateralism, Chapter 7 turned the focus to how both regionalism and multilateralism affect the actions of multinational corporations operating on a global scale. The conclusion was that as long as regionalism is not protectionist, there was little practical difference between them in terms of what they mean for MNC strategies. Regionalism is a more important influence on the question of *how* firms should service global markets, rather than *whether* they should do so.

#### **8.4 Methodological and Theoretical Aspects**

This research has raised more questions related to methodology than it has answered. The inadequacies of each of the approaches commonly used to measure regionalisation have been discussed in detail. Problems in the gravity model approach mean that the added complexity is not rewarded with added clarity of explanation. It is argued that regional trade intensity indexes can be used, if handled with care, but no single methodology is conclusively superior.

Another concern is that focusing heavily on trade flows at a time when there is mobility of both goods and factors of production could be misleading. Even if the data for non-trade flows were available in sufficient detail, the potential for flows of capital to either complement or substitute for flows of goods adds a further level of complexity.

From a theoretical side, it has been illustrated that there is an uncomfortable overlap between theories of international economic integration (such as customs union theory) and theories of international production (as advanced by the likes of Dunning). This research has drawn on both areas in analysing the effects of regionalism, as no single perspective appears to offer a full explanation of the dynamics at work. However, the two fields do not sit well

together, with concepts such as "strategy" within the international business literature difficult to incorporate into economic trade theories.

It is becoming increasingly apparent that a new mode of analysis is needed which overcomes the current segregation between trade and investment; but whether this is possible in a theoretical or a practical sense is unclear. The co-existence of trade-creating and trade-substituting FDI would appear to make a search for a general theory of international business an unfulfilling one, as would the increased flow of intangibles. However, the real world is developing more rapidly than the theory on this subject, leaving us ever more poorly placed to analyse regionalism, regionalisation and global integration. In the face of such theoretical complexities, the tendency is to focus on the details of specific sectors, or to collate anecdotal evidence of corporate behaviour. However, such findings cannot be extrapolated into a general theory, leaving us little better off in our attempt to understand the implications of regional integration.

## **8.5 Conclusion**

The evidence put forward in this research is that international transactions are regionalising, partly in response to the establishment and development of preferential regional trading arrangements. Methodological difficulties mean that this is difficult to demonstrate conclusively, but the weight of evidence suggests it is the case for Europe and North America. This, together with inadequacies in the data, mean that any conclusions from statistical calculations must be considered alongside discussion of systemic, macroeconomic and microeconomic factors at work.

While the evidence suggests that world trade and world production are regionalising, this should not be allowed to obscure the more powerful force of globalisation which is also taking place. Although globalisation is at times manifested as regionalisation, this is as much a function of the organisational exigencies of the multinational corporation, rather than a reflection of the preferential bias imposed by regionalism.

## APPENDICES

### APPENDIX A1. Data for charts in Chapter 3.

Figure 3.1

	EU6	EU15
1958	30.6	45.3
1959	33.5	46.8
1960	34.6	48.2
1961	36.8	50.7
1962	38.9	52.4
1963	40.9	53.5
1964	41.9	54.4
1965	42.7	55.0
1966	43.4	55.0
1967	43.8	54.9
1968	45.4	55.4
1969	47.9	57.3
1970	48.5	58.0
1971	49.6	58.8
1972	50.5	60.2
1973	49.5	60.3
1974	45.6	56.8
1975	45.2	56.5
1976	46.0	57.6
1977	44.8	57.5
1978	45.5	58.4
1979	45.3	59.4
1980	43.4	57.5
1981	41.2	55.3
1982	42.0	56.7
1983	42.3	57.8
1984	41.5	57.5
1985	41.8	58.5
1986	44.6	62.1
1987	45.3	63.7
1988	45.2	64.1
1989	44.6	63.9
1990	45.1	64.7
1991	45.1	64.9
1992	45.1	65.3
1993	41.1	60.7
1994	41.1	61.2
1995	41.4	61.8
1996	40.3	61.0

Figure 3.2

	Method 1	Method 2	Method 3
1958	1.213	1.439	1.613
1959	1.303	1.545	1.789
1960	1.291	1.527	1.791
1961	1.328	1.568	1.887
1962	1.350	1.590	1.961
1963	1.403	1.652	2.092
1964	1.464	1.725	2.217
1965	1.456	1.713	2.223
1966	1.495	1.760	2.310
1967	1.522	1.793	2.367
1968	1.570	1.849	2.496
1969	1.571	1.844	2.573
1970	1.583	1.857	2.615
1971	1.582	1.853	2.651
1972	1.578	1.846	2.672
1973	1.550	1.814	2.582
1974	1.545	1.818	2.458
1975	1.516	1.783	2.394
1976	1.548	1.820	2.473
1977	1.514	1.781	2.381
1978	1.498	1.758	2.368
1979	1.476	1.732	2.324
1980	1.484	1.746	2.288
1981	1.634	1.939	2.489
1982	1.618	1.918	2.486
1983	1.644	1.950	2.541
1984	1.695	2.015	2.603
1985	1.663	1.975	2.557
1986	1.578	1.861	2.489
1987	1.566	1.844	2.487
1988	1.612	1.902	2.568
1989	1.609	1.900	2.546
1990	1.514	1.780	2.387
1991	1.535	1.807	2.425
1992	1.569	1.849	2.488
1993	1.614	1.915	2.455
1994	1.611	1.911	2.449
1995	1.606	1.905	2.450
1996	1.627	1.932	2.453

Figure 3.3

	Belgium	France	Germany	Italy	Holland
1958	2.050	1.142	1.514	1.000	1.891
1959	2.043	1.333	1.610	1.180	1.976
1960	2.043	1.344	1.581	1.207	1.930
1961	2.076	1.418	1.625	1.238	1.971
1962	2.078	1.471	1.642	1.310	1.939
1963	2.157	1.528	1.705	1.336	2.016
1964	2.254	1.602	1.741	1.395	2.118
1965	2.210	1.623	1.756	1.383	2.084
1966	2.269	1.708	1.794	1.428	2.101
1967	2.280	1.759	1.833	1.462	2.123
1968	2.288	1.860	1.893	1.505	2.176
1969	2.276	1.881	1.881	1.510	2.129
1970	2.297	1.860	1.910	1.550	2.142
1971	2.316	1.845	1.912	1.562	2.107
1972	2.283	1.836	1.884	1.582	2.113
1973	2.258	1.798	1.854	1.546	2.069
1974	2.295	1.774	1.865	1.488	2.113
1975	2.265	1.704	1.837	1.471	2.083
1976	2.335	1.747	1.866	1.530	2.090
1977	2.264	1.715	1.838	1.490	2.061
1978	2.221	1.712	1.805	1.488	2.046
1979	2.187	1.673	1.781	1.488	1.997
1980	2.171	1.662	1.806	1.528	2.029
1981	2.450	1.826	2.043	1.609	2.313
1982	2.427	1.812	2.035	1.615	2.251
1983	2.455	1.850	2.060	1.650	2.293
1984	2.560	1.918	2.109	1.718	2.372
1985	2.517	1.893	2.035	1.713	2.356
1986	2.358	1.815	1.866	1.737	2.198
1987	2.329	1.815	1.856	1.734	2.138
1988	2.389	1.853	1.926	1.807	2.189
1989	2.365	1.860	1.943	1.785	2.178
1990	2.269	1.740	1.794	1.698	2.055
1991	2.298	1.728	1.863	1.721	2.113
1992	2.362	1.756	1.914	1.761	2.165
1993	2.499	1.903	1.850	1.829	2.214
1994	2.429	1.879	1.868	1.809	2.245
1995	2.464	1.902	1.841	1.803	2.186
1996	2.512	1.902	1.882	1.805	2.248



Figure 3.4

	Method 1	Method 2	Method 3
1958	1.021	1.065	1.491
1959	1.051	1.096	1.564
1960	1.066	1.111	1.610
1961	1.105	1.151	1.720
1962	1.115	1.161	1.765
1963	1.136	1.182	1.827
1964	1.175	1.223	1.926
1965	1.171	1.219	1.929
1966	1.192	1.242	1.977
1967	1.209	1.260	2.011
1968	1.245	1.298	2.103
1969	1.245	1.296	2.145
1970	1.263	1.316	2.206
1971	1.257	1.308	2.210
1972	1.279	1.331	2.305
1973	1.294	1.347	2.344
1974	1.308	1.365	2.282
1975	1.285	1.340	2.221
1976	1.341	1.400	2.381
1977	1.342	1.401	2.377
1978	1.338	1.396	2.398
1979	1.340	1.398	2.434
1980	1.349	1.408	2.396
1981	1.496	1.569	2.662
1982	1.486	1.557	2.689
1983	1.523	1.595	2.816
1984	1.579	1.656	2.938
1985	1.565	1.640	2.946
1986	1.502	1.569	2.947
1987	1.491	1.557	2.989
1988	1.533	1.602	3.125
1989	1.544	1.613	3.146
1990	1.468	1.531	2.973
1991	1.505	1.571	3.086
1992	1.540	1.608	3.208
1993	1.599	1.675	3.133
1994	1.611	1.688	3.190
1995	1.602	1.678	3.195
1996	1.619	1.697	3.196

Figure 3.5

	EU6	Stage 1	Stage 2	Stage 3
1958	1.439	0.573	1.278	1.480
1959	1.545	0.584	1.183	1.466
1960	1.527	0.577	1.201	1.417
1961	1.568	0.601	1.166	1.402
1962	1.590	0.618	1.173	1.347
1963	1.652	0.624	1.162	1.294
1964	1.725	0.636	1.228	1.289
1965	1.713	0.623	1.208	1.248
1966	1.760	0.633	1.193	1.224
1967	1.793	0.644	1.199	1.162
1968	1.849	0.651	1.147	1.152
1969	1.844	0.625	1.105	1.092
1970	1.857	0.646	1.095	1.072
1971	1.853	0.621	1.087	1.036
1972	1.846	0.675	1.080	1.027
1973	1.814	0.742	1.120	1.045
1974	1.818	0.829	1.101	1.074
1975	1.783	0.859	1.061	1.053
1976	1.820	0.930	1.071	1.097
1977	1.781	0.964	1.108	1.151
1978	1.758	0.988	1.121	1.154
1979	1.732	1.058	1.114	1.151
1980	1.746	1.104	1.099	1.205
1981	1.939	1.256	1.202	1.312
1982	1.918	1.265	1.242	1.311
1983	1.950	1.329	1.296	1.353
1984	2.015	1.402	1.370	1.403
1985	1.975	1.411	1.386	1.385
1986	1.861	1.279	1.525	1.348
1987	1.844	1.274	1.570	1.365
1988	1.902	1.310	1.639	1.411
1989	1.900	1.336	1.664	1.435
1990	1.780	1.275	1.625	1.394
1991	1.807	1.328	1.656	1.454
1992	1.849	1.341	1.714	1.491
1993	1.915	1.342	1.851	1.656
1994	1.911	1.368	1.837	1.624
1995	1.905	1.374	1.868	1.615
1996	1.932	1.378	1.911	1.622

Figure 3.6

	EU6	Stage 1	Stage 2	Stage 3
1958	0.445	1.154	0.958	1.169
1959	0.459	1.145	0.944	1.201
1960	0.455	1.168	1.068	1.282
1961	0.459	1.290	1.095	1.347
1962	0.462	1.312	1.122	1.347
1963	0.461	1.351	1.099	1.417
1964	0.474	1.397	1.126	1.522
1965	0.455	1.421	1.111	1.539
1966	0.454	1.486	1.122	1.616
1967	0.464	1.553	1.112	1.713
1968	0.477	1.597	1.162	1.866
1969	0.455	1.686	1.146	1.882
1970	0.456	1.837	1.186	1.941
1971	0.444	1.893	1.164	1.953
1972	0.487	1.875	1.215	2.000
1973	0.532	1.871	1.161	2.044
1974	0.599	1.938	1.104	1.988
1975	0.608	1.929	1.004	1.824
1976	0.680	2.088	1.020	1.974
1977	0.724	2.070	1.031	1.828
1978	0.720	2.155	1.001	1.766
1979	0.752	2.126	1.017	1.762
1980	0.778	2.051	0.942	1.651
1981	0.947	2.328	1.079	1.866
1982	0.961	2.187	1.048	1.806
1983	0.999	2.105	1.164	1.878
1984	1.079	2.044	1.257	1.985
1985	1.079	1.944	1.232	1.890
1986	0.973	1.885	1.301	1.672
1987	0.938	1.821	1.273	1.584
1988	0.967	1.787	1.280	1.587
1989	0.990	1.830	1.255	1.584
1990	0.907	1.814	1.180	1.471
1991	0.941	1.916	1.205	1.533
1992	0.979	1.998	1.227	1.543
1993	1.063	1.899	1.377	1.659
1994	1.111	1.930	1.401	1.728
1995	1.119	1.964	1.409	1.703
1996	1.136	1.885	1.417	1.704

Figure 3.7

	EU6	Stage 1	Stage 2	Stage 3
1958	1.188	1.092	0.563	0.925
1959	1.042	1.059	0.980	0.898
1960	1.101	1.185	0.898	0.952
1961	1.077	1.243	1.252	0.956
1962	0.985	1.249	1.101	0.901
1963	0.966	1.160	1.079	0.913
1964	0.993	1.148	1.393	0.917
1965	0.971	1.119	1.065	0.879
1966	0.934	1.120	1.098	0.928
1967	0.945	1.157	1.337	0.913
1968	0.905	1.235	1.407	1.008
1969	0.850	1.238	1.439	0.957
1970	0.832	1.205	1.345	0.908
1971	0.842	1.271	1.633	0.922
1972	0.836	1.226	1.460	0.988
1973	0.885	1.216	1.512	1.036
1974	0.872	1.100	1.409	0.983
1975	0.845	0.980	1.431	0.931
1976	0.862	0.990	1.268	0.951
1977	0.918	1.074	1.399	0.831
1978	0.907	1.059	1.524	0.762
1979	0.918	1.033	1.453	0.743
1980	0.912	1.037	1.405	0.735
1981	1.098	1.176	1.703	0.885
1982	1.065	1.128	1.575	0.786
1983	1.106	1.203	1.394	0.803
1984	1.135	1.256	1.770	0.819
1985	1.172	1.287	1.668	0.883
1986	1.195	1.345	2.389	0.932
1987	1.210	1.303	2.643	0.920
1988	1.282	1.388	3.178	0.965
1989	1.292	1.314	3.157	0.971
1990	1.197	1.244	2.960	0.924
1991	1.225	1.241	2.961	0.925
1992	1.288	1.249	3.251	0.927
1993	1.402	1.252	3.779	0.979
1994	1.446	1.300	4.090	0.976
1995	1.442	1.276	4.202	0.908
1996	1.504	1.287	4.265	0.893

