Trading Blocs: States, Firms, and Regions in the World Economy
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CHAPTER 8

Multinationals and the New Regionalism

Trading blocs were popular instruments of trade policy throughout the twentieth century, from the imperial systems of the interwar period to the customs unions and free trade areas formed in Western Europe and North America. Today these arrangements are even more widespread, often linking together countries that lack a common "regional" bond (such as the United States and Singapore, Mexico and the EU, South Korea and Chile). With the WTO stalled since the Cancun walkout, the most vibrant and comprehensive proposals of late to open trade and liberalize investment have been regional and bilateral initiatives—EU enlargement, discussions to link NAFTA and Mercosur into a Free Trade Area of the Americas, the "ASEAN+3" forum in Asia, and the determination of countries such as Chile, Mexico, and Singapore to follow a bilateral track to freer trade.

This burst of regional and bilateral activity has puzzled scholars and policy analysts. Theoretical work recognizes that domestic politics plays a key role in the political economy of trade. But standard trade models cannot explain enthusiasm for regional arrangements, and there have been few theoretically motivated attempts to evaluate a large number of historical or contemporary cases. According to Mansfield and Milner (1999, 604), "there is a lack of empirical evidence indicating which domestic groups support regional trade agreements, whose interests these agreements serve, and why particular groups prefer regional to multilateral trade liberalization." Because the domestic sources of trading blocs remain unclear, existing assessments of the implications for the world trading system rest on conjecture rather than systematic analysis. As Mansfield and Milner (1999, 604) note, "we know little about whether, once in place, regional arrangements foster domestic support for broader, multilateral trade liberalization or whether they undermine such support."

This book addresses these issues through an analytical explanation of how

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the trade preferences of domestic groups filter through political processes to influence national policies toward regional and global trade. The framework begins with domestic actors—firms and industry associations—and builds upward to derive expectations about policy. The main analytical task is to explain how technological and market factors affect the policy preferences of domestic actors. From there, the approach considers preference aggregation to illuminate how collective action and the design of state institutions affect the ability of domestic groups to obtain the policies they seek.

The Argument

Simply put, states establish regional arrangements in response to pressure from organized interests in society. Business groups have been the principal source of these pressures. As the cases in chapters 3–7 detail, two considerations have figured prominently in the calculus of organized groups seeking trading blocs.

One factor is the growing scale of manufacturing, which dates from the inception of the moving assembly line and techniques for high-pressure chemical synthesis in the early twentieth century to modern innovations in development, design, and "learning by doing" in microelectronics and IT. Scale economies are prevalent in a range of industries, including integrated circuits, consumer electronics, automobiles, and industrial and synthetic chemicals. This technological development makes enlarged markets and common standards attractive to firms facing competitive pressure to produce on a large scale.

Economic studies, government reports, and press accounts routinely tout scale effects as potential benefits of regional integration. A few scholars have incorporated scale considerations in studies of trading blocs (e.g., Chase 2003; Milner 1997; Busch and Milner 1994; Froot and Yoffie 1993). Yet empirical work to date has not examined these variables in a systematic fashion on a large number of cases. This book, by demonstrating the importance of scale economies in the political activities of business groups seeking regional arrangements, fills that gap.

A second, more recent trend is the growth of production sharing—the practice of dispersing production across borders to locate different stages where they can be most efficiently performed. In products ranging from microchips to televisions, automobiles, computers, and cell phones, the manufacturing process involves multiple countries. Often production sharing is regionally oriented, so multinational companies have incentives to seek special arrangements to liberalize trade and safeguard investment across the borders that link geographically separated production facilities.

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As production sharing has expanded with technological changes and advances in IT, differences in national standards and regulatory practices have emerged as prominent concerns for firms doing business across borders. In particular, TRIMs are a significant policy issue for multinational companies that have developed or that seek to establish regional procurement networks. Yet the political economy of trade remains rooted in the study of barriers to trade at national borders; regulatory rules inside national boundaries have received little analytical attention. The argument in this book illuminates why regional arrangements have become attractive to multinational firms as a framework to promote liberalization and deregulation in FDI.

