# 10 Regional Trading Arrangements and Multilateral Cooperation

Regional and bilateral trading arrangements–most notably customs unions and free trade areas–greatly multiplied in number during the latter years of the twentieth century.[1] Some commentators, especially economists, have been critical of this development. They have been concerned that these arrangements often constituted no more than preferential trading areas and that they were a possible threat to multilateral trade cooperation.[2] Others have taken a more sanguine view. They have stressed that the arrangements enlarged the geographical areas in which trade in goods and services–and sometimes also in labor and capital–move freely, thus contributing to the same broad aim as multilateral trading arrangements.[3] In fact, GATT and the WTO recognize that authentic customs unions or free trade areas are quite consistent with their own intent. The issue is complex, and though it is hard to do the subject justice within the confines of one chapter, the tensions that have arisen between regional and multilateral arrangements should at least be outlined.

## A GENERAL PERSPECTIVE

Regional or bilateral trading arrangements have been no less a part of the history of trade cooperation than has the gradual emergence of a multilateral trade regime. The former developed as forms of trade relations among states long before multilateral relations took shape, and they have remained major instruments of national trade policy. Virtually all members of the WTO today are also participants in some separate regional or bilateral trading arrangement (though some of these arrangements are more putative than actual).[4] The persistence of a large and shifting constellation of regional and bilateral trading arrangements over the last 150 years suggests that these arrangements have not, on the whole, proved to be an impediment to the development of multilateral trade cooperation.

However, national trade policies in support of regional or bilateral arrangements have at times appeared as courses of action seriously in conflict with multilateral cooperation. The spread of preferential trading arrangements among countries contributed to the fragmentation of the world trading system in the interwar years; the leading trading nations sought to create protected trading areas that excluded competition from each other. Many have suspected that the same motives may have been at work in more recent years.

The essential source of concern lies in the fact that while, by definition, regional or bilateral trading arrangements among countries discriminate against outsiders, the success of the multilateral trade regime has rested heavily on the idea of nondiscrimination. The acceptance of nondiscrimination as a rule governing the conduct of national trade policy has restrained the leading trading nations from using their power to vie with each other in gaining preferential access to third countries' markets.

Of course, the motive behind many regional or bilateral trading arrangements has not been simply a desire to gain short-term economic or commercial advantage over other countries. Throughout history, political aims, such as the unification of states or the formation of alliances for reasons of national security, have lain behind numerous arrangements. Perhaps especially in the last fifty years or so, the economic benefits of integrating national markets into larger economic areas have also gained recognition as a powerfully persuasive reason for regional or bilateral trade arrangements.

## THE ARRANGEMENTS OF THE EUROPEAN UNION AND THE UNITED STATES

Both the European Union and the United States were leading actors in setting the new trend, but the former played the larger role, as much for reasons of geography as anything else. Nowhere in the last twenty years has there been more activity in the formation of regional and bilateral agreements than in the European Union (known as the European Community before 1992).[5] Since its formation in the 1950s and throughout its subsequent expansion from six to fifteen members, it has defined its trading relations with a number of other countries on the basis of preferential agreements. In the earlier years, a notable instance was the Yaoundé Convention signed in the 1960s with former colonial territories; it was later continued as the Lomé Convention, which granted these territories preferential, nonreciprocal access to the European Community's markets. In 1975, the European Community also signed a free trade agreement with Israel.

In the 1980s and 1990s, the number of agreements began to multiply rapidly.[6] The primary cause was the transformation that took place in the European political scene as a result of the end of the Cold War and the breakup of the former Soviet bloc. One consequence was an increase in the size of the European Union itself as some former members or associates of the European Free Trade Association, no longer concerned about asserting their political neutrality in the East-West conflict, became full members (these include Austria, Finland, and Sweden). Another result was the emergence of a group of Central European countries eager to establish firm political links with the Western European countries and intent on carrying out market-oriented reforms of their economies.

In the new political configuration of Europe, both the European Union and the United States responded positively to enlargement of the established political, military, and economic alliances. In contemplating the possible further enlargement of the European Union, however, its present member countries were–and still are–confronted with the question of where the boundaries of the Union as a political entity should be drawn. In trade policy, the provisional response to this "unanswerable question" (as J. M. Roberts dubs it) was to draw up free trade agreements with the individual countries, leaving