Figure 3.8

	EU6	Stage 1	Stage 2	Stage 3
1958	1.150	1.102	0.952	0.876
1959	1.136	1.127	0.919	1.082
1960	1.089	1.227	0.857	1.324
1961	1.088	1.279	0.844	1.482
1962	1.013	1.290	0.876	1.501
1963	0.978	1.340	0.885	1.468
1964	0.965	1.481	0.883	1.631
1965	0.933	1.496	0.861	1.731
1966	0.909	1.565	0.901	1.982
1967	0.875	1.637	0.906	2.116
1968	0.866	1.761	1.023	2.246
1969	0.810	1.795	0.927	2.613
1970	0.781	1.855	0.935	2.827
1971	0.756	1.835	0.898	2.963
1972	0.748	1.896	0.937	3.089
1973	0.767	1.962	0.991	3.130
1974	0.801	1.932	0.929	3.194
1975	0.766	1.748	0.836	3.194
1976	0.802	1.894	0.932	3.152
1977	0.850	1.777	0.779	3.018
1978	0.847	1.741	0.726	2.994
1979	0.834	1.707	0.680	3.027
1980	0.886	1.622	0.670	3.175
1981	1.020	1.828	0.723	3.485
1982	1.006	1.784	0.729	3.305
1983	1.044	1.850	0.689	3.103
1984	1.107	1.955	0.737	3.293
1985	1.098	1.854	0.755	3.210
1986	1.032	1.645	0.819	3.058
1987	1.020	1.549	0.821	2.985
1988	1.075	1.556	0.856	3.071
1989	1.090	1.540	0.879	3.205
1990	1.012	1.472	0.843	2.959
1991	1.071	1.503	0.905	2.923
1992	1.111	1.525	0.836	2.731
1993	1.303	1.697	0.935	2.854
1994	1.266	1.739	0.894	2.894
1995	1.152	1.525	0.801	2.654
1996	1.210	1.511	0.850	2.667

Figure 3.9

	CUSFTA	NAFTA
1960	32.3	33.7
1961	33.0	34.3
1962	33.5	34.8
1963	32.8	34.1
1964	33.2	34.5
1965	34.7	35.7
1966	36.1	36.9
1967	38.4	39.1
1968	39.3	40.0
1969	40.8	41.5
1970	37.9	38.6
1971	39.5	40.1
1972	39.9	40.6
1973	37.6	38.3
1974	35.0	35.9
1975	34.8	35.7
1976	35.0	35.8
1977	34.3	35.1
1978	33.5	34.5
1979	32.8	34.1
1980	31.4	33.2
1981	33.0	34.9
1982	33.0	34.4
1983	35.8	37.1
1984	36.9	38.1
1985	37.3	38.6
1986	35.0	36.2
1987	35.1	36.3
1988	35.2	36.5
1989	35.4	36.8
1990	35.8	37.4
1991	35.9	39.1
1992	36.5	39.9
1993	37.9	41.3
1994	39.1	42.7
1995	38.5	42.2
1996	39.5	43.6

Figure 3.10

	Method 1	Method 2	Method 3
1960	1.444	2.564	1.979
1961	1.542	2.754	2.138
1962	1.556	2.776	2.171
1963	1.571	2.814	2.178
1964	1.608	2.885	2.243
1965	1.678	3.009	2.385
1966	1.674	2.988	2.415
1967	1.791	3.199	2.668
1968	1.795	3.197	2.704
1969	1.935	3.461	2.988
1970	1.868	3.356	2.778
1971	1.972	3.549	3.001
1972	2.019	3.639	3.096
1973	2.021	3.666	3.012
1974	1.930	3.510	2.782
1975	1.945	3.542	2.798
1976	1.931	3.513	2.783
1977	1.939	3.534	2.772
1978	1.905	3.476	2.696
1979	1.924	3.519	2.702
1980	1.929	3.543	2.669
1981	1.980	3.629	2.793
1982	2.001	3.673	2.824
1983	2.062	3.766	3.013
1984	1.904	3.440	2.803
1985	1.924	3.475	2.846
1986	1.886	3.421	2.714
1987	1.996	3.640	2.886
1988	1.965	3.578	2.842
1989	1.959	3.564	2.838
1990	2.124	3.890	3.109
1991	2.155	3.952	3.160
1992	2.196	4.028	3.251
1993	2.110	3.841	3.166
1994	2.200	4.009	3.361
1995	2.294	4.204	3.490
1996	2.330	4.266	3.595

Figure 3.11

	Mexico	Canada
1960	4.151	3.547
1961	4.575	3.777
1962	4.223	3.851
1963	4.583	3.852
1964	4.472	3.807
1965	4.025	3.865
1966	3.586	3.733
1967	3.735	4.050
1968	3.573	3.922
1969	3.758	4.337
1970	3.961	4.146
1971	3.927	4.253
1972	4.328	4.151
1973	4.253	4.527
1974	4.079	4.336
1975	4.449	4.644
1976	4.284	4.373
1977	4.380	4.314
1978	4.543	4.339
1979	4.852	4.361
1980	4.778	4.362
1981	3.995	4.496
1982	3.804	4.614
1983	3.885	4.510
1984	3.238	3.948
1985	3.268	3.924
1986	3.558	3.968
1987	3.797	4.134
1988	4.086	4.212
1989	4.388	4.273
1990	4.667	4.933
1991	5.582	5.201
1992	5.603	5.279
1993	5.153	4.926
1994	5.234	4.969
1995	5.499	5.185
1996	5.440	5.279



Figure 3.12

	ASEAN	East Asia	APEC
1970	18.3	27.6	55.6
1971	18.7	27.2	56.3
1972	16.9	26.9	57.0
1973	16.4	30.3	56.6
1974	14.7	29.8	53.3
1975	15.5	29.1	51.6
1976	16.1	28.7	53.1
1977	16.3	29.3	52.9
1978	16.3	31.1	54.1
1979	17.9	32.9	53.8
1980	18.2	33.1	52.7
1981	18.4	33.0	54.3
1982	22.4	34.0	56.0
1983	23.7	34.1	58.3
1984	20.4	34.1	60.4
1985	19.7	34.8	61.3
1986	18.2	32.7	61.3
1987	18.9	34.7	61.4
1988	17.8	36.2	62.0
1989	17.5	37.1	62.4
1990	17.7	37.8	61.5
1991	18.8	40.4	62.2
1992	19.0	41.4	62.6
1993	19.7	42.1	63.7
1994	20.2	43.8	65.0
1995	20.4	44.9	65.1
1996	21.3	44.8	64.1

Figure 3.13

	Method 1	Method 2	Method 3
1970	2.769	3.016	3.812
1971	2.641	2.876	3.619
1972	2.577	2.805	3.530
1973	2.709	2.947	3.877
1974	2.472	2.688	3.493
1975	2.552	2.777	3.568
1976	2.407	2.616	3.354
1977	2.388	2.595	3.346
1978	2.314	2.511	3.312
1979	2.468	2.679	3.629
1980	2.348	2.548	3.441
1981	2.230	2.418	3.257
1982	2.233	2.420	3.291
1983	2.110	2.285	3.106
1984	2.010	2.175	2.953
1985	2.077	2.248	3.084
1986	1.986	2.149	2.883
1987	2.070	2.239	3.108
1988	2.009	2.170	3.076
1989	2.027	2.189	3.147
1990	2.113	2.282	3.329
1991	2.081	2.245	3.397
1992	2.074	2.235	3.438
1993	1.904	2.048	3.163
1994	1.940	2.086	3.298
1995	1.971	2.119	3.416
1996	1.997	2.152	3.255

Year	Method 1	Method 2	Method 3
1970	1.714	1.795	3.219
1971	1.741	1.824	3.335
1972	1.769	1.854	3.449
1973	1.780	1.866	3.461
1974	1.665	1.745	3.031
1975	1.668	1.749	2.959
1976	1.678	1.758	3.056
1977	1.686	1.767	3.067
1978	1.687	1.767	3.154
1979	1.716	1.798	3.211
1980	1.687	1.768	3.096
1981	1.676	1.755	3.143
1982	1.712	1.792	3.313
1983	1.688	1.765	3.366
1984	1.612	1.682	3.288
1985	1.646	1.718	3.430
1986	1.699	1.775	3.609
1987	1.739	1.817	3.767
1988	1.674	1.747	3.626
1989	1.657	1.728	3.597
1990	1.708	1.783	3.676
1991	1.672	1.744	3.639
1992	1.659	1.730	3.637
1993	1.542	1.603	3.357
1994	1.562	1.624	3.494
1995	1.597	1.662	3.626
1996	1.569	1.635	3.225

Figure 3.14

Figure 3.15

	NAFTA	EU15	East Asia
1965	8.4	29.8	19.9
1966	8.2	30.2	20.1
1967	8.1	29.6	21.0
1968	8.1	31.3	22.3
1969	8.5	33.4	22.7
1970	8.5	33.9	23.4
1971	9.0	33.9	24.1
1972	8.4	33.8	22.8
1973	9.4	36.9	24.9
1974	9.5	44.4	33.5
1975	10.0	39.9	29.9
1976	10.0	42.9	31.6
1977	10.7	42.9	30.1
1978	12.5	41.4	23.9
1979	16.0	43.5	27.5
1980	14.9	45.1	32.4
1981	15.4	46.2	32.9
1982	15.6	46.3	32.5
1983	16.1	46.1	31.4
1984	17.7	48.9	33.1
1985	19.0	49.7	32.0
1986	18.1	43.5	26.3
1987	16.3	42.7	26.7
1988	15.4	42.8	27.1
1989	16.5	45.2	28.9
1990	15.8	43.9	31.2
1991	15.6	42.0	30.8
1992	16.4	40.3	30.7
1993	17.6	39.3	29.2
1994	17.7	42.2	31.2
1995	17.8	44.6	33.5
1996	18.0	44.9	32.6

Figure 3.16

	NAFTA	EU15	East Asia
1965	0.099	0.182	0.388
1966	0.103	0.188	0.385
1967	0.103	0.187	0.368
1968	0.115	0.203	0.359
1969	0.126	0.216	0.362
1970	0.129	0.223	0.353
1971	0.136	0.221	0.346
1972	0.149	0.225	0.320
1973	0.175	0.249	0.367
1974	0.215	0.303	0.450
1975	0.203	0.267	0.415
1976	0.208	0.300	0.413
1977	0.213	0.300	0.391
1978	0.215	0.289	0.300
1979	0.240	0.304	0.368
1980	0.259	0.318	0.412
1981	0.251	0.362	0.397
1982	0.227	0.360	0.393
1983	0.221	0.368	0.358
1984	0.216	0.405	0.360
1985	0.210	0.407	0.360
1986	0.206	0.342	0.283
1987	0.229	0.332	0.298
1988	0.242	0.343	0.295
1989	0.243	0.365	0.316
1990	0.265	0.336	0.356
1991	0.276	0.330	0.346
1992	0.286	0.324	0.343
1993	0.276	0.329	0.299
1994	0.309	0.356	0.325
1995	0.356	0.374	0.355
1996	0.366	0.381	0.351

Figure 3.17

	NAFTA	EU15	East Asia
1965	0.027	0.067	0.073
1966	0.028	0.068	0.073
1967	0.026	0.067	0.074
1968	0.028	0.070	0.079
1969	0.028	0.071	0.079
1970	0.031	0.071	0.082
1971	0.030	0.070	0.085
1972	0.032	0.067	0.081
1973	0.038	0.073	0.084
1974	0.051	0.096	0.114
1975	0.048	0.087	0.103
1976	0.049	0.091	0.109
1977	0.051	0.091	0.103
1978	0.053	0.086	0.079
1979	0.058	0.088	0.089
1980	0.063	0.096	0.105
1981	0.059	0.103	0.106
1982	0.054	0.100	0.104
1983	0.049	0.097	0.100
1984	0.051	0.104	0.105
1985	0.049	0.103	0.101
1986	0.050	0.082	0.085
1987	0.052	0.078	0.083
1988	0.056	0.077	0.082
1989	0.056	0.082	0.085
1990	0.056	0.077	0.091
1991	0.055	0.074	0.085
1992	0.055	0.070	0.083
1993	0.055	0.077	0.078
1994	0.058	0.082	0.081
1995	0.064	0.085	0.085
1996	0.063	0.088	0.090

Figure 3.18

	From Canada	From USA
1985	0.354	-0.469
1986	1.059	-0.939
1987	0.652	2.499
1988	0.882	2.304
1989	0.806	1.930
1990	1.414	2.498
1991	0.134	3.571
1992	3.064	2.061
1993	2.349	2.059
1994	1.813	3.660
1995	3.033	1.987

Figure 3.19

	From Germany	From France
1985	0.839	0.3898
1986	0.513	1.8469
1987	1.027	0.1540
1988	0.781	3.0409
1989	0.771	2.0108
1990	0.521	1.4960
1991	0.528	1.2959
1992	0.368	1.4824
1993	0.681	2.4491
1994	0.500	3.0290
1995	0.396	0.4691

Figure 3.20

	North America	Asia	NICs
1987	1.228	5.370	9.896
1988	1.152	5.596	11.663
1989	1.185	5.903	12.023
1990	1.288	6.342	13.465
1991	1.395	5.592	12.550
1992	1.528	4.437	10.979
1993	1.474	3.911	9.545
1994	1.252	3.596	9.119

Belgium's trade intensity with:

	France	Germany	Italy	Holland
1958	1.919	1.524	0.668	4.658
1959	1.938	1.502	0.745	4.569
1960	1.944	1.625	0.708	4.545
1961	2.096	1.573	0.720	4.681
1962	2.132	1.663	0.766	4.478
1963	2.273	1.754	0.895	4.443
1964	2.321	1.928	0.856	4.375
1965	2.360	1.871	0.805	4.335
1966	2.465	1.959	0.788	4.446
1967	2.563	1.932	0.863	4.405
1968	2.690	1.935	0.832	4.285
1969	2.733	2.029	0.828	3.880
1970	2.782	2.059	0.848	3.811
1971	2.760	2.117	0.828	3.751
1972	2.734	2.065	0.850	3.714
1973	2.727	2.012	0.889	3.558
1974	2.788	2.022	0.857	3.757
1975	2.631	2.057	0.832	3.680
1976	2.701	2.105	0.935	3.726
1977	2.596	2.033	0.896	3.748
1978	2.566	2.015	0.892	3.653
1979	2.491	1.981	0.914	3.677
1980	2.438	1.937	0.932	3.755
1981	2.758	2.175	0.970	4.429
1982	2.771	2.168	0.957	4.326
1983	2.777	2.221	0.941	4.371
1984	2.992	2.220	1.014	4.635
1985	3.042	2.147	0.997	4.579
1986	2.873	1.978	1.041	4.243
1987	2.822	1.987	1.059	4.146
1988	2.789	2.064	1.083	4.345
1989	2.831	2.025	1.081	4.312
1990	2.679	1.995	1.060	4.034
1991	2.683	2.050	1.041	4.095
1992	2.771	2.081	1.060	4.260
1993	3.023	2.187	1.124	4.282
1994	2.960	2.055	1.054	4.365
1995	2.903	2.154	1.089	4.401
1996	3.003	2.142	1.073	4.698