Following these premises, the book shows that the formation of trading blocs in the interwar period responded to domestic pressure for larger markets so producers could gain scale economies. Recently, the need for integrated regional markets to allow firms to concentrate production, increase scale, and split up the production process has been central to the single market program in the EC, free trade in North America, and tentative steps toward regionalism in East Asia.

These findings challenge work in the field that explains trading blocs in terms of alliances and power politics (Gruber 2000; Gowa 1994), transaction costs in multilateral negotiations (Haggard 1997), and intergovernmental bargains among nations (Moravcsik 1998). Regional arrangements, the book maintains, cannot be understood without analyzing how market competition and technological change affect group interests and how shifting preferences and domestic coalitions shape policy responses. To illuminate these factors, the book incorporates scale economies and production sharing into a domestic approach to the political economy of trade.

Implications for the Trading System

Analysts who welcome the trend toward trading blocs contend that it accelerates progress toward global free trade by breaking negotiations into small groups of states with similar interests. As multilateral discussions have moved from tariffs to nontariff barriers and "inside the border" regulatory measures, this view proposes, regional groupings of interlocking free trade areas can more effectively promote the multilateral integration of the world economy. Critics of trading blocs counter that these arrangements are designed to fortify protectionist barriers and divert trade. From this perspective, regional blocs are likely to raise new trade barriers against outsiders, hindering progress toward global free trade. Moreover, these analysts argue, discriminatory arrangements

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undermine the WTO and weaken the MFN norm at its core. The result is a "patchwork quilt" of competing regional, bilateral, and multilateral agreements. In the worst case scenario, some even suggest that recent trends threaten to unleash protectionist pressures reminiscent of the 1930s, presaging a return to the mercantilist conflict of the interwar period.

In this book's explanatory framework, either result is possible. The analytical approach suggests that regionalism promotes global trade liberalization when it creates opportunities for producers to restructure manufacturing facilities. Specifically, when companies expand output to serve a larger regional market or deepen production-sharing networks, manufacturing costs decline, and the need for trade protection against outsiders diminishes. Alternatively, protectionism is more likely to take root when firms cannot effectively capture scale economies or engage in production sharing.

The Interwar Collapse

Chapters 3 and 4 provide a new interpretation of protectionism and trading blocs in the 1930s. These case studies argue that domestic pressure for trade protection and the formation of imperial blocs responded to technological changes that increased the optimal scale of manufacturing. Because the United States controlled a market of continental proportions, it alone among the major powers had no need for a larger economic area. Elsewhere, the rise of heavy industry coincided with efforts to obtain foreign markets to compensate for the small size of the nation state. This reaction was most intense in Japan, Britain, and Germany—countries big enough to support industries with large returns to scale, but too small to permit many factories to operate close to MES. Because national boundaries severely constrained producers in these countries, firms and industry groups sought protectionist policies and the creation of imperial blocs. Britain already had an empire, so it needed only to negotiate commonwealth preferences at the Ottawa Conference. In Japan and Germany, however, captive markets had to be acquired rather than brokered, and so conquest became a tool of foreign economic policy.

The key factor was the asymmetry between the United States and other countries in the scale of production and the size of national markets. Producers from the United States were so far ahead in the use of mass production techniques that their presence in foreign markets threatened to stunt the growth of the same industries in the rest of the world. Because producers in lagging nations could not compete on an equal basis, they embraced protectionism. Yet they could not flourish inside national markets that were small

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compared to the optimal scale of production. Only through captive export outlets sheltered from U.S. competition could firms in these industries increase market shares enough to reach internationally viable scales of production.

