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Toward Trade Blocs?

The European Community's decision to achieve full economic integration by 1992 and the pending U.S.-Canada Free Trade Agreement have raised important questions about the future shape of world trade and the appropriate direction of U.S. foreign trade policy. The debate that has been sparked by these two developments centers on the pros and cons of trade regionalism versus trade multilateralism. Most analysts favor a multilateral approach to trade issues, but they are divided regarding the advisability of regional trade blocs. Some fear that regionalism may lead to a "Fortress Europe" mentality and the abandonment of multilateral approaches. Others, in contrast, find the formation of regional blocs potentially beneficial and argue that the U.S. ought to widen the U.S.-Canada agreement to encompass nations in the Pacific Basin region.

This *Letter* discusses the recent trend toward the formation of regional trade blocs and examines the pros and cons of trade regionalism. Although trade blocs have the potential to diminish trade with non-member nations, this need not be the case. In fact, over the last forty years, regional economic integration coupled with multilateral reductions of trade barriers has aided in the rapid expansion of world trade and world output. Both as a practical matter and as a guiding principle, the United States should continue to pursue multilateral reductions of barriers to world trade, and yet not close the door to any nation that might seek to enter into a free-trade agreement with the United States.

Regional trade blocs

Regional trade blocs are by no means a new phenomenon. A number of regional trade blocs have been in existence for some time: the Committee on Mutual Economic Assistance (COMECON) for the Soviet bloc nations; the European Free Trade Association for northern European nations; the Lomé Convention by which the European Community provides special treatment to imports from 63 African, Caribbean, and Pacific nations; the Latin American Free Trade Association and the Andean Group for South American countries; the Central American Common Market; the Caribbean Community; the free-trade agreement between the United States and Israel; the Association of South East Asia Nations (ASEAN) that seeks freer trade among the six nations of that region; and the recently concluded free-trade agreement between Australia and New Zealand.

However, two recent developments in particular give rise to a widely shared perception that trade regionalism is growing, perhaps at the expense of multilateralism. The first is the recent decision by the twelve nations of the European Community (EC) to achieve full economic integration by the end of 1992. This agreement requires the member nations to remove all border controls on the intra-community movement of goods and people, adopt common standards for industrial products, harmonize rates of value-added tax, abolish control over capital movement within the community, open up public contracts for community-wide bidding, and enable businesses to operate under a common set of rules and regulations throughout the community. In short, the aim is to form a single market for the community's 320 million people—compared to the 250 million people in the United States and the 122 million in Japan.

The second recent development is the U.S.-Canada free trade agreement, which was signed by President Reagan and Prime Minister Mulroney in January 1988 and is now awaiting ratification by the two countries' legislatures. Ratification would set in motion, beginning January 1, 1989, a ten-year process that would eliminate all tariffs between the two countries, remove import quotas and licensing requirements on agricultural products, abolish restrictions on energy trade, allow free entry and grant national treatment to banks and other types of financial institutions, open biddings on government procurement contracts, and set up a mechanism for subjecting trade disputes to compulsory arbitration. The agreement would achieve considerably less economic integration than that envisioned in the European Community's plan. Nevertheless, the U.S.-Canada agreement would be a major step towards eliminating both tariff and non-tariff trade barriers between these two neighbors.

A multilateral approach

Since the early 1940s the United States has been at the forefront of trade negotiations, advocating multilateral, non-discriminatory removal of trade restrictions. The U.S. leadership was instrumental in the signing of the first General Agreement on Tariffs and Trade (GATT) in 1947 and the establishment of a Secretariat to promote free trade on a worldwide basis. Since then, seven rounds of multilateral negotiations have been conducted under GATT auspices, resulting in substantial reductions in tariff and non-tariff barriers to international trade. Recently, an eighth round, the Uruguay Round, started, with a view toward expanding the negotiations to cover agricultural trade and trade in services—both hitherto excluded—as well as protection of patents and copyrights.

This multilateral approach to trade policy was adopted after the disastrous experiences of the 1930s, when high national trade barriers contributed to both the sharp contraction in world trade and to the severity and longevity of the Great Depression. Bilateral negotiations for tariff reductions, initiated by the United States in the 1930s, proved to be both time-consuming and self-defeating, since bilateral negotiations with subsequent countries frequently diminished or negated the benefits from previously negotiated reductions in trade barriers with other countries. In contrast, multilateral reductions of trade barriers negotiated under GATT rules have ensured that the benefits are shared by all the participating members.

Regionalism versus multilateralism

Under the GATT's Article 24, member nations are allowed to enter into regional trade agreements that accord more favorable trade treatment to members than to non-members only if such agreements do not result in higher average trade barriers against non-members than before the agreement. Of course, there is a risk that the lower barriers within the trade bloc will encourage substitution of imports from members for imports from non-members; however, these agreements have been allowed on the premise that the reduced trade barriers within the region would increase member nations' incomes, which, in turn, would increase the trade bloc's total demand for imports from outside the bloc.