France's trade intensity with:

	Belgium	Germany	Italy	Holland
1958	1.719	1.230	0.906	0.606
1959	1.731	1.435	1.297	0.759
1960	1.830	1.421	1.271	0.777
1961	1.966	1.485	1.360	0.829
1962	1.977	1.561	1.415	0.844
1963	2.106	1.567	1.539	0.886
1964	2.195	1.657	1.542	0.996
1965	2.201	1.656	1.537	1.090
1966	2.320	1.722	1.685	1.117
1967	2.470	1.729	1.770	1.172
1968	2.552	1.809	1.886	1.308
1969	2.550	1.803	1.954	1.356
1970	2.605	1.788	1.968	1.241
1971	2.574	1.769	2.009	1.224
1972	2.541	1.749	2.031	1.193
1973	2.551	1.673	2.054	1.162
1974	2.639	1.638	1.920	1.186
1975	2.457	1.574	1.867	1.208
1976	2.438	1.610	2.068	1.167
1977	2.344	1.556	2.067	1.197
1978	2.323	1.521	2.081	1.249
1979	2.258	1.488	2.026	1.218
1980	2.223	1.450	2.117	1.165
1981	2.416	1.627	2.205	1.356
1982	2.484	1.601	2.192	1.319
1983	2.532	1.642	2.199	1.382
1984	2.722	1.650	2.290	1.470
1985	2.766	1.632	2.204	1.454
1986	2.576	1.554	2.267	1.305
1987	2.543	1.566	2.237	1.317
1988	2.524	1.602	2.293	1.379
1989	2.544	1.605	2.245	1.428
1990	2.424	1.517	2.059	1.327
1991	2.422	1.515	2.059	1.290
1992	2.528	1.532	2.079	1.298
1993	2.601	1.741	2.109	1.422
1994	2.519	1.723	2.128	1.359
1995	2.466	1.788	2.111	1.392
1996	2.480	1.791	2.065	1.421

Germany's trade intensity with:

	Belgium	France	Italy	Holland
1958	1.519	1.238	1.487	1.939
1959	1.440	1.452	1.604	1.980
1960	1.530	1.382	1.470	2.041
1961	1.530	1.485	1.521	2.018
1962	1.535	1.539	1.575	1.965
1963	1.645	1.549	1.614	2.104
1964	1.782	1.607	1.540	2.110
1965	1.791	1.598	1.575	2.147
1966	1.843	1.677	1.583	2.167
1967	1.848	1.725	1.601	2.255
1968	1.866	1.799	1.656	2.336
1969	1.909	1.792	1.625	2.289
1970	1.970	1.735	1.721	2.327
1971	2.009	1.734	1.723	2.283
1972	1.936	1.710	1.697	2.313
1973	1.882	1.647	1.694	2.308
1974	1.928	1.637	1.593	2.441
1975	1.940	1.585	1.603	2.375
1976	1.963	1.679	1.604	2.326
1977	1.923	1.651	1.538	2.353
1978	1.926	1.601	1.532	2.306
1979	1.919	1.588	1.503	2.278
1980	1.862	1.628	1.580	2.312
1981	2.136	1.905	1.661	2.659
1982	2.112	2.011	1.577	2.568
1983	2.194	1.959	1.625	2.632
1984	2.191	1.985	1.700	2.737
1985	2.111	1.891	1.628	2.716
1986	1.931	1.715	1.630	2.354
1987	1.921	1.704	1.658	2.308
1988	2.001	1.795	1.731	2.338
1989	1.953	1.865	1.712	2.391
1990	1.873	1.678	1.605	2.186
1991	1.916	1.794	1.662	2.205
1992	2.001	1.797	1.744	2.273
1993	1.753	1.862	1.643	2.196
1994	1.770	1.885	1.704	2.148
1995	1.782	1.828	1.657	2.164
1996	1.820	1.865	1.651	2.285

Italy's trade intensity with:

	Belgium	France	Germany	Holland
1958	0.599	0.878	1.397	0.595
1959	0.669	1.252	1.539	0.665
1960	0.702	1.315	1.523	0.701
1961	0.699	1.368	1.578	0.650
1962	0.745	1.441	1.659	0.716
1963	0.869	1.531	1.609	0.767
1964	0.872	1.603	1.669	0.892
1965	0.851	1.567	1.616	1.001
1966	0.864	1.674	1.648	1.008
1967	0.963	1.776	1.640	0.990
1968	0.926	1.882	1.683	1.018
1969	0.882	1.961	1.682	0.958
1970	0.905	1.932	1.777	0.992
1971	0.891	2.009	1.784	0.948
1972	0.879	2.031	1.800	0.977
1973	0.878	2.017	1.732	0.968
1974	0.884	1.916	1.660	0.968
1975	0.841	1.891	1.643	0.961
1976	0.964	2.058	1.639	0.954
1977	0.882	2.073	1.598	0.874
1978	0.838	2.065	1.588	0.923
1979	0.864	2.025	1.579	0.968
1980	0.908	2.068	1.633	0.932
1981	0.940	2.156	1.719	1.000
1982	0.968	2.271	1.655	0.994
1983	0.993	2.306	1.696	1.052
1984	1.109	2.356	1.768	1.095
1985	1.121	2.323	1.756	1.134
1986	1.151	2.372	1.761	1.156
1987	1.172	2.366	1.765	1.099
1988	1.209	2.424	1.851	1.162
1989	1.202	2.417	1.799	1.176
1990	1.169	2.223	1.742	1.131
1991	1.177	2.220	1.786	1.160
1992	1.197	2.217	1.843	1.219
1993	1.136	2.283	2.005	1.213
1994	1.107	2.294	1.971	1.220
1995	1.094	2.323	1.954	1.201
1996	1.107	2.355	1.909	1.283

Netherlands trade intensity with:

	Belgium	France	Germany	Italy
1958	4.610	0.659	2.048	0.678
1959	4.521	0.802	2.132	0.672
1960	4.503	0.787	2.182	0.683
1961	4.721	0.868	2.185	0.674
1962	4.550	0.888	2.159	0.696
1963	4.452	0.995	2.319	0.767
1964	4.438	1.085	2.419	0.867
1965	4.309	1.132	2.295	0.945
1966	4.305	1.148	2.367	0.934
1967	4.352	1.212	2.423	0.933
1968	4.103	1.342	2.509	0.962
1969	3.790	1.413	2.475	0.938
1970	3.727	1.303	2.573	0.965
1971	3.671	1.304	2.514	0.935
1972	3.797	1.256	2.540	0.929
1973	3.628	1.233	2.474	0.921
1974	3.757	1.268	2.580	0.896
1975	3.673	1.281	2.556	0.894
1976	3.771	1.270	2.502	0.925
1977	3.624	1.284	2.488	0.876
1978	3.570	1.310	2.440	0.900
1979	3.598	1.263	2.398	0.868
1980	3.738	1.239	2.452	0.912
1981	4.409	1.422	2.827	0.992
1982	4.279	1.415	2.730	0.957
1983	4.196	1.476	2.793	0.976
1984	4.302	1.549	2.908	1.001
1985	4.466	1.533	2.859	0.987
1986	4.166	1.444	2.535	1.054
1987	4.136	1.422	2.437	1.018
1988	4.336	1.450	2.474	1.056
1989	4.288	1.476	2.474	1.026
1990	4.064	1.416	2.300	0.991
1991	4.108	1.417	2.396	1.008
1992	4.297	1.441	2.441	1.034
1993	3.629	1.533	2.678	1.046
1994	3.669	1.585	2.674	1.060
1995	3.515	1.588	2.613	1.014
1996	3.644	1.665	2.675	1.052

## NAFTA Trade Intensities

	Method 1	Method 2	Method 3
1960	1.449	2.005	2.014
1961	1.543	2.143	2.170
1962	1.552	2.154	2.194
1963	1.572	2.188	2.210
1964	1.607	2.237	2.271
1965	1.664	2.317	2.391
1966	1.655	2.298	2.407
1967	1.765	2.452	2.649
1968	1.769	2.453	2.683
1969	1.903	2.647	2.958
1970	1.846	2.575	2.765
1971	1.946	2.718	2.978
1972	1.994	2.788	3.079
1973	1.998	2.806	3.000
1974	1.916	2.695	2.788
1975	1.931	2.718	2.805
1976	1.921	2.702	2.792
1977	1.935	2.726	2.792
1978	1.901	2.679	2.719
1979	1.924	2.715	2.743
1980	1.928	2.726	2.722
1981	1.959	2.765	2.821
1982	1.968	2.780	2.820
1983	2.029	2.857	3.005
1984	1.871	2.616	2.787
1985	1.896	2.651	2.845
1986	1.877	2.635	2.736
1987	1.985	2.796	2.911
1988	1.957	2.752	2.872
1989	1.955	2.749	2.881
1990	2.111	2.979	3.149
1991	2.171	3.062	3.314
1992	2.201	3.102	3.397
1993	2.108	2.956	3.302
1994	2.191	3.073	3.504
1995	2.298	3.237	3.666
1996	2.321	3.264	3.778

## APPENDIX A2

### Definitions of regional groupings used in calculations

CUSFTA	Canada and United States of America
NAFTA	CUSFTA and Mexico
EU6	Belgium, France, Italy, Germany, Luxembourg and Netherlands
EU9	EU6, Denmark, Ireland and the United Kingdom
EU12	EU9, Greece, Portugal and Spain
EU15	EU12, Austria, Finland and Sweden
ASEAN	Brunei, Indonesia, Philippines, Malaysia, Singapore and Thailand
EAST ASIA	ASEAN and China, Hong Kong, Japan, Korea and Taiwan
APEC 15	East Asia, Canada, the United States of America, Australia and New Zealand
APEC18	APEC 15, Chile, Mexico and Papua New Guinea

## REFERENCES

- AGGARWAL, R. & L.A. SOENEN (1989) "Managing Persistent Real Changes in Currency Values", *Columbia Journal of World Business*, Vol. 24, Fall, 60-67.
- AHLUWALIA, M.S. (1994) "India's quiet revolution", *Columbia Journal of World Business*, Vol. 29, Spring, 6-12.
- AHO, C.M. (1994) "Fortress Europe: Will the EU Isolate Itself From North America and Asia", *Columbia Journal of World Business*, Vol. 29, Fall, 32-39.
- AKYÜZ, Y. (1995) "Taming International Finance", in J. Michie & J. Grieve Smith, eds., *Managing the Global Economy*, Oxford University Press, Oxford.
- ALIBER, R.Z. (1970) "A Theory of Direct Foreign Investment" in C.P. Kindleberger, ed., *The International Firm*, MIT Press, Cambridge, MA.
- ALIBER, R.Z. (1971) "The Multinational Enterprise in a Multiple Currency World" in J.H. Dunning, ed., *The Multinational Enterprise*, George Allen & Unwin, London.
- ANDERSON, K. (1993) "Anti-Dumping Laws in the United States—Use and Welfare Consequences", *Journal of World Trade*, Vol. 27, 99-117.
- ANDERSON, K. & R. BLACKHURST, eds. (1993) *Regionalism and the Global Trading System*, Harvester Wheatsheaf, London.
- ANDERSON, K. & H. NORHEIM (1993) "History, Geography and Regional Economic Integration", in K. Anderson & R. Blackhurst, eds., *Regionalism and the Global Trading System*, Harvester Wheatsheaf, London.
- AOKI, M. (1986) "Horizontal vs. Vertical Information Structure of the Firm", *American Economic Review*, Vol. 76, 971-983.
- APEC EMINENT PERSONS GROUP (1994) *Achieving the APEC Vision: Free and Open Trade in the Asia Pacific*, APEC, Singapore.
- BAKER, J. (1988) "The Geopolitical Implications of the US-Canada Trade Pact", *The International Economy*, Jan/Feb.
- BAIN, J.S. (1956) *Barriers to New Competition*, Harvard University Press, Cambridge, MA.
- BAIROCH, P. (1976) *Commerce extérieur et développement économique de l'Europe au XIXe siècle*, Mouton, Paris.
- BAIROCH, P. & R. KOZUL-WRIGHT (1996) "Globalization myths: some historical reflections on integration, industrialization and growth in the world economy", *UNCTAD Discussion Paper*, 113.
- BALASSA, B. (1961) *The Theory of Economic Integration*, Allen & Unwin, London.
- BALASSA, B. (1975) "Trade creation and diversion in the European common market", in B. Balassa, ed., *European Economic Integration*, North-Holland, Amsterdam.
- BALASSA, B. & L. BAUWENS (1988) "The determinants of intra-European trade in manufactured goods", *European Economic Review*, Vol. 32, 1421-1437.
- BALDWIN, R.E. (1948) "Equilibrium in International Trade: A Diagrammatic Analysis", *Quarterly Journal of Economics*, Vol. 62, 748-762.
- BALDWIN, R.E. (1969) "The Case Against Infant-Industry Tariff Protection", *Journal of Political Economy*, Vol. 77, 295-305.
- BALDWIN, R.E. (1982) *The inefficacy of trade policy*, Princeton University International Finance Section, Essays in International Finance No 150.
- BALDWIN, R.E. (1990) "The Growth Effects of 1992", *Economic Policy*, Vol. 4, 248-281.
- BALDWIN, R.E. & J.E. RICHARDSON, eds. (1991) *The Uruguay Round and Beyond: Problems and Prospects*, NBER Conference Report, NBER, Cambridge MA.
- BALDWIN, R.E. (1992a) "Assessing the fair trade and safeguards laws in terms of modern trade and political economy analysis", *The World Economy*, Vol. 15, 185-202.
- BALDWIN, R.E. (1992b) "Measurable Dynamic Gains From Trade", *Journal of Political Economy*, Vol. 100, 162-174.
- BALDWIN, R.E. (1993) "Adapting the GATT to a more regionalized world", in K. Anderson & R. Blackhurst, eds., *Regional Integration and the Global Trading System*, Harvester Wheatsheaf, London.
- BANK OF JAPAN (various issues) *Monthly Economic Statistics*, Bank of Japan, Tokyo.
- BANK FOR INTERNATIONAL SETTLEMENTS (1996) *Central Bank Survey of Foreign Exchange and Derivatives Market Activity 1995*, Bank for International Settlements, Basle.
- BARTLETT, C.A. & S. GHOSHAL (1989) *Managing Across Borders: The Transnational Solution*, Harvard Business School Press, Boston, MA.