Contemporary Trading Blocs: Beachheads, Not Fortresses

In contrast to the interwar period, recent regional arrangements have joined countries that already imposed few, if any, border controls on the movement of one another's goods and services. When the EC moved to complete the single market, its customs union was two decades old, and no formal trade barriers (other than Article 115 restraints) existed across European borders. Before the CUSFTA treaty, more than three-quarters of Canada-U.S. trade was duty free. Though trade barriers in Mexico were more significant at the start of the NAFTA negotiations, the country had slashed tariffs, eliminated import licensing, and removed most quotas. Border measures simply were not significant impediments to trade when these agreements were formulated.

In addition to removing the surviving border barriers to trade, contemporary regional arrangements have extended inside national borders to harmonize regulatory practices, create institutional frameworks to settle disputes, and establish codes related to services, intellectual property, government procurement, foreign investment, and TRIMs. The single-market program targeted a series of trade impediments rooted in incompatible product standards, technical requirements, and administrative and customs procedures in EC countries. The CUSFTA and NAFTA treaties incorporated unprecedented provisions to strengthen intellectual property rights, open public procurement, liberalize FDI, and eliminate TRIMs. Japan's economic partnership with Singapore (JSEPA) included innovative measures such as the creation of an electronic network to ease customs administration.

The formation of these regional arrangements validates the continued importance of scale economies. When manufacturing had been fragmented due to regional barriers to producing and marketing goods on a wider scale, industries with large returns to scale sought trade liberalization and harmonized policy regimes. In the EC, companies had to operate on a national basis because different technical and product standards, preferential practices in government procurement, and other nontariff barriers survived the customs union's formation. In response, large firms lobbied individually and through the ERT for the 1992 program so they could standardize product runs for a Europe-wide market. In North America, "miniature replica" plants, vestiges of import substitution in Canada and Mexico, could not survive once protectionist policies were

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liberalized, but they also could not be integrated with U.S. production as long as trade barriers and TRIMs remained in place. To rationalize and streamline these operations, U.S. multinationals sought free trade agreements with Canada and Mexico to eliminate trade barriers and regulatory rules on foreign investment. In all of these cases, the desire to gain scale economies was a strong motive for regional trade liberalization.

In addition to large returns to scale, production-sharing networks have been a second crucial factor in the formation of regional arrangements. With more opportunities to locate stages of manufacturing across borders, many firms have established regional production strategies that rely on intrafirm trade in technology, parts, and components. Firms from the United States introduced this practice by outsourcing labor-intensive tasks to Mexico and Canada. Companies involved in intrafirm and OAP trade were energetic advocates of CUSFTA and NAFTA. Many firms in the EC also spread manufacturing across borders, though data limitations made it difficult for me to systematically establish a correlation with pressure to complete the single market. In Asia, Japanese multinationals have developed offshore procurement bases in ASEAN countries and China, and reverse imports into Japan are growing. Preliminary evidence suggests that production sharing in the Asian region helped to build support for free trade with Singapore.

Compared to the 1930s, trade diversion has been less of a priority in modern trading blocs. Firms in Japan, Britain, and continental Europe surmounted their great size disadvantages during postwar reconstruction, so international differences in scales of production at the plant level narrowed considerably. Rising incomes produced larger national markets, which helped to loosen the geographic constraints on industries with large returns to scale. And today the power of exclusion is more limited than in the past: foreign companies can invest inside trading blocs to share in the benefits of regional integration. These factors have promoted external trade liberalization or limited the imposition of new trade barriers, in striking contrast to interwar imperial protection.

Thus, the forces driving today's regionalism differ from those that led to the collapse of the trading system in the 1930s. Contemporary trading blocs have not been protectionist instruments. External trade barriers have declined of late in U.S. industries with large returns to scale; though it is difficult to establish this with the same certainty for the EU, there is evidence that protectionist lobbying has declined in these industries. These findings support a central implication of the book: regional arrangements can help to prepare companies—and countries—to more vigorously pursue multilateral trade liberalization by creating opportunities for firms to restructure. Popular prophecies

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about the fragmentation of the world economy into self-contained regional groupings are simply misguided; extant trading blocs do not pose a threat to the multilateral trading system.