Whether the positive trade-creating income effect would indeed outweigh the negative trade-diverting substitution effect depends critically on the extent to which the trade bloc's external trade barriers after the agreement are on average higher or lower than before. The more a regional agreement is coupled with a lowering of the trade bloc's external trade barriers, the more likely is the agreement to enhance welfare for the non-member nations as well as for member nations. In this sense, the seven rounds of GATT trade-barrier reductions have helped to ensure that the income effects of the creation of trade blocs outweigh the substitution effects. Trade regionalism thus can be compatible with trade multilateralism.

Although the U.S.-Canada free-trade agreement eliminates many trade barriers between the two nations and leaves their respective trade barriers against others unchanged, the leaders of both governments have pledged to work toward multilateral reductions of trade barriers in the Uruguay Round. The agreement, therefore, should be viewed as a step toward freer trade in the spirit of GATT, and not as a step toward greater fragmentation. Similarly, further European economic integration need not be a move away from trade multilateralism if the European Community's trade barriers with non-members are lowered after 1992.

Pacific free-trade area?

Supporters of the U.S.-Canada free-trade agreement see substantial gains for both countries in terms of job creation and greater output growth, without significant adverse effects on third nations. The logic of this claim suggests that the free trade area should be enlarged to include other countries with which the two nations already have close trade relations. The prime candidates would seem to be nations in the Pacific Basin region.

Attractive as this idea may seem, a Pacific free-trade area is unlikely in the foreseeable future. Negotiations to create free-trade areas tend to be time consuming and politically difficult even among neighboring countries with strong economic and cultural ties, as the experiences of the EC nations and the United States and Canada suggest. Pacific Basin nations, moreover, differ widely in their cultural traditions and stages of economic development. Bilateral trade negotiations between the U.S. and these countries in recent years do not seem encouraging to the idea of a Pacific free-trade area.

In any event, Pacific trade has grown rapidly without regionwide free-trade agreements. For instance, U.S. trade with Asia-Pacific countries grew from 22 percent of total U.S. trade in 1976 to 35 percent in 1986. To varying degrees, intra-regional trade also increased as a share of individual Asia Pacific countries' total trade during the same period. In 1986, intra-regional trade accounted for more than 60 percent of the total trade of all Asia-Pacific countries, a high proportion of which was in every case trade with the United States. Thus, it appears that market forces already have accomplished much of what extensive trade negotiations would be intended to achieve. Further increases in Pacific trade may best be pursued in the context of the Uruguay Round of multilateral GATT negotiations.

Policy concerns

Trade multilateralism has been the guiding principle of U.S. trade policy and the GATT negotiations over the past forty years. Recently, however, public opinion seems to be inclining toward a view that rejects multilateralism as outdated and out of touch with the real world. Articles in the popular press and even in some prestigious business journals now argue that this kind of idealistic thinking has bound the United States to hold its market wide open for foreign imports, even though foreign countries discriminate against U.S. exports. They suggest that the United States should abandon the multilateral doctrine and instead adopt a "fair trade" or "tailored trade" approach that would require reciprocity from its trade partners; the U.S. market would be open only to those that open their markets to U.S. goods.

Since the proponents of this view typically regard foreign markets as less open than the U.S. market, adoption of this approach would necessarily mean either a general rise in U.S. trade barriers or the formation of trade blocs with selected trade partners and an increase in trade barriers against all others. In either case, calls for reciprocity often are no more than thinly disguised calls for trade protection—a policy that in the past has stifled the world economy.

As a tactic, threats of higher trade barriers may succeed in getting concessions in isolated cases in the short run. However, such a strategy for the long run risks being called bluff. Failure to raise barriers then destroys the credibility of such a policy, while a decision to raise barriers invites retaliation and inflicts injuries on all.

In short, regional free-trade arrangements coupled with reductions in external trade barriers continue to be a sound policy approach for the United States and the world economy. Although trade blocs in themselves are not necessarily harmful to national welfare, their formation takes protracted and often arduous negotiations, with uncertain outcome. Given the scarcity of experienced trade negotiators in all countries, both the United States and the world community would be well advised in the next several years to concentrate on insuring the success of the Uruguay Round of GATT negotiations, rather than attempting to form any new trade blocs or enlarging the existing ones.

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MONETARY POLICY OBJECTIVES FOR 1988

On July 13, Federal Reserve Board Chairman Alan Greenspan presented a mid-year report to the Congress on the Federal Reserve's monetary policy objectives for the remainder of 1988. The report reviews economic and financial developments in 1988 and presents the economic outlook heading into 1989. For single or multiple copies of the report, write to the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco, CA 94120, or phone (415) 974-2246.