- BARTOLINI, L. & G.M. BODNAR (1996) *Are Exchange Rates Excessively Volatile? And What Does "Excessively Volatile" Mean, Anyway?* Research Paper 9601, Federal Reserve Bank of New York.
- BAYARD, T. & K. ELLIOTT (1992) "Aggressive unilateralism and section 301: market opening or market closing?", *The World Economy*, Vol. 15, 685-705.
- BAYOUMI, T. & B. EICHENGREEN (1993) "Shocking aspects of European monetary integration", in F. Torres & F. Giavazzi, eds., *Adjustment and growth in the European Monetary Union*, Cambridge University Press, Cambridge.
- BEAN, C. (1992) "Economic and Monetary Union in Europe", *Journal of Economic Perspectives*, Vol. 6, 31-52.
- BELLO, J. & A.F. HOMER (1990) "The heart of the 1988 trade act: a legislative history of the amendments to section 301", in J. Bhagwati & H.T. Patrick, eds., *Aggressive Unilateralism: America's 301 Trade Policy and the World Trading System*, Harvester Wheatsheaf, Hemel Hempstead, Herts.
- BELOUS, R.S. & R.S. HARTLEY, eds. (1990) *The Growth of Regional Trading Blocs in the Global Economy*, National Planning Association, Washington, DC.
- BEN-DAVID, D. (1991) "Equalizing Exchange: A Study of the Effects of Trade Liberalization", *NBER Working Paper 3706*, NBER, Cambridge, MA.
- BERGLAS, E. (1983) "The Case for Unilateral Tariff Reductions: Foreign Tariffs Rediscovered", *American Economic Review*, Vol. 73, 1141-1142.
- BERGSTEN, C.F. & W.R. CLINE (1983) "Trade Policy in the 1980s: an Overview", in *Trade Policy in the 1980s*, C.F. Bergsten & W.R. Cline, eds., Institute for International Economics, Washington, DC.
- BERGSTEN, C.F. (1991) "Commentary", in *Policy Implications of Trade and Currency Zones*, Federal Reserve Bank of Kansas City.
- BERGSTEN, C.F. & M. NOLAND (1993a) *Pacific Dynamism and the International Economic System*, Institute for International Economics, Washington, DC.
- BERGSTEN, C.F. & M. NOLAND (1993b) *Reconcilable Differences? United States-Japan Economic Conflict*, Institute for International Economics, Washington, DC.
- BERGSTEN, C.F. (1994) "APEC and World Trade", *Foreign Affairs*, Vol. 73, May/June, 20-26.
- BERGSTEN, C.F. (1995) *APEC: The Bogor Declaration and the Path Ahead*, Institute for International Economics, Washington, DC.
- BERNAL, R.L. (1994) "From NAFTA to Hemisphere Free Trade", *Columbia Journal of World Business*, Vol. 29, Fall, 22-31.
- BERTRAND, T.J. & J. VANEK (1971) "The Theory of Tariffs, Taxes and Subsidies: Some Aspects of the Second Best", *American Economic Review*, Vol. 61, 925-931.
- BEST, M. (1990) *The New Competition*, Harvard University Press, Cambridge, MA.
- BHAGWATI, J. (1964) "The Pure Theory of International Trade: A Survey", *Economic Journal*, Vol. 74, 1-81.
- BHAGWATI, J. (1982) "Directly Unproductive, Profit-Seeking (DUP) Activities", *Journal of Political Economy*, Vol. 90, October, 988-1002.
- BHAGWATI, J. (1990) "Departures from Multilateralism: Regionalism and Aggressive Unilateralism", *Economic Journal*, Vol. 100, 1304-1317.
- BHAGWATI, J. & H.T. PATRICK, eds. (1990) *Aggressive Unilateralism: America's 301 Trade Policy and the World Trading System*, Harvester Wheatsheaf, Hemel Hempstead, Herts.
- BHAGWATI, J. (1991) *The World Trading System at Risk*, Harvester Wheatsheaf, Hemel Hempstead, Herts.
- BHAGWATI, J. (1992a) "The threats to the world trading system", *The World Economy*, Vol. 15, 443-456.
- BHAGWATI, J. (1992b) "Regionalism versus multilateralism", *The World Economy*, Vol. 15, 535-555.
- BHAGWATI, J. (1993) "Regionalism and Multilateralism: an Overview", in J. de Melo & A. Panagariya, eds., *New Dimensions in Regional Integration*, World Bank CEPR, Cambridge University Press, Cambridge.
- BHAGWATI, J., P. KRISHNA & A. PANAGARIYA, eds. (1999) *Trading Blocs*, MIT Press, Cambridge, MA.
- BLACKHURST, R. & D. HENDERSON (1993) "Regional integration agreements, world integration and the GATT", in K. Anderson & R. Blackhurst, eds., *Regionalism and the Global Trading System*, Harvester Wheatsheaf, London.



- BLEANEY, M. & D. GREENAWAY (1993) "Long-run trends in the relative of primary commodities and in the terms of trade of developing countries", *Oxford Economic Papers*, Vol. 45, 349-363.
- BLISS, C. (1994) *Economic Theory and Policy for Trading Blocks*, Manchester University Press, Manchester.
- BRANDER, J.A. & B.J. SPENCER (1981) "Tariffs and the Extraction of Foreign Monopoly Rents under Potential Entry", *Canadian Journal of Economics*, Vol. 14, No. 3, 371-389.
- BRANDER, J.A. & B.J. SPENCER (1984) "Tariff protection and imperfect competition", in H. Kierzkowski, ed., *Monopolistic Competition and International Trade*, Clarendon Press, Oxford.
- BRECHER, R.A. & J.N. BHAGWATI (1981) "Foreign Ownership and the Theory of Trade and Welfare", *Journal of Political Economy*, Vol. 89, 497-511.
- BROCK, W.A. & S.P. MAGEE (1978) "The Economics of Special Interest Politics: The Case of the Tariff", *American Economic Review, Papers and Proceedings*, Vol. 68, 246-250.
- BROWN, A.J. (1949) *Applied Economics: Aspects of the World Economy in War and Peace*, George Allen and Unwin, London.
- BRUNO, M. (1972) "Market Distortions and Gradual Reform", *Review of Economic Studies*, Vol. 39, 373-383.
- BUCHANAN, N.S. (1955) "Lines on the Leontief Paradox", *Economia Internazionale*, Vol. 8, 791-794.
- BUCKLEY, P.J. & M. CASSON (1985) *The Economic Theory of the Multinational Enterprise*, Macmillan, London.
- BUREAU OF ECONOMIC ANALYSIS (1995) *Survey of Current Business*, Department of Commerce, Washington, DC.
- CABLE, V. & D. HENDERSON, eds. (1994) *Trade Blocs? The Future of Regional Integration*, The Royal Institute of International Affairs, London.
- CABLE, V. (1994) "Overview", in V. Cable and D. Henderson, eds., *Trade Blocs? The Future of Regional Integration*, The Royal Institute of International Affairs, London.
- CAVES, R.E. (1976) "Economic Models of Political Choice: Canada's Tariff Structure", *Canadian Journal of Economics*, Vol. 9, 278-300.
- CECCHINI, P. (1988) *The European Challenge: 1992—The Benefits of a Single Market*, Wildwood House, Aldershot.
- CHARNOVITZ, S. (1993) "Environmentalism Confronts GATT Rules", *Journal of World Trade*, Vol. 28, 37-53.
- CHAUDHRY, P.E. & M.G. WALSH (1995) "Intellectual Property Rights: Changing Levels of Protection Under GATT, NAFTA and the EU", *Columbia Journal of World Business*, Vol. 30, Summer, 80-92.
- CHOATE, P. (1990) *Agents of Influence: How Japanese lobbyists are manipulating Western political and economic systems*, Business Books, London.
- CLARK, P.B. (1973) "Uncertainty, Exchange Risk, and the Level of International Trade", *Western Economic Journal*, 302-313.
- CLINE, W.R. (1978) "Benefits and Costs of Economic Integration in Central America", in W.R. Cline & C. Delgado, eds., *Economic Integration in Central America*, The Brookings Institution, Washington, DC.
- CLINE, W.R. & C. DELGADO, eds. (1978) *Economic Integration in Central America*, The Brookings Institution, Washington, DC.
- CLINE, W.R., ed. (1983) *Trade Policy in the 1980s*, Institute for International Economics, Washington, DC.
- COASE, R.H. (1937) "The nature of the firm", *Economica*, Vol. 4, 386-405.
- COLLIER, P. (1979) "The Welfare Effects of Customs Unions: an Anatomy", *Economic Journal*, Vol. 89, 84-95.
- COMMITTEE ON EXTERNAL RELATIONS (1992) *Report on Nafta*, Report to the European Parliament, Strasbourg, Nov.
- CONFEDERATION OF BRITISH INDUSTRY (1995) *Business in Europe*, CBI, London.
- CONYBEARE, J.A.C. (1987) *Trade Wars: The Theory and Practice of International Commercial Rivalry*, Columbia University Press, New York.
- CONYBEARE, J.A.C. & M. ZINKULA (1996) "Who Voted Against the NAFTA? Trade Unions Versus Free Trade", *World Economy*, Vol. 19, 1-12.
- COOPER, C.A. & B.F. MASSELL (1965) "A new look at customs unions theory", *Economic Journal*, Vol. 75, 742-747.

- CORDEN, W.M. (1972) "Economies of Scale and Customs Union Theory", *Journal of Political Economy*, Vol. 80, 465-475.
- CORDEN, W.M. (1974) *Trade Policy and Economic Welfare*, Oxford University Press, Oxford.
- CORDEN, W.M. (1976) "Customs Union Theory and nonuniformity of tariffs", *Journal of International Economics*, Vol. 6, 99-106.
- CORDEN, W.M. (1984) "The Normative Theory of International Trade", in R.W. Jones & P.B. Kenen, eds., *Handbook of International Economics*, North Holland, Amsterdam.
- COWHEY, P. & J. ARONSON (1992/3) "A New Trade Order" *Foreign Affairs*, Vol. 72, 183-195.
- CULBERT, J. (1987) "War-time Anglo-American talks and the making of the GATT", *The World Economy*, Vol. 10, 381-408.
- CUSHMAN, D. (1988) "Exchange Rate Uncertainty and Foreign Direct Investment in the United States", *Weltwirtschaftliches Archiv*, Vol. 124, 322-336.
- DASGUPTA, P.S. & J.E. STIGLITZ (1974) "Benefit-cost analysis and trade policies", *Journal of Political Economy*, Vol. 82, 1-33.
- DASGUPTA, S., A. MODY & S. SINHA (1995) *Japanese Multinationals in Asia: Capabilities and Motivations*, World Bank, mimeo.
- DEARDORFF, A.V. (1984) "Testing Trade Theories and Predicting Trade Flows", in R.W. Jones and P.B. Kenen, eds., *Handbook of International Economics*, North Holland, Amsterdam
- DE GRAUWE, P. (1994) *The Economics of Monetary Integration*, Oxford University Press, Oxford.
- DE LA TORRE, J. & M. KELLY (1992) "Regional Trade Arrangements", *Occasional Paper No. 93*, International Monetary Fund, Washington, DC.
- DE MELO, J., C. MONTENEGRO & A. PANAGARIYA (1992) "Regional Integration, Old and New", *Policy Research Working Paper 985*, World Bank, Washington, DC.
- DE MELO, J. & A. PANAGARIYA, eds. (1993) *New Dimensions in Regional Integration*, CEPR, Cambridge University Press, Cambridge.
- DE MELO, J., A. PANAGARIYA & D. RODRIK (1993) "The New Regionalism: A Country Perspective" in J. de Melo & A. Panagariya, eds., *New Dimensions in Regional Integration*, CEPR, Cambridge University Press, Cambridge.
- DESTLER, I.M. (1992) *American Trade Politics, 2nd edition*, Institute for International Economics, Washington, DC.
- DICKEN, P. (1992) *Global Shift: The Internationalization of Economic Activity, 2nd edition*, Chapman, London.
- DIXIT, A.K. & V. NORMAN (1980) *Theory of International Trade*, Cambridge University Press, Cambridge.
- DIXIT, A.K. & A.S. KYLE (1985) "The Use of Protection and Subsidies for Entry Promotion and Deterrence", *American Economic Review*, Vol. 75, 139-152.
- DOMINGUEZ, K.M. & J.A. FRANKEL (1993) *Does Exchange Rate Intervention Work?*, Institute for International Economics, Washington, DC.
- DORNBUSCH, R. (1989) "The Dollar in the 1990s: Competitiveness and the Challenges of New Economic Blocs", in *Monetary Policy Issues in the 1990s*, Federal Reserve Bank of Kansas City.
- DORNBUSCH, R. (1991) "Policy Options for Freer Trade: The Case for Bilateralism", in R.Z. Lawrence & C.L. Schultze, eds., *An American Trade Strategy: Options for the 1990s*, The Brookings Institution, Washington, DC.
- DOS SANTOS, T. (1970) "The Structure of Dependence", *American Economic Review*, Vol. 60, 231-236
- DOUGLAS, S.P. & Y. WIND (1987) "The Myth of Globalization", *Columbia Journal of World Business*, Vol. 22, Winter, 19-30.
- DROBNICK, R. (1992) "Economic Integration in the Pacific Region", *Technical Paper No.65*, OECD Development Centre, May, Paris.
- DRYSDALE, P. & R. GARNAUT (1982) "Trade intensities and the analysis of bilateral trade flows in a many country world: a survey", *Hitotsubashi Journal of Economics*, Vol 22, 62-84.
- DRYSDALE, P. & R. GARNAUT (1994) "Trade intensities and the analysis of bilateral trade flows in a many country world: a survey", in R. Garnaut & P. Drysdale, eds., *Asia Pacific Regionalism: Readings in International Economic Relations*, Harper Educational, Pymble, NSW, Australia.
- DRYSDALE, P. (1988) *International Economic Pluralism: Economic Policy in East Asia and the Pacific*, Columbia University Press, New York.
- DUNN, R.M. Jr. (1993) "Winners and Losers From NAFTA", in A.R. Riggs and T. Velk, eds., *Beyond NAFTA: An economic, political and sociological perspective*, The Fraser Institute, Vancouver.