To be sure, modern trading blocs contain discriminatory and exclusive elements. *Discrimination* exists when exports from outside the region face external barriers that do not apply to products traded within the region. *Exclusion* occurs through efforts to prevent outsiders from investing around external barriers to reap benefits from regional trade liberalization. Both discrimination and exclusion are important features of recent regional arrangements. It is important therefore to evaluate the effects of these measures on outsiders.

Discrimination and Exclusion

In the EU and NAFTA, the common external tariff (in the EU), staging periods for free trade (in NAFTA), antidumping actions, and rules of origin favor companies located inside these trading blocs, at the expense of outsiders. The USITC (1993, ix) explains, "NAFTA rules of origin are intended to ensure that the benefits of tariff reductions will accrue principally to the NAFTA parties." Willy de Clercq, the former EC commissioner for external relations, made the point in plainer language: "We are not building a single market in order to turn it over to hungry foreigners" (Winters 1993, 207). The objective is simply to assist indigenous industries. However, the effects on outsiders vary.

The EU: Discriminating against Outsiders

European integration had very different implications for companies based in the United States and those based in Japan. Since the Treaty of Rome, U.S. multinationals have maintained a strong commercial presence in Europe. Historically, the European sales of U.S. affiliates have surpassed exports from the United States by a factor of at least five. Because U.S. affiliates in the EC were created as autonomous units independent of their parent companies, they could easily increase output and local content in response to external trade barriers. As a result, U.S. multinationals have been well positioned to benefit from European integration. Back in 1958, Ford told the U.S. House of Representatives (1958a, 238–44) that while "the United States w[ould] find the European market virtually closed to its manufactured goods," the EC's formation was a favorable development because "existing plants will be expanded and in some instances relocated" in response to the opening of regional trade. Deere welcomed the opportunity to centralize assembly and manufacturing at different locations

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(Broehl 1984, 663–64), while ITT could benefit through its "forward commercial bases in Europe" (U.S. House of Representatives 1962, 2:1256). Discrimination and trade diversion were no concern for these companies.

The single market program also offered large benefits for U.S. multinationals. Once divergent national regulations for food and beverages, chemicals, pharmaceuticals, automobiles, and telecommunication equipment were phased out, affiliates in different EC countries could be closely integrated with one another. For U.S. multinationals in these industries, regulatory harmonization was more important than export freedom from the outside. Writing before the single market's completion, Hufbauer (1990, 24–25) noted: "EC-1992 . . . holds great promise for General Motors, International Business Machines, Merck, American Telephone and Telegraph, and a long list of other U.S. firms with a strong presence in Europe." As a result, industry groups representing large U.S. companies strongly supported the 1992 program.

For export-dependent firms, however, European integration caused more harm than help. Origin rules, procurement practices, antidumping measures, and the common external tariff strongly favored companies located inside the EC over those exporting to it. Semiconductor rules of origin requiring wafer fabrication in Europe caused Intel, Motorola, and Texas Instruments to expand local capacity or make new investments. Directives stipulating 50 percent EC content for procurement contracts in heavy electric machinery and telecommunication gear likewise led multinationals to bolster their local presence. Smaller firms that did not manufacture in Europe, or that operated EC plants with low local content, had to export over the tariff wall (USITC 1990c, chap. 6, 30–31, 44–45). Thus, the single market was good news for U.S. multinationals but "bad news for exporters, especially small ones without the scale of operations to justify locating in Europe" (U.S. Congress 1991, 199).

Because U.S. multinationals had been "Europeanized" long before the single-market program, they could not be excluded from reaping the same restructuring gains as European-owned firms. By 1989, more than 2 million Europeans worked in affiliates of U.S. companies. IBM-Europe employed 109,000. Moreover, IBM, Ford, AT&T, and other firms maintained lobbying offices in Brussels and, in some cases, devoted more resources to their political efforts than their European competitors, so "their well-being [was] as important to the Community as the well-being of strictly European firms" (Bowen 1991a, 267–68).