- DUNNING, J.H. (1977) "Trade, Location of Economic Activity and the Multinational Enterprise: A Search for an Eclectic Approach" in B. Ohlin *et al.*, eds., *The International Allocation of Business Activity*, Macmillan, London.
- DUNNING, J.H. (1980) "Towards an Eclectic Theory of International Production", *Journal of International Business Studies*, Vol. 11, 9-31.
- DUNNING, J.H. & P. ROBSON, eds. (1988) *Multinationals and the European Community*, Basil Blackwell, Oxford.
- DUNNING, J.H. (1993a) *The Globalization of Business*, Routledge, London.
- DUNNING, J.H. (1993b) *Multinational Enterprises and the Global Economy*, Addison Wesley, Wokingham.
- EDEN, L. (1992) "Bringing the Firm Back In: Multinationals in IPE", *Millennium: Journal of International Studies*, Vol. 20, 197-224.
- EICHENGREEN, B. (1990) "One Money for Europe? Lessons from the US currency union", *Economic Policy*, April 118-87.
- EICHENGREEN, B. (1994) *International Currency Arrangements for the 21st Century*, The Brookings Institution, Washington, DC.
- EICHENGREEN, B. & D. IRWIN (1995) "Trade blocs, currency blocs and the reorientation of world trade in the 1930s", *Journal of International Economics*, Vol. 38, 1-24.
- EL-AGRAA, A.M. (1988) "The European Community", in A.M. El-Agraa, ed., *International Economic Integration*, Macmillan, London.
- EMERSON, M., D. GROS, A. ITALIANER, J. PISANI-FERRY & H REICHENBACH (1992) *One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union*, Oxford University Press, Oxford.
- EMMERIJ, L. (1992) "Globalization, Regionalization and World Trade", *Columbia Journal of World Business*, Vol. 27, Summer, 6-13.
- EMMOTT, B. (1993) *Japan's Global Reach*, Century Business, London.
- ENCARNATION, D. (1993) "A common evolution? A comparison of United States and Japanese Transnational corporations", *Transnational Corporations*, Vol. 2, No. 1, 7-31.
- EPAC (1995) "Tariff reform and economic growth", Economic Planning Advisory Commission, *Commission Paper*, 10, Canberra.
- ERZAN, R. & A. YEATS (1992) "Free Trade Agreements with the United States: What's in it for Latin America?", *Policy Research Working Paper 827*, World Bank, Washington, DC.
- ETHIER, W. (1982) "National and international returns to scale in the modern theory of international scale", *American Economic Review*, Vol. 72, 389-405.
- EUROSTAT (1997) *National Accounts*, Luxembourg.
- EVANS, P. & J. WALSH (1994) *The EIU Guide to the New GATT*, Economist Intelligence Unit, London.
- FATEMI, K. (1990) *The Maquiladora Industry: Economic Solution or Problem?*, Praeger, New York.
- FEDERAL RESERVE BANK OF DALLAS (1991) *North American Free Trade: Proceedings of a Conference*, June, Dallas.
- FEDERAL RESERVE BANK OF KANSAS CITY (1991) *Policy Implications of Trade and Currency Zones*, Jackson Hole, Wyoming.
- FELDSTEIN, M. (1991) "Does One Market Require One Money?", in *Policy Implications of Trade and Currency Zones*, Federal Reserve Bank of Kansas City.
- FELIX, D. (1995) "Financial globalization versus free trade: the case for the Tobin tax", *UNCTAD Discussion Paper*, 108.
- FIELEKE, N. (1992) "One Trading World, or Many: The Issue of Regional Trading Blocs", *New England Economic Review*, Federal Reserve Bank of Boston, May/June 3-20.
- FINGER, J.M. (1979) "Trade Liberalisation: A Public Choice Perspective", in R.C. Amacher, G. Haberler & T.D. Willett, eds., *Challenges to a Liberal International Economic Order*, America Enterprise Institute, Washington, DC.
- FINGER, J.M. (1993) *Antidumping: How it Works and Who Gets Hurt*, University of Michigan Press, Ann Arbor, Michigan.
- FINGER, J.M. & K.C. FUNG (1994) "Can Competition Policy Control 301?", *Policy Research Working Paper 1253*, World Bank, Washington, DC.
- FISHLOW, A. & S. HAGGARD (1992) *The United States and the Regionalisation of the World Economy*, OECD Development Centre, June, Paris.
- FOROUTAN, F. (1993) "Regional Integration in Sub-Saharan Africa: Past Experience and Future Prospects", in J. de Melo & A. Panagariya, eds., *New Dimensions in Regional Integration*, World Bank CEPR, Cambridge University Press, Cambridge.

- FRANCOIS, J.F. & C.R. SHIELLS (1992) *The Dynamic Effects of Trade Liberalization: A Survey*, US International Trade Commission, No 2608, Washington, DC.
- FRANK, A.G. (1967) *Capitalism and Underdevelopment in Latin America: historical studies of Chile and Brazil*, Monthly Press Review, New York.
- FRANKEL, J.A. & H.G. JOHNSON, eds. (1976) *The monetary approach to the Balance of Payments*, University of Toronto Press, London.
- FRANKEL, J.A. (1991) "Is a yen block forming in eastern Asia?", in Richard O'Brien, ed., *Finance and the International Economy 5*, Oxford University Press for the American Express Bank, Oxford.
- FRANKEL, J.A. & M. KAHLER, eds. (1993) *Regionalism and Rivalry: Japan and the U.S. in Pacific Asia*, University of Chicago Press, Chicago.
- FRANKEL, J.A., S-J. WEI & E. STEIN (1993) "Continental Trading Blocs: Natural of Supernatural?" *NBER Working Paper 4588*, NBER, Cambridge, MA.
- FRANKEL, J.A., S-J. WEI & E. STEIN (1994) *APEC and Regional Trading Arrangements in the Pacific*, Institute for International Economics, Washington, DC.
- FRIEDMAN, M. & A.J. SCHWARZ (1963) *A Monetary History of the United States 1867-1960*, Princeton University Press, Princeton.
- FRITSCH, W. (1992) "Latin America in a Changing Global Environment", *Technical Paper No 66*, OECD Development Centre, May, Paris.
- FRITSCH, W., ed. (1993) *Latin America in the Global Economy*, Northsouth Institute, Miami.
- FROEBEL, F., J. HEINRICHES & O. KREYE (1980) *The New International Division of Labour*, Cambridge University Press, Cambridge.
- FROOT, K.A., ed. (1993) *Foreign Direct Investment*, University of Chicago Press, Chicago.
- FUKUYAMA, F. (1992) *The End of History and the Last Man*, Free Press, New York.
- FUNABASHI, Y. (1988) *Managing the Dollar: From the Plaza to the Louvre*, Institute for International Economics, Washington, DC.
- GAGNON, J.E. (1993) "Exchange rate variability and the level of international trade", *Journal of International Economics*, Vol. 34, 269-287.
- GALLAROTTI, G. (1985) "Toward a Business Cycle Model of Tariffs", *International Organization*, Vol. 39, Winter, 155-187.
- GARNAUT, R. & P. DRYSDALE (1994) *Asia Pacific Regionalism: Readings in International Economic Relations*, Harper Educational, Pymble, NSW, Australia.
- GATT (1986) *The Text of the General Agreement of Tariffs and Trade*, GATT, Geneva.
- GATT (1992) *GATT: What It Is, What It Does*, GATT, Geneva.
- GATT (1992) *Annual Report*, GATT, Geneva.
- GENBERG, H. & F. NADAL DE SIMONE (1993) "Regional integration agreements and macroeconomic discipline" in K. Anderson & R. Blackhurst, eds., *Regional Integration and the Global Trading System*, Harvester Wheatsheaf, London.
- GERTLER, M.S. & E. SCHOENBERGER (1992) "Commentary. Industrial Restructuring and continental trading blocs: the European Community and North America", *Environment and Planning A*, Vol. 24, 2-10.
- GIBB, R. & W. MICHALAK, eds. (1994) *Continental Trading Blocs: The Growth of Regionalism in the World Economy*, John Wiley & Sons, Cirencester.
- GIBB, R. (1994) "Regionalism in the world economy", in R. Gibb & W. Michalak, eds., *Continental Trading Blocs: The Growth of Regionalism in the World Economy* John Wiley & Sons, Cirencester.
- GIAVAZZI, F. & A. GIOVANNINI (1990) *Limiting Exchange Rate Flexibility*, MIT Press, Cambridge, MA.
- GILBREATH, J. (1993) "Fish or Foul", *Hemisfile*, Nov/Dec, 10-11.
- GILPIN, R. (1987) *The Political Economy of International Relations*, Princeton University Press, Princeton, NJ.
- GLICK, R. & M. HUTCHINSON (1990) "Financial Liberalization in the Pacific Basin: Implications for Real Interest Rate Linkages", *Journal of the Japanese and International Economies*, Vol. 4, 36-48.
- GOODHART, C.A.E. (1995) "The political economy of monetary union", in P.B. Kenen, *Understanding Interdependence*, Princeton University Press, Princeton, NJ.
- GOWA, J. (1994) *Allies, Adversaries and International Trade*, Princeton University Press, Princeton, NJ.
- GRAHAM, E.M. & P.R. KRUGMAN (1993) "The Surge of Foreign Direct Investment in the 1980s", in K.A. Froot, ed., *Foreign Direct Investment*, University of Chicago Press, Chicago.

- GRAHAM, E.M. (1994) *Towards an Asia Pacific Investment Code*, Institute for International Economics, Washington, DC.
- GRAHAM, E.M. & N.T. ANZAI (1994) "The Myth of a *De Facto* Asian Economic Bloc: Japan's Foreign Direct Investment in East Asia", *Columbia Journal of World Business*, Vol. 29, Fall, 6-20.
- GRAHAM, E.M. & P.R. KRUGMAN (1995) *Foreign Direct Investment in the United States*, Institute for International Economics, Washington, DC.
- GRANT, W. (1993) "Pressure Groups and the European Community: An Overview", in S. Mazey & J. Richardson eds., *Lobbying in the European Community*, Oxford University Press, Oxford.
- GREENAWAY, D. (1988) "Intra-Industry Trade, Intra-Firm Trade and European Integration: Evidence, Gains and Policy Aspects", in J.H. Dunning & P. Robson, eds., *Multinationals and the European Community*, Basil Blackwell, Oxford.
- GREENAWAY, D. (1989) "Regional Trading Arrangements and Intra-Industry Trade: Evidence and Policy Issues", in D. Greenaway et al., eds., *Economic Aspects of Regional Trading Arrangements*, New York University Press, New York.
- GREENAWAY, D., T. HYCLAK, & R.J. THORNTON, eds. (1989) *Economic Aspects of Regional Trading Arrangements*, New York University Press, New York.
- GRINOLS, E.L. (1981) "An extension of the Kemp-Wan theorem on the formation of customs unions", *Journal of International Economics*, Vol. 11, 259-266.
- GROSSMAN, G. (1992) *Imperfect Competition and International Trade*, MIT Press, Cambridge, MA.
- GROSSMAN, G. & E. HELPMAN (1995) "The Politics of Free-Trade Agreements", *American Economic Review*, Vol. 84, 667-690.
- GRUBEL, H.G. (1968) "Internationally Diversified Portfolios: Welfare Gains and Capital Flows", *American Economic Review*, Vol. 58, 1299-1314.
- GRUBEN, W.C. & J.H. WELCH (1994) "Is NAFTA Economic Integration?", *Federal Reserve Bank of Dallas Economic Review*, 35-48.
- GRUNWALD, J. & K. FLAMM (1985) *The Global Factory: Foreign Assembly in International Trade*, The Brookings Institution, Washington, DC.
- GUJARATI, D.N. (1988) *Basic Econometrics*, McGraw Hill, New York.
- GWYNNE, R. (1994) "Regional Integration in Latin America: the revival of a concept?" in R. Gibb & W. Michalak, eds., *Continental Trading Blocs: The Growth of Regionalism in the World Economy* John Wiley & Sons, Cirencester.
- HAAS, E.B. (1964) *Beyond the Nation State: Functionalism and International Organization*, Stanford University Press, Stanford, CA.
- HAN, S-T. (1992) *European Economic Integration: The Impact on Asian Newly Industrialising Economies*, OECD Development Centre, Paris.
- HABERLER, G. (1936) *The Theory of International Trade*, William Hodge & Co., London.
- HANLON, P. (1996) *Global Airlines: Competition in a Transnational Industry*, Butterworth Heinemann, Oxford.
- HARRIS, R.G. (1985) "Summary of a Project on the General Equilibrium Evaluation of Canadian Trade Policy", in *Canada—United States Free Trade*, J. Whalley, ed., University of Toronto Press, Toronto.
- HAUS, L.A. (1992) *Globalizing the GATT: the Soviet Union's Successor States, Eastern Europe and the International Trading System*, The Brookings Institution, Washington, DC.
- HECKSCHER, E.F. (1935) *Mercantilism*, George Allen & Unwin, London.
- HELLEINER, E. (1994) *States and the Reemergence of Global Finance*, Cornell University Press, London.
- HELLEINER, G.K. (1977) "Transnational Enterprises and the New Political Economy of U.S. Trade Policy", *Oxford Economic Papers*, Vol. 29, 102-116.
- HELPMAN, E. & A. RAZIN (1978) *A Theory of International Trade Under Uncertainty*, Academic Press, New York.
- HELPMAN, E. (1984) "A Simple Theory of International Trade with Multinational Corporations", *Journal of Political Economy*, Vol. 92, 451-471.
- HELPMAN, E. & P.R. KRUGMAN (1985) *Market Structure and Foreign Trade*, MIT Press, Cambridge, MA.
- HELPMAN, E. & P.R. KRUGMAN (1989) *Trade Policy and Market Structure*, MIT Press, Cambridge, MA.

- HENDERSON, D. (1994) "Putting 'Trade Blocs' Into Perspective", in V. Cable & D. Henderson, eds., *Trade Blocs? The Future of Regional Integration*, The Royal Institute of International Affairs, London.
- HERRING, R.J. & R.E. LITAN (1995) *Financial Regulation in the Global Economy*, The Brookings Institution, Washington, DC.
- HINDLEY, B. & P.A. MESSERLIN (1993) "Guarantees of market access and regionalism", in K. Anderson & R. Blackhurst, eds., *Regionalism and the Global Trading System*, Harvester Wheatsheaf, London.
- HOLDER, R. (1994) "The West Pacific Rim", in R. Gibb & W. Michalak, eds., *Continental Trading Blocs: The Growth of Regionalism in the World Economy* John Wiley & Sons, Cirencester.
- HOPKINSON, N., ed. (1992) "Completing the GATT Uruguay Round, Renewed Multilateralism or a World of Regional Trading Blocs?" *Wilton Park Paper No 61*, HMSO, London.
- HOFFMEYER, E. (1958) "The Leontief Paradox Critically Examined", *Manchester School of Economic and Social Studies*, Vol. 26, 160-179.
- HOLDER, R. (1994) "The West Pacific Rim" in R. Gibb & W. Michalak, eds., *Continental Trading Blocs: The Growth of Regionalism in the World Economy* John Wiley & Sons, Cirencester.
- HOUTHAKKER, H.S. (1957) "An International Comparison of Household Expenditure Patterns, Commemorating the Centenary of Engel's Law", *Econometrica*, Vol. 52, 532-551.
- HUDEC, R.E. (1990) "Thinking about the New Section 301: Beyond Good and Evil", in J. Bhagwati & H.T. Patrick, *Aggressive Unilateralism: America's 301 Trade Policy and the World Trading System*, Harvester Wheatsheaf, Hemel Hempstead, Herts.
- HUFBAUER, G.C. (1989) *The Free Trade Debate: Reports of the Twentieth Century Fund Task Force on the Future of American Trade Policy*, Priority Press, New York.
- HUFBAUER, G.C. ed. (1990a) *Europe 1992: an American Perspective*, The Brookings Institution, Washington, DC.
- HUFBAUER, G.C. (1990b) "An Overview" in G.C. Hufbauer, ed., *Europe 1992: an American Perspective*, The Brookings Institution, Washington, DC.
- HUFBAUER, G.C. & J.J. SCHOTT (1992) *North American Free Trade: Issues and Recommendations*, Institute for International Economics, Washington, DC.
- HUFBAUER, G.C. & J.J. SCHOTT (1993) *NAFTA: An Assessment*, Institute for International Economics, Washington, DC.
- HUFBAUER, G.C. & J.J. SCHOTT (1994) *Western Economic Integration*, Institute for International Economics, Washington, DC.
- HULL, R. (1993) "Lobbying Brussels: A View from Within", in S. Mazey & J. Richardson eds., *Lobbying in the European Community*, Oxford University Press, Oxford.
- HUNTER, J. (1984) *Concise Dictionary of Modern Japanese History*, California University Press, London.
- HYMER, S.H. (1976) *The International Operations of National Firms*, Lexington Books, Lexington, MA.
- INTERNATIONAL MONETARY FUND (1984) "Exchange Rate Volatility and World Trade", *Occasional Paper No 28*, International Monetary Fund, Washington, DC.
- INTERNATIONAL MONETARY FUND (1993) *Balance of Payments Manual*, IMF, Washington, DC.
- INTERNATIONAL MONETARY FUND (various issues) *International Financial Statistics*, IMF, Washington, DC.
- INTERNATIONAL MONETARY FUND (various issues) *Balance of Payments Yearbook*, IMF, Washington, DC.
- INTERNATIONAL MONETARY FUND (various issues) *Direction of Trade Statistics Yearbook*, IMF, Washington, DC.
- IRWIN, D.A. (1990) "Free Trade at Risk? An Historical Perspective", *International Finance Discussion Papers*, Board of Governors of the Federal Reserve System, Washington, DC.
- IRWIN, D.A. (1993a) "Multilateral and bilateral trade policies in the world trading system: an historical perspective", in J. de Melo & A. Panagariya, eds., *New Dimensions in Regional Integration*, CEPR, Cambridge University Press, Cambridge.
- IRWIN, D.A. (1993b) "The GATT's Contribution to Economic Recovery in Post-war Western Europe", *International Finance Discussion Papers*, Board of Governors of the Federal Reserve System, Washington, DC.
- JACKSON, J.H. (1990) *Restructuring the GATT System*, Royal Institute of International Affairs, London.
- JACKSON, J.H. (1992) "Reflections on the Implications of NAFTA for the World Trading System", *Columbia Journal of Transnational Law*, Vol. 30, 501-511.

- JOHNSON, C. (1982) *MITI and the Japanese Miracle*, Stanford University Press, Stanford, CA.
- JOHNSON, H.G. (1965) "An economic theory of protectionism, tariff bargaining and the formation of customs unions", *Journal of Political Economy*, Vol. 73, 256-283.
- JOHNSON, H.G. (1967) "Optimum Tariffs and Retaliation", in H.G. Johnson, ed., *International Trade and Economic Growth*, George Allen & Unwin, London.
- JONES, R.W. & P.B. KENEN (1984) *Handbook of International Economics*, North Holland, Amsterdam.
- JONUNG, L. (1984) "Swedish Experience under the Classical Gold Standard, 1873-1914", in M.D. Bordo & A.J. Schwartz, eds., *A Retrospective of the Classical Gold Standard, 1821-1931*, University of Chicago Press, Chicago.
- JOVANOVIĆ, M.N. (1992) *International Economic Integration*, Routledge, London.
- KAHLER, M. (1995) *International Institutions and the Political Economy of Integration*, The Brookings Institution, Washington, DC.
- KATRAK, H. (1977) "Multi-National Monopolies and Commercial Policy", *Oxford Economic Papers*, Vol. 29, 283-291.
- KELLY, M., et al. (1992) *Issues and Developments in International Trade Policy*, International Monetary Fund, Washington, DC.
- KEMP, M.C. (1962) "The Gain From International Trade", *Economic Journal*, Vol. 72, 803-819.
- KEMP, M.C. & T. NEGISHI (1970) "Variable Returns to Scale, Commodity Taxes, Factor Market Distortions and their Implications for Trade Gains", *Swedish Journal of Economics*, Vol. 72, 1-11.
- KEMP, M.C. & H.Y. WAN (1976) "An elementary proposition concerning the formation of customs unions", *Journal of International Economics*, Vol. 6, 95-97.
- KENEN, P.B. (1969) "The theory of optimum currency areas: an eclectic view", in R.A. Mundell & A.K. Swoboda, eds., *Monetary Problems of the International Economies*, Chicago University Press, Chicago.
- KENEN, P.B., ed. (1995) *Understanding Interdependence*, Princeton University Press, Princeton, NJ.
- KENNEDY, C. (1992) "Relations between transnational corporations and Governments of host countries: a look to the future", *Transnational Corporations*, Vol. 1, No. 1, 67-91.
- KENNEDY, P. (1979) *A Guide to Econometrics*, Martin Robertson, Oxford.
- KENNEDY, P. (1987) *The Rise and Fall of the Great Powers*, Random House, New York.
- KIERZKOWSKI, H., ed. (1984) *Monopolistic Competition and International Trade*, Clarendon Press, Oxford.
- KINDLEBERGER, C.P. (1969) *American Business Abroad*, Yale University Press, New Haven.
- KINDLEBERGER, C.P. (1973) *The World in Depression 1929-1939*, Allen Lane, The Penguin Press, London.
- KINDLEBERGER, C.P. (1975) "The rise of free trade in Western Europe", *The Journal of Economic History*, Vol. 35, 110-134.
- KNICKERBOCKER, F. (1973) *Oligopolistic Reaction and Multinational Enterprise*, Harvard University Press, Cambridge, MA.
- KIRMANI, N., et al. (1994a) *International Trade Policies: The Uruguay Round and Beyond, Volume I. Principal Issues*, International Monetary Fund, Washington, DC.
- KIRMANI, N., et al. (1994b) *International Trade Policies: The Uruguay Round and Beyond, Volume II. Background Papers*, International Monetary Fund, Washington, DC.
- KOBRIN, S.J. (1995) "Regional integration in a globally networked economy", *Transnational Corporations*, Vol. 4, No. 2, 15-33.
- KOJIMA, K. (1964) "The Pattern of International Trade Among Advanced Countries" *Hitotsubashi Journal of Economics*, Vol. 5, 16-36.
- KOJIMA, K. (1973) "A Macroeconomic Approach to Foreign Direct Investment", *Hitotsubashi Journal of Economics*, Vol. 14, 1-21.
- KOJIMA, K. (1978) *Direct Foreign Investment: A Japanese Model of Multinational Business Operations*, Croon Helm, London.
- KOZUL-WRIGHT (1995) "Transnational Corporations and the Nation State", in J. Michie & J. Grieve Smith, eds., *Managing the Global Economy*, Oxford University Press, Oxford.
- KRASNER, S.D. (1976) "State Power and the Structure of International Trade", *World Politics*, Vol. 28, 317-343.
- KRASNER, S.D. (1983) *International Regimes*, Cornell University Press, Ithaca, NY.
- KRISHNA, P. (1998) "Regionalism and Multilateralism: A Political Economy Approach", in J. Bhagwati, P. Krishna & A. Panagariya, eds., *Trading Blocs*, MIT Press, Cambridge, MA.

- KRUEGER A.O. & H. SONNENSCHNEIN (1967) "The Terms of Trade, the Gains from Trade, and Price Divergence", *International Economic Review*, Vol. 8, 121-127.
- KRUEGER, A.O. (1974) "The political economy of the rent-seeking society", *American Economic Review*, Vol. 64, 291-303.
- KRUEGER, A.O. (1984) "Trade Policies in Developing Countries", in R.W. Jones & P.B. Kenen, eds., *Handbook of International Economics*, North Holland, Amsterdam.
- KRUEGER, A.O. (1992) "Trade prospects for the developing countries", *The World Economy*, Vol. 15, 457-474.
- KRUGMAN, P.R. (1979) "Increasing Returns, Monopolistic Competition and International Trade", *Journal of International Economics*, Vol. 9, 469-479.
- KRUGMAN, P.R. (1980) "Scale economies, product differentiation and the pattern of trade", *American Economic Review*, Vol. 70, 950-959.
- KRUGMAN, P.R. (1983) "New theories of trade among industrial economies", *American Economic Review*, Vol. 73, 343-347.
- KRUGMAN, P.R. (1984) "Import protection as export promotion: international competition in the presence of oligopoly and economies of scale", in H. Kierzkowski, ed., *Monopolistic Competition and International Trade*, Clarendon Press, Oxford.
- KRUGMAN, P.R., ed. (1986) *Strategic Trade Policy and the New International Economics*, MIT Press, Cambridge, MA.
- KRUGMAN, P.R. (1989) *Exchange Rate Instability*, MIT Press, Cambridge, MA.
- KRUGMAN, P.R. (1990) "Increasing Returns and Economic Geography", *National Bureau of Economic Research, Working Paper Series No. 3245*, NBER, Cambridge, MA.
- KRUGMAN, P.R. (1991a) "The Move Toward Free Trade Zones" in *Policy Implications of Trade and Currency Zones*, Federal Reserve Bank of Kansas City.
- KRUGMAN, P.R. (1991b) *Geography and Trade*, MIT Press, Cambridge, MA.
- KRUGMAN, P.R. (1995) "What Do We Need to Know about the International Monetary System?" in P.B. Kenen, ed., *Understanding Interdependence*, Princeton University Press, Princeton, NJ.
- KUZNETS, S. (1959) *Economic Growth*, The Free Press of Glencoe, Illinois.
- KUZNETS, S. (1966) *Modern Economic Growth*, The Colonial Press, Clinton, MA.
- LAIRD, S. & A. YEATS (1990b) "Trends in Non-Tariff Barriers of Developed Countries", *Weltwirtschaftliches Archiv*, Vol. 126, 299-325.
- LAIRD, S. & A. YEATS (1990b) *Quantitative Methods for Trade Barrier Analysis*, New York University Press, New York.
- LAKE, D.A. (1991) "British and American Hegemony Compared: Lessons for the Current Era of Decline", in M. Fry, ed. *History, the White House and the Kremlin: Statesmen as Historians*, Pinter Publishers, London.
- LANGHAMMER, R. & U. HIEMENZ (1991) "Regional Integration among Developing Countries: Survey of Past Performance and Agenda for Future Policy Action", *UNDP-World Bank Trade Expansion Program Occasional Paper 7*, Trade Policy Division, World Bank, Washington, DC.
- LARDY, N. (1994) *China and the World Economy*, Institute for International Economics, Washington, DC.
- LAWRENCE, R.Z. & C.L. SCHULTZE, eds. (1990) *US Trade Strategy: Options for the 1990s*, The Brookings Institution, Washington, DC.
- LAWRENCE, R.Z. (1991a) "Scenarios for the World Trading System and their Implications for Developing Countries", *Technical Paper No 47*, OECD Development Centre, Nov, Paris.
- LAWRENCE, R.Z. (1991b) "Emerging regional arrangements: building blocks or stumbling blocks?" in Richard O'Brien, ed., *Finance and the International Economy 5*, Oxford University Press for the American Express Bank, Oxford.
- LAWRENCE, R.Z. (1996) *Regionalism, multilateralism and deeper integration*, The Brookings Institution, Washington, DC.
- LEAMER, E.E. (1980) "The Leontief Paradox, Reconsidered", *Journal of Political Economy*, Vol. 88, 495-503.
- LEAMER, E.E. (1992) "Wage effects of a U.S.-Mexican Free Trade Agreement", *NBER Working Paper 3391*, NBER, Cambridge, MA.
- LEE, Y.S. (1989) "A study of the determinants of intra-industry trade among the Pacific Basin countries", *Weltwirtschaftliches Archiv*, Vol. 125, 346-358.
- LEONTIEF, W.W. (1954) "Domestic Production and Foreign Trade: The American Capital Position Re-examined" in R.E. Caves & H.G. Johnson, *Readings in International Economics*, (1968) Irwin, Homewood, Ill.