For Japan, however, European integration was a negative development. Japanese multinationals were latecomers to the EC. In 1989, Japan's European affiliates employed only sixty thousand workers; mostly these subsidiaries acted as distributors for exports rather than stand-alone production plants. At

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the launch of the single-market program, Japanese industry manufactured less than 20 percent of its European sales locally; by comparison, 80 percent of U.S. sales in the EC were produced there.

Because of concerns that fortress Europe would block exports, the 1992 program unleashed a flood of Japanese FDI, particularly in consumer electronics and automobiles. Japanese affiliates accounted for 40 percent of European VCR capacity and 25 percent of color TVs by 1990. Automakers Toyota, Honda, and Nissan surpassed one million vehicles, more than 10 percent of the EU market, by the mid-1990s. But Japanese transplants came onstream at lower volumes than factories at home, so initially they could not exploit scale economies.[1] Japan's EC affiliates also relied on technology and components imported from corporate parents in Japan.

In response, Brussels wielded powers of exclusion against Japanese companies that could not have been effectively applied to U.S. multinationals. Japanese VCRs, photocopiers, desktop printers, and other electronics faced 45 percent origin rules. To enforce antidumping orders, the European Commission levied anticircumvention duties on products with less than 40 percent EC content.[2] France pushed (unsuccessfully) for 80 percent EC content rules in the Nissan Bluebird dispute, and subsequently the British government secured commitments from Nissan, Toyota, and Honda for 85 percent EC content within three years of operations.[3]

As long as Japanese companies depended on exports for their European sales, they were easy targets first for quantitative restraints and antidumping measures to discriminate against their products, then later content rules and anticircumvention orders to deny their affiliates EC treatment. But transplants enabled Japanese firms to gain a foothold in the EC to support expansion to larger production volumes. Components suppliers soon followed original equipment manufacturers, and Japanese multinationals reconstituted their

1. A Philips executive predicted, "Japanese factories in Europe are going to suffer in the future, because they are all very small. . . . Some of these factories are only producing 100–200,000 television sets per year" (Dai 1996, 143). The largest TV plant, a Hitachi factory in Britain, produced 320,000 units, one-fourth of the volume in Japan; VCR plants manufactured 150,000–200,000 units, compared to 1 million or more in Japan (Cawson et al. 1990, 325–26).

2. After a series of disputes over photocopiers, printers, electronic typewriters, electronic weighing scales, and hydraulic excavators, Japan successfully challenged "screwdriver assembly" rules in dispute settlement. The EC subsequently modified the rule, ostensibly to ensure WTO consistency, but in the process the measure was broadened to cover false origin declarations, altered products, and assembly kits due to circumvention complaints involving cameras, bicycles, and compact disks (WTO 2001 1:67–68).

3. These figures were higher than local content in Japan's North American plants, and satisfying them required the local manufacture of both engines and transmissions (U.S. Congress 1991, 207).

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Japan-based procurement networks in the EC. Once European electronics companies began to outsource production to Asia, Japanese transplants generally maintained higher EC content. Thereafter, powers of exclusion could be wielded only by targeting foreign affiliates directly—which Brussels did not do, despite ambiguous language in the auto VER that limited Japanese transplants to 1.2 million EU sales.

Thus, the single-market program Europeanized Japanese multinationals. In fact, several U.S. and Japanese multinationals have gained admission into European industry groups. Some even joined protectionist lobbies after they had achieved fully integrated production in the EC: Ford and GM consistently backed restraints on Japanese autos; U.S. multinationals with EC affiliates, except for Intel, supported tougher origin rules for semiconductors (Flamm 1990, 272). Japanese transplants even backed tariff increases on VCRs to blunt import competition from South Korea and smaller Japanese firms (Cawson et al. 1990, 327–28).