- LEONTIEF, W.W. (1956) "Factor Proportions and the Structure of American Trade: Further Theoretical and Empirical Analysis", *Review of Economics and Statistics*, Vol. 38, 386-407.
- LERNER, A.P. (1936) "The Symmetry Between Import and Export Taxes", *Economica*, Vol. 3, 306-313.
- LEUTWILER, F. (1985) *Trade Policies for a Better Future*, GATT, Geneva.
- LEVY, P.I. (1997) "A Political-Economic Analysis of Free-Trade Agreements", in J. Bhagwati, P. Krishna and A. Panagariya, eds. *Trading Blocs*, MIT Press, Cambridge, MA.
- LINDEMANN, H. (1966) *An Econometric Study of International Trade Flows*, North Holland, Amsterdam.
- LIPSEY, R.G. & K.J. LANCASTER (1956-57) "The general theory of second best", *Review of Economic Studies*, Vol. 24.
- LIPSEY, R.G. (1957) "The theory of customs unions: trade diversion and welfare", *Economica*, Vol. 24, 40-46.
- LIPSEY, R.G. (1960), "The theory of customs unions: a general survey", *Economic Journal*, Vol. 70, 496-513.
- LIPSEY, R.G., D. SCHWANEN, & R.J. WONNACOTT (1994) *The NAFTA: What's In, What's Out, What's Next*, Policy Study 21, C.D. Howe Institute, Toronto.
- LIST, F. (1837) *The Natural System of Political Economy*, Frank Cass, London (1983).
- LIST, F. (1841) *The National System of Political Economy*, J.B. Lippincott, Philadelphia, PA (1856).
- LLOYD, P.J. (1992) "Regionalisation and World Trade", *OECD Economic Studies*, No 18, Spring, Paris.
- LLOYD, P.J. (1993) "A Tariff Substitute for Rules of Origin in Free Trade Areas", *The World Economy*, Vol. 16, 6-12.
- LORENZ, D. (1992) "Economic Geography and the Political Economy of Regionalisation: The Example of Western Europe", *American Economic Review*, AEA Review Papers and Proceedings.
- LUDLOW, P. (1982) *The making of the European Monetary System*, Butterworth, London.
- LUSTIG, N., B. BOSWORTH & R.Z. LAWRENCE, eds. (1992) *North American Free Trade: Assessing the Impact*, The Brookings Institution, Washington, DC.
- McCLOSKEY, D.N. (1980) "Magnanimous Albion: Free Trade and British National Income", *Explorations in Economic History*, Vol. 17, 303-320.
- McCONNELL, J. & A. MacPHERSON (1994) "The North American Free Trade Area: an overview of issues and prospects" in R. Gibb & W. Michalak, eds., *Continental Trading Blocs: The Growth of Regionalism in the World Economy*, John Wiley & Sons, Cirencester.
- McKEOWN, T.J. (1984) "Firms and Tariff Regime Change: Explaining the Demand for Protection", *World Politics*, Vol. 36, 215-233.
- McKINNON, R.I. (1963) "Optimal Currency Areas", *American Economic Review*, Vol. 53, 717-724.
- McMILLAN, J. (1993) "Does regional integration foster open trade? Economic theory and GATT's Article XXIV", in K. Anderson & R. Blackhurst, eds., *Regionalism and the Global Trading System*, Harvester Wheatsheaf, London.
- MADDISON, A. (1982), *Phases of Capitalist Development*, Oxford University Press, Oxford.
- MAGEE, S.P. (1977) "Three Simple Tests of the Stolper-Samuelson Theorem", *Working Paper 77-28*, Bureau of Business Research, University of Texas-Austin, Austin, TX.
- MAGEE, S.P., W.A. BROCK, & L. YOUNG (1989) *Black Hole Tariffs and Endogenous Policy Theory: Political Economy in General Equilibrium*, Cambridge University Press, Cambridge.
- MAKOWER, H. & G. MORTON (1953) "A contribution towards a theory of customs unions" *Economic Journal*, Vol. 62, 33-49.
- MANSFIELD, E.D. & H.V. MILNER, eds. (1997) *The Political Economy of Regionalism*, Columbia University Press, New York
- MARKIDES, C. & N. BERG (1988) "Manufacturing Offshore is Bad Business" *Harvard Business Review*, Vol. 66, Sept-Oct., 113-119.
- MARKUSEN, J.R. & J.R. MELVIN, (1981) "Trade, Factor Prices, and the Gains from Trade with Increasing Returns to Scale", *Canadian Journal of Economics*, Vol. 14, 450-469.
- MARKUSEN, J.R. (1981) "Trade and the Gains from Trade with Imperfect Competition", *Journal of International Economics*, Vol. 11, 531-555.
- MARKUSEN, J.R. (1984) "Multinationals, Multi-Plant Economies, and the Gains from Trade", *Journal of International Economics*, Vol. 16, 205-226.

- MATYAS, L. (1997) "Proper Econometric Specification of the Gravity Model", *The World Economy*, Vol. 20, 363-368.
- MAZEY, S. & J. RICHARDSON, eds. (1993) *Lobbying in the European Community*, Oxford University Press, Oxford.
- MEADE, J.E. (1955) *The theory of customs unions*, North Holland, Amsterdam.
- MICHALAK, W. (1994) "The Political Economy of Trading Blocs" in R. Gibb & W. Michalak, eds., *Continental Trading Blocs: The Growth of Regionalism in the World Economy*, John Wiley & Sons, Cirencester.
- MICHALAK, W. (1994) "Regional Integration in eastern Europe" in R. Gibb & W. Michalak, eds., *Continental Trading Blocs: The Growth of Regionalism in the World Economy*, John Wiley & Sons, Cirencester.
- MICHIE, J. & J. GRIEVE SMITH, eds. (1995) *Managing the Global Economy*, Oxford University Press, Oxford.
- MILLER, R. (1993) "Determinants of US Manufacturing Investment Abroad" *Finance and Development*, World Bank/IMF, Washington, DC.
- MILNER, H. (1988) *Resisting Protectionism: Global Industries and the Politics of International Trade*, Princeton University Press, Princeton, NJ.
- MILNER, H. (1990) "The Political Economy of US Trade Policy: A Study of the Super 301 Provision", in J. Bhagwati & H.T. Patrick, *Aggressive Unilateralism: America's 301 Trade Policy and the World Trading System*, Harvester Wheatsheaf, Hemel Hempstead, Herts.
- MILNER, H. (1997) "Industries, Governments and Regional Trade Blocs" in E. Mansfield & H. Milner, eds., *The Political Economy of Regionalism*, Columbia University Press, New York.
- MILWARD, A.S. (1992) *The European Rescue of the Nation-State*, Routledge, London
- MINHAS, B.S. (1963) *An International Comparison of Factor Costs and Factor Use*, North Holland, Amsterdam.
- MINISTRY OF FINANCE (1996) *Annual Report of the International Finance*, Government Printing Office, Tokyo.
- MINISTRY OF FINANCE (1997) *Balance of Payments Annual*, Government Printing Office, Tokyo.
- MORAVCSIK, A. (1993) "Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach", *Journal of Common Market Studies*, Vol. 31, 473-524.
- MORAWETZ, D. (1974) *The Andean Group: A Case Study in Economic Integration Among Developing Countries*, MIT Press, Cambridge, MA.
- MUNDELL, R.A. (1957) "International Trade and Factor Mobility", *American Economic Review*, Vol. 47, June, 321-335.
- MUNDELL, R.A. (1961) "The theory of optimum currency areas", *American Economic Review*, September, 657-665.
- MUNDELL, R.A. & A.K. SWOBODA, eds. (1969) *Monetary Problems of the International Economies*, Chicago University Press, Chicago.
- MYTELKA, L., ed. (1991) *Strategic Partnerships: States, Firms and International Competition*, Pinter Publishers, London.
- MYTELKA, L., ed. (1994) *South-South Co-operation in a Global Perspective*, OECD Development Centre, Paris.
- NESTER, W.R. (1990) *Japan's Growing Power Over East Asia and the World Economy*, Macmillan, London.
- NOGUES, J.J. & R. QUINTANILLA (1993) "Latin America's integration and the multilateral trading system", in J. de Melo & A. Panagariya, eds., *New Dimensions in Regional Integration*, World Bank CEPR, Cambridge University Press, Cambridge.
- O'BRIEN, R. (1992) *Global Financial Integration: The End of Geography*, Pinter Publishers, London.
- OECD (1988) *The Newly Industrialising Countries—Challenges and Opportunities for OECD Countries*, OECD, Paris.
- OECD (1990) *Recent Developments in Regional Trading Arrangements Among OECD Countries: Main Implications for Third Countries and the Multilateral Trading System*, Trade Committee, OECD, Paris.
- OECD (1994) *The Performance of Foreign Affiliates in OECD Countries*, OECD, Paris.
- OECD (1995) *Regional Integration and the Multilateral Trading System: Synergy and Divergence*, OECD, Paris.
- OECD (1997a) *International Direct Investment Statistics Yearbook*, OECD, Paris.
- OECD (1997b) *Activities of Foreign Affiliates in OECD Countries*, OECD, Paris.
- OHLIN, B. (1933) *Interregional and International Trade*, Harvard University Press, Cambridge, MA.

- OHMAE, K. (1985) *Triad Power: The Coming Shape of Global Competition*, Free Press, New York.
- OHMAE, K. (1990) *The Borderless World: Power and Strategy in the Interlinked Economy*, Harper Perennial, New York.
- OHYAMA, M. (1972) "Trade and Welfare in General Equilibrium", *Keio Economic Studies*, Vol. 9, 37-73.
- OKWUIZUMI, K., K.E. CALDER & G.W. GONG, eds. (1992) *The US-Japan Economic Relationship in East and Southeast Asia*, Centre for Strategic and International Studies, Washington, DC.
- OLSON, M. (1965) *The Logic of Collective Action*, Harvard University Press, Cambridge, MA.
- OLSON, M. (1982) *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*, Yale University Press, New Haven.
- OMAN, C. (1994) *Globalisation and Regionalisation: The Challenge for Developing Countries*, OECD Development Centre, Paris.
- OSTRY, S. (1990) *Governments and Corporations in a Shrinking World: Trade and Innovation Policies in the United States, Europe and Japan*, Council on Foreign Relations Press, New York.
- OSTRY, S. & R.R. NELSON (1995) *Techno-Nationalism and Techno-Globalism: Conflict and Cooperation*, The Brookings Institution, Washington, DC.
- OXLEY, A. (1990) *The Challenge of Free Trade*, Harvester Wheatsheaf, Worcester.
- PAGE, S. (1992) "Some Implications of Europe 1992 for Developing Countries", *Technical Paper No 60*, OECD Development Centre, April, Paris.
- PAGE, S. (1996) *Intensity Measures for Regional Groups*, Paper Prepared for EADI 8th General Conference, Vienna, World Trade Working Group, ODI, London.
- PALMETER, D. (1993) "Rules of origin in customs unions and free trade areas", in K. Anderson & R. Blackhurst, eds., *Regionalism and the Global Trading System*, Harvester Wheatsheaf, London.
- PANAGARIYA, A. & R. FINDLAY (1994) "A Political Economy Analysis of Free Trade Areas and Customs Unions", *Policy Research Working Paper 1261*, World Bank, Washington, DC.
- PANIC, M. (1991) "The impact of multinationals on national economic policies" in B. Bürgermeier & J.L. Mucchielli, eds., *Multinationals and Europe 1992*, Routledge, London.
- PARRA, A.R. (1995) "The scope of new investment laws and international instruments", *Transnational Corporations*, Vol. 4, No. 3, 27-48.
- PATTERSON, G. (1983) "The European Community as a Threat to the System" in W.R. Cline, ed., *Trade Policy in the 1980s*, Institute for International Economics, Washington, DC.
- PATTERSON, G. (1989) "Implications for the GATT and the world trading system", in J. Schott, ed., *Free Trade Areas and US Policy*, Institute for International Economics, Washington, DC.
- PEREZ NUNEZ, W. (1990) "From Globalization to Regionalization: The Mexican Case", *Technical Paper No 24*, OECD Development Centre, August, Paris.
- PERRONI, C. & J. WHALLEY (1996) "How Severe is Global Retaliation Risk under Increasing Regionalism?", *American Economic Review*, Vol. 86, 57-61.
- PERLMUTTER, H. (1969) "The tortuous evolution of the multinational enterprise", *Columbia Journal of World Business*, Vol. 4, 9-18.
- PETRI, P. (1994) "The East Asian Trading Bloc: An Analytical History", in R. Garnaut & P. Drysdale, eds., *Asia Pacific Regionalism: Readings in International Economic Relations*, Harper Educational, Pymble, NSW, Australia.
- PINDER, J. (1991) *European Community: The Building of a Union*, Oxford University Press, Oxford.
- PIORE, M.J. & C. SABEL (1980) *The Second Industrial Divide*, Basic Books, New York.
- POLAK, J.J. (1996) "Is APEC a Natural Regional Trading Bloc? A Critique of the 'Gravity Model' of International Trade", *The World Economy*, Vol. 19, 533-543.
- PREEG, E.M. (1989) "The GATT trading system in transition: an analytical survey of recent literature", *The Washington Quarterly*, 12, 201-213.
- PREEG, E.M. (1992) "The US leadership role in world trade: past, present and future", *The Washington Quarterly*, 15, 81-91.
- PRIMO BRAGA, C.A. & A. YEATS (1992) How Minilateral Trading Arrangements May Affect the Post-Uruguay Round World, *Policy Research Working Paper 974*, World Bank, Washington DC.
- PRIMO BRAGA, C.A. & G. BANNISTER (1994) "East Asian investment and trade: prospects for growing regionalization in the 1990s", *Transnational Corporations*, Vol. 3, No. 1, 97-136.