To conclude, the single-market program harmed exporters through discrimination, but foreign companies invested around external barriers and established local production to mitigate export dependence. Despite the EC's use of content rules and other TRIMs, limited powers of exclusion allowed multinationals to share in the benefits of the single-market program. In a few cases, foreign companies were an additional constituency for external trade protection in the EC.

NAFTA: Excluding Outsiders

In North America as in the EC, Japan was slow to establish a local presence. While European firms had developed manufacturing capabilities in the United States, Japanese firms depended on exports to the U.S. market at the time of NAFTA. However, Japan was better positioned in North America than in the EC. Trade restraints on automobiles, consumer electronics, semiconductors, and steel forced Japanese firms to begin investing early in the 1980s. In the ensuing years, Japanese companies acquired or forced out of business most U.S. consumer electronics producers and made major inroads in the beleaguered steel industry. Under the automobile VER, production in Japan's U.S. affiliates reached 2 million as exports from Japan declined to 2.3 million in 1992 from 3.6 million in 1986.[4] Japanese companies also built substantial capacity in

4. "The Enemy Within" 1993, 68.

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Canada and Mexico for television and automotive assembly, picture tubes, and automotive engines.

Free trade offered large benefits to multinational companies that had established regional procurement networks with high North American content. For example, Nissan and Volkswagen owned engine and automotive assembly plants in Mexico with volumes comparable to those of U.S. rivals. In some cases, foreign multinationals could capture larger gains than North American firms. Free trade, U.S. electronics suppliers and labor unions complained, "would also allow Japanese-owned television manufacturers on both sides of the border to rationalize their production and gain market share at the expense of the integrated television manufacturers in the United States" (U.S. Senate 1986, 185).

To limit the benefits for Asian and European companies, particularly new entrants that had not established fully integrated production in the region, free trade agreements included rules of origin. Notably, the NAFTA treaty strengthened CUSFTA rules of origin for automobiles, computers, electronics, home appliances, industrial machinery, ball bearings, steel, textiles, and apparel—all major Japanese exports, fueling suspicion that the arrangement had been crafted to obstruct Japan. These measures pressured Asian electronics and telecommunications producers to relocate to North America to compete with companies receiving NAFTA treatment. In automobiles, NAFTA delayed duty-free status for firms that had not initiated production under Mexico's Automotive Decrees. Mexican TRIMs continued to apply to these companies, but not the Big Three, Volkswagen, or Nissan. Toyota, Honda, and Hyundai pushed for NAFTA origin rules of 50 percent or less; Volkswagen and Nissan initially backed this figure, but both firms later concluded that a higher origin rule afforded additional protection against these late entrants (Hufbauer and Schott 1992, 226; Cameron and Tomlin 2000, 134–35).

Other exclusive measures in NAFTA have received less attention. Foreign multinationals that do not qualify for NAFTA treatment lost three significant benefits they had previously enjoyed. First, Mexico eliminated maquiladora privileges for goods exported to the United States and Canada. In place of duty-free trade, there are 5 percent tariffs for twenty product categories; other items must pay the difference between Mexican and U.S. (or Canadian) tariffs to enter these markets. For Matsushita and other Japanese electronics firms, which source parts and components in Asia, the new policy is less favorable than the one in place at the time they invested.[5] Second, exports from Mexico to the

5. "Japanese Fall Foul of Rise in Mexico Costs," *Financial Times,* December 21, 2000, 12.

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United States no longer receive tariff preferences under GSP and OAP provisions. The loss of preferential status primarily harms Asian affiliates producing automotive products, consumer electronics, office machines, and electrical machinery because these goods tend to have low North American content, which makes it difficult to satisfy NAFTA origin rules. Third, the CUSFTA treaty terminated APTA privileges for foreign automakers in Canada. In 1996, export-based and production-based duty remissions, incentives that motivated Toyota, Honda, and Nissan to invest in Canada, were fully phased out. Thus, firms that do not qualify for NAFTA treatment are worse off under the new trade regime.

These measures were major factors pushing the EC to negotiate free trade with Mexico to achieve NAFTA parity.[6] At this writing, Japan has just completed a similar arrangement as a drawbridge for its automakers and consumer electronics companies over the protectionist moats in the NAFTA treaty.[7]

Liberalization and Discrimination

Why have recent regional arrangements involved discrimination and exclusion? Some of these measures are plain concessions to protectionist groups to blunt the negative impact of trade liberalization. But in many cases, they are necessary to persuade companies to restructure. Without such provisions, eliminating past biases would threaten producers that have labored under policy distortions and discourage them from making risky investments to reorient unproductive operations.

In the EC before 1992, nontariff barriers encouraged inefficient behavior: consumer electronics firms manufactured in multiple plants instead of centralizing production, steel companies left outmoded capacity in operation rather than retiring it, and automakers vertically integrated production in national markets when specialization across borders would have been cheaper. Similar actions occurred in North America: U.S. multinationals established miniature replicas in all three markets, even when concentration at one location would have been economically optimal; Mexican and Canadian affiliates manufactured high-cost local inputs and sold unprofitable exports to corporate parents; and small-scale plants oriented to host markets coexisted with large, export-oriented factories, particularly in Mexico. In both Europe and

6. Under the EU-Mexico Free Trade Agreement, completed in 2000, trade barriers will be eliminated by 2007, two years before NAFTA tariff schedules are fully phased in. Significantly, Mexico's 20 percent tariff on EU automobiles immediately dropped to 3.3 percent, and this duty was eliminated in 2003 (WTO 2001 1:102 n. 40).

7. "Mexico and Japan Expect to Sign Trade Agreement," *New York Times,* September 17, 2004, 1.

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North America, excess duplication, short product runs, and insufficient specialization plagued established companies. Yet these practices responded rationally to the policies in place at the time capital was sunk in manufacturing structures.

If new entrants could freely invest in an open trading climate without having to satisfy the same regulations, competitive pressure would discourage incumbents from making costly investments to reorganize. The European Commission, for example, lamented that Japanese automotive affiliates "work with the most up-to-date facilities right from the start." Its study concluded: "the Japanese are being favored to the disadvantage of established European manufacturers who cannot abandon existing plants . . . because of problems associated with the closure of facilities" (Commission of the European Communities 1990, 46). Similarly, U.S. automobile and computer companies told the USITC that they would not be able to compete on equal terms with foreign producers once trade barriers and TRIMs were phased out.

As a result, established companies locked in to preexisting trade and regulatory regimes tend to demand two sets of safeguards to proceed with restructuring. First, they want governments to issue irrevocable commitments to liberalize trade and industrial practices to guard against the risk of policy reversals. Second, they need governments to guarantee that they will be protected against new entrants while they adjust to a new policy climate. To satisfy these demands, regional trade agreements enumerate explicit obligations, establish rules that discriminate between incumbents and new entrants, and provide transitional protection.

The prototype was the APTA, which amounted to a regulatory contract between Canada and the Big Three. The CUSFTA treaty later extended mutual free trade to all products and eliminated most TRIMs. In effect, U.S. multinationals agreed to rationalize North American manufacturing, provided that Canada codified its pledge to undertake trade and regulatory liberalization in a formal treaty with provisions to shelter incumbents from newly established competitors. The NAFTA treaty likewise was designed to ensure that Mexico's unilateral reforms were durable so that trade barriers could not be restored and state control over foreign investors reinstated *ex post.* In short, today's trading blocs have been commitment devices for states and firms, not tools to divert foreign trade and investment.

Regional Arrangements and the WTO

GATT Article XXIV governs the formation of trading blocs under multilateral rules. This provision exempts customs unions, free trade areas, and "interim

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agreements" from the discipline of MFN obligations. It further stipulates that parties to such arrangements liberalize "substantially all the trade" between them and set tariffs that (individually or collectively) "shall not be higher or more restrictive" than before. To ensure that interim agreements lead to free trade areas of customs unions in a "reasonable amount of time," members must submit a "plan and schedule."[8]

Economists have long complained that Article XXIV is so fraught with undefined terms, ambiguities, and loopholes that the GATT secretariat has no legal discipline over regional arrangements. Bhagwati (1991, 58) laments, "regional blocs are indeed GATT-consistent, even if they may be considered threatening to GATT's basic conception of the world trading system." Since the creation of the GATT, 121 working parties have found only one case of full compliance with Article XXIV, yet no regional arrangement has been judged to be nonconforming.[9] This record prompted a former deputy director-general to complain (WTO 1995a, 70–71):

> of all the GATT articles, this is one of the most abused, and those abuses are among the least noted. Unfortunately, therefore, those framing any new [regional arrangement] need have little fear that they will be embarrassed by some GATT body finding them in violation of their international obligations and commitments and recommending that they abandon or alter what they are about to do.

With the formation of the WTO, members approved a "Memorandum of Understanding on Article XXIV" and created a Committee on Regional Trade Agreements to conduct future reviews. Since then, free trade areas and customs unions have flourished, but the WTO has yet to adopt a single report on Article XXIV compliance.

Many analysts maintain that the MFN rule is sacred; all liberalization must be nondiscriminatory to avert the recrudescence of 1930s-style protectionism. Yet it is not clear that the present flexibility is worse than dogmatic adherence to MFN. The case studies in this book strongly suggest that U.S. and European companies favorable to regional free trade would not have accepted the same liberalization on MFN terms. Discriminatory provisions in these arrangements illustrate the practical difficulty of eliminating behind-the-border regulatory measures multilaterally. Comparable measures to liberalize trade and indus-

8. "Regional Trade Agreements: Goods Rules," WTO, http://www.wto.org/english/tratop_e/region_e/regatt_e.htm#gatt.

9. This was the 1993 customs union between the Czech and Slovak republics, two countries that had been joined together as an independent state for the previous seventy-five years.

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trial policy worldwide would have required too many special undertakings to negotiate among a large number of actors. Moreover, MFN rules prevent states from cushioning the blow of trade and regulatory liberalization to compensate firms for the costs imposed on them by past policies.[10] Simply, discrimination is the price of liberalization designed to encourage firms to organize resources more efficiently.

Particularly in the area of FDI, the absence of multilateral rules has encouraged regional initiatives. The TRIMs Agreement, which failed to institute comprehensive rules like those for intellectual property, services, and national standards, "is frequently interpreted to represent a failure of the Uruguay Round to make significant progress on investment issues" (Brewer and Young 1998, 458). Though WTO members have faced pressure to eliminate local content, trade balancing, and foreign exchange-balancing requirements, most developing nations missed the January 2000 deadline for implementing their commitments, and nine countries received extensions of up to seven years.[11] In several cases, multinational firms joined host governments in seeking delays. Meanwhile, "the use of investment-diverting and investment-distorting measures not covered in the current agreement has vastly increased" (Moran 2000, 223). This has made TRIMs an important feature of recent regional arrangements—which have, in turn, established detailed codes for FDI presently lacking at the multilateral level.

In sum, trading blocs can be springboards for freer trade worldwide, as long as they effectively promote industrial restructuring. Over time, companies that reorganize manufacturing facilities inside regional arrangements tend to become more favorable to multilateral liberalization. In the transition period while these adjustments are taking place, FDI by firms located outside the region mitigates the negative external effects of discrimination and exclusion. Finally, the healthy (albeit imperfect) multilateral structure in the WTO encourages further liberalization and discourages overt protectionism. Thus, the book concludes with a sanguine appraisal of the future of the global trading system in a world of regional arrangements.

10. It is worth noting, for example, that Nissan and Volkswagen received the same treatment under NAFTA as the Big Three.

11. "Nations Fail to Agree on Investment," *Financial Times,* January 25, 2000, 14.