- PUGEL, T.A. & I. WALTER (1985) "U.S. Corporate Interests and the Political Economy of Trade Policy", *Review of Economics and Statistics*, Vol. 67, 465-473.
- RAY, E.J. (1981) "The Determinants of Tariff and Nontariff Trade Restrictions in the United States", *Journal of Political Economy*, Vol. 81, 105-121.
- REICH, R. (1991) *The Work of Nations*, Alfred A. Knopf, New York.
- RICHARDSON, J.D. (1990) "The political economy of strategic trade policy", *International Organization*, Vol. 44, 107-135.
- RIEDEL, J. (1990) "Intra-Asian Trade and Foreign Direct Investment" *Asian Development Review*.
- ROBSON, P. (1980) *The Economics of International Integration*, Allen & Unwin, London.
- RUGGIE, J.G. (1982) "International Regimes, Transactions, and Change: Embedded Liberalism in the Postwar Economic Order", *International Organization*, Vol. 36, 379-415.
- RUGMAN, A.M. (1975) "Motives for Foreign Investment: The Market Imperfections and Risk Diversification Hypothesis", *Journal of World Trade Law*, Vol. 9, 567-573.
- RUGMAN, A.M. (1976) "Risk Reduction by International Diversification", *Journal of International Business Studies*, Vol. 7, 75-80.
- RUGMAN, A.M. (1979) *International Diversification and the Multinational Enterprise*, Lexington, Farnborough.
- RUGMAN, A.M. & A. VERBEKE (1990) *Global Corporate Strategy and Trade Policy*, Routledge, London.
- ROUEN, R. & C. KAI (1995) "China's GDP in US Dollars Based on Purchasing Power Parity", *Policy Research Working Paper 1415*, World Bank, Washington, DC.
- RYBCZYNSKI, T.M. (1955) Factor endowments and relative commodity prices", *Economica*, Vol. 22, 336-341.
- SACHS, J., & A. WARNER (1995) "Economic reform and the process of global integration", *Brookings Institution Papers on Economic Activity*, Vol. 1, 1-118.
- SAMUELSON, P.A. (1939) "The Gains from International Trade", *Canadian Journal of Economics and Political Science*, Vol. 5, 195-205.
- SAMUELSON, P.A. (1949) "International Factor-Price Equalisation Once Again", *Economic Journal*, Vol. 59, 181-197.
- SAMUELSON, P.A. (1962) "The Gains from International Trade Once Again", *Economic Journal*, Vol. 72, 820-829.
- SAPIR, A. (1993) "Regionalism and the new theory of international trade: do the bells toll for the GATT? A European outlook", *The World Economy*, Vol. 16, 423-438.
- SAPSFORD, D. (1985) "The Statistical Debate of the Net Barter Terms of Trade Between Primary Commodities and Manufactures: a Comment and Some Additional Evidence", *Economic Journal*, Vol. 95, 781-788.
- SAXONHOUSE, G. (1993) "Trading blocs and East Asia", in J. de Melo & A. Panagariya, eds., *New Dimensions in Regional Integration*, World Bank CEPR, Cambridge University Press, Cambridge.
- SCHERER, F.M. (1994) *Competition Policies for an Integrated World Economy*, The Brookings Institution, Washington, DC.
- SCHOTT, J.J. & M.G. SMITH, eds. (1988) *The Canada United States Free Trade Agreement: the Global Impact*, Institute for International Economics, Washington, DC.
- SCHOTT, J.J., ed. (1989) *Free Trade Areas and US Trade Policy*, Institute for International Economics, Washington, DC.
- SCHOTT, J.J., ed. (1990) *Completing the Uruguay Round: A Results Oriented Approach to the GATT Trade Negotiations*, Institute for International Economics, Washington, DC.
- SCHOTT, J.J. (1991) "Trading Blocs and the World Trading System", *The World Economy* Vol. 14, 1-17.
- SCHOTT, J.J. (1995) *From Bogor to Miami ... and Beyond: Regionalism in the Asia-Pacific and the Western Hemisphere*, Institute for International Economics, Washington, DC.
- SCOTT, A.J. & M. STORPER, eds. (1986) *Production, Work, Territory: The Geographical Anatomy of Industrial Capitalism*, Unwin & Hyman, Boston, MA.
- SECCHI, C. (1990) "Protectionism, Internal Market Completion, and the Advantages of a Unified Market", in E. Grilli & E. Sasso, eds., *The New Protectionist Wave*, Macmillan, London.
- SERVAN-SCHREIBER, J.J. (1967) *Le defi americain*, Denoel, Paris.
- SINGAPORE DEPARTMENT OF STATISTICS (various issues) *Yearbook of Statistics*, Singapore.
- SNAPE, R.H., J. ADAMS & D. MORGAN (1993) *Regional Trade Agreements: Implications and Options for Australia*, Australian Government Publishing Service, Canberra.
- SÖDERSTEN, B. (1980) *International Economics*, Macmillan, London.

- SPRAOS, J. (1980) "The Statistical Debate of the Net Barter Terms of Trade Between Primary Commodities and Manufactures", *Economic Journal*, Vol. 90, 107-128.
- SRINIVASAN, T.N., J. WHALLEY & I. WOOTON (1993) "Measuring the effects of regionalism on trade and welfare", in K. Anderson & R. Blackhurst, eds., *Regional Integration and the Global Trading System*, Harvester Wheatsheaf, London.
- STEAGALL, J.W. & K. JENNINGS (1996) "Unions, PAC contributions and the NAFTA vote", *Journal of Labor Research*, Vol. 17, 515-521.
- STOECKEL, A, D. PEARCE & G. BANKS (1990) *Western Trade Blocs: Game Set or Match for Asia-Pacific and the World Economy*, Centre for International Economics, Canberra.
- STOLPER, W.F. & P.A. SAMUELSON (1941) "Protection and real wages", *Review of Economic Studies*, Vol. 9, 58-73.
- STOPFORD, J.M. (1992) "Offensive and Defensive Responses by European Multinationals to a World of Trade Blocs", *Technical Paper No 64*, OECD Development Centre, May, Paris.
- STOPFORD, J.M. & S. STRANGE (1992) *Rival States, Rival Firms*, Cambridge University Press, Cambridge.
- STRANGE, S. (1988) *States and Markets*, Pinter Publishers, London.
- STRANGE, S. (1992) "Big Business and the State", *Millennium: Journal of International Studies*, Vol. 20, 245-250.
- SUMMERS, L. (1991) "Regionalism and the World Trading System", in *Policy Implications of Trade and Currency Zones*, Federal Reserve Bank of Kansas City.
- SVEDBERG, P. (1979) "Optimal Tariff Policy on Imports from Multinationals", *Economic Record*, Vol. 55, 64-67.
- SWERLING, B.C. (1954) "Capital Shortage and Labour Surplus in the United States", *Review of Economics and Statistics*, Vol. 36, 286-289.
- SYKES, A.O. (1995) *Product Standards for Internationally Integrated Goods Markets*, The Brookings Institution, Washington, DC.
- TAKACS, W.E. (1981) "Pressures for Protectionism: An Empirical Analysis", *Economic Inquiry*, Vol. 19, 687-693.
- TANZI, V. (1995) *Taxation in an Integrating World*, The Brookings Institution, Washington, DC.
- TAYLOR, M.J. & N.J. THRIFT, eds. (1986) *Multinational and the Restructuring of the World Economy*, Croon Helm, Beckenham.
- TEMIN, P. (1976) *Did Monetary Forces Cause the Great Depression?*, W.W. Norton, New York.
- THOMSEN, S. (1993) "Japanese Direct Investment in the European Community: The Product Cycle Revisited", *The World Economy*, Vol. 16, 301-315.
- THOMSEN, S. (1994) "Regional Integration and Multinational Production", in V. Cable and D. Henderson, eds., *Trade Blocs? The Future of Regional Integration*, The Royal Institute of International Affairs, London.
- TINBERGEN, J. (1962) *Shaping the World Economy—Suggestions for an International Economic Policy*, Twentieth Century Fund, New York.
- THUROW, L. (1992) *Head to Head: The Coming Economic Battle Among Japan, Europe and America*, William Murrow, New York.
- TOVIAS, A. (1991) "A survey of the theory of economic integration", *Journal of European Integration*, Vol. 15, 5-23.
- TRACHTMAN, J.P. (1992) "GATT Dispute Settlement Panel: United States—Restrictions on Imports of Tuna", *American Journal of International Law*, Vol. 86, 142-151.
- TRANSATLANTIC BUSINESS DIALOGUE (1995) *Overall Conclusions*, Transatlantic Business Dialogue, 10-11 November, Seville, Spain.
- TRAVIS, W.P. (1964) *The Theory of Trade and Protection*, Harvard University Press, Cambridge, MA.
- TYSON, L. (1987) "Creating Advantage: Strategic Policy for National Competitiveness", *BRIE Working Paper*, Berkeley, CA.
- TYSON, L. (1992) *Who's Bashing Whom? Trade Conflict in High Technology Industries*, Institute for International Economics, Washington, DC.
- UNCTAD (1993) *Explaining and Forecasting Regional Flows of Foreign Direct Investment*, UNCTAD Programme on Transnational Corporations, United Nations, New York.
- UNCTAD (1992) *World Investment Directory, Vol.1, Asia and the Pacific*, United Nations, New York.
- UNCTAD (1993) *World Investment Report 1993: Transnational Corporations and Integrated International Production*, United Nations Conference on Trade and Development, United Nations, New York.

- UNCTAD (1994) *World Investment Report: Transnational Corporations, Employment and the Workplace*, United Nations Conference on Trade and Development, United Nations, New York.
- UNCTAD (1995) *World Investment Report: Transnational Corporations and Competitiveness*, United Nations Conference on Trade and Development, United Nations, New York.
- UNCTAD (1996) *World Investment Report: Investment, Trade and International Policy Arrangements*, United Nations Conference on Trade and Development, United Nations, New York.
- UNITED NATIONS (1990) *Regional Trading Blocs: A Threat to the Multilateral Trading System: Views and Recommendations of the Committee for Development Planning*, Department of International Economics and Social Affairs, United Nations, New York.
- UNITED NATIONS (1991) *World Investment Report 1991: The Triad in Foreign Direct Investment* Transnational Corporations and Management Division, United Nations, New York.
- UNITED NATIONS (1992) *World Investment Report 1992: Transnational Corporations as Engines of Growth*, Transnational Corporations and Management Division, United Nations, New York.
- UNITED NATIONS (1993) *From the Common Market to EC 1992*, Transnational Corporations and Management Division, United Nations, New York.
- UNITED NATIONS (1996) *International Trade Statistics Yearbook*, United Nations, New York.
- US DEPARTMENT OF COMMERCE (1995a) *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and their Foreign Affiliates, Preliminary 1993 Estimates*, US Department of Commerce, US Government Printing Office, Washington, DC.
- US DEPARTMENT OF COMMERCE (1995b) *Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies, Preliminary 1993 Estimates*, US Department of Commerce, US Government Printing Office, Washington, DC.
- US DEPARTMENT OF COMMERCE (1996a) *U.S. Direct Investment Abroad: Operations of U.S. Parent Companies and their Foreign Affiliates, Preliminary 1993 Estimates*, US Department of Commerce, US Government Printing Office, Washington, DC.
- US DEPARTMENT OF COMMERCE (1996b) *Foreign Direct Investment in the United States: Operations of U.S. Affiliates of Foreign Companies, Preliminary 1993 Estimates*, US Department of Commerce, US Government Printing Office, Washington, DC.
- US INTERNATIONAL TRADE COMMISSION (1993) *The Potential Impact on the US Economy and Selected Industries of the NAFTA Agreement*, Washington, DC.
- VAITSOS, C. (1978) "Crisis in Regional Economic Cooperation (Integration) among Developing Countries: A Survey" *World Development*, Vol. 6, 719-769.
- VERNON, R. (1966) "International Investment and International Trade in the Product Cycle" in *Quarterly Journal of Economics*, Vol. 80, 190-207.
- VERNON, R. (1971) *Sovereignty at Bay*, Basic Books, New York.
- VINER, J. (1950) *The Customs Union Issue*, Carnegie Foundation for International Peace, New York.
- WALLACE, W. (1994) *Regional Integration: The West European Experience*, The Brookings Institution, Washington, DC.
- WALTZ, K.N. (1979) *The Theory of International Politics*, Addison-Wesley, London.
- WEINTRAUB, S. (1994) *NAFTA: What Comes Next?* The Washington Papers, Center for Strategic and International Studies, Washington, DC.
- WELLS, L. (1992) "Conflict or Indifference: US Multinationals in a World of Regional Trading Blocs", *Technical Paper No 57*, OECD Development Centre, March, Paris.
- WHALLEY, J. (1985) *Trade Liberalisation Among Major World Trading Areas*, MIT Press, Cambridge, MA.
- WHALLEY, J. (1993) "Regional Trade Agreements in North America: CUSTA and NAFTA", in J. de Melo & A. Panagariya, eds., *New Dimensions in Regional Integration*, World Bank CEPR, Cambridge University Press, Cambridge.
- WINSTON, C. (1993) "Economic Deregulation: Days of Reckoning for Microeconomists" *Journal of Economic Literature*, September.
- WINTERS, L.A. (1991) "Digging for Victory", *The World Economy*, Vol. 13, 170-90.
- WINTERS, L.A. (1993) "The European Community: a case of successful integration?", in J. de Melo & A. Panagariya, eds., *New Dimensions in Regional Integration*, World Bank CEPR, Cambridge University Press, Cambridge.
- WISE, M. (1994) "The European Community" in R. Gibb & W. Michalak, eds., *Continental Trading Blocs: The Growth of Regionalism in the World Economy*, John Wiley & Sons, Cirencester.

- WOLF, M. (1994) *The Resistible Appeal of Fortress Europe*, Centre for Policy Studies, London.
- WOLFEREN, K. van (1989) *The Enigma of Japanese Power*, Macmillan, London.
- WOMACK, J., D. JONES, & D. ROOS (1990) *The Machine that Changed the World*, Maxwell Macmillan, New York.
- WONNACOTT, P. & R. WONNACOTT (1981) "Is Unilateral Tariff Reduction Preferable to a Customs Union? The Curious Case of the Missing Foreign Tariffs", *American Economic Review*, Vol. 71, 704-714.
- WONNACOTT, P. & R. WONNACOTT (1984) "How General is the Case for Unilateral Tariff Reduction?", *American Economic Review*, Vol. 74, 491.
- WONNACOTT, P. & M. LUTZ (1989) "Is There a Case for Free Trade Areas?", in J.J. Schott, ed., *Free Trade Areas and US Trade Policy*, Institute for International Economics, Washington, DC.
- WONNACOTT, P. (1994) *Merchandise Trade in the APEC Region*, Institute for International Economics, Washington, DC.
- WORLD BANK (1996) *World Tables*, World Bank, Washington, D.C.
- WORLD TRADE ORGANIZATION (1995) *Regionalism and the World Trading System*, World Trade Organization, Geneva.
- YAMAZAWA, I. (1992) "On Pacific Economic Integration", *Economic Journal*, Vol. 102, 1519-1529.
- YARBROUGH, B.V. & R.M. YARBROUGH (1997) "Dispute settlement in international trade" in E.D. Mansfield & H.V. Milner, *The Political Economy of Regionalism*, Columbia University Press, New York.
- YOFFIE, D.B. & H.V. MILNER (1989) "An alternative to free trade or protectionism: why corporations seek strategic trade policy", *California Management Review*, Vol. 31, 111-131.
- YOFFIE, D.B., ed. (1993) *Beyond Free Trade: Firms, Governments and Global Competition*, Harvard Business School Press, Boston, MA.
- YOSHIDA, M., I. AKIMUNE, M. NOHARA & K. SATO (1994) "Regional Economic Integration in East Asia: Special Features and Policy Implications", in V. Cable & D. Henderson, eds., *Trade Blocs? The Future of Regional Integration*, The Royal Institute of International Affairs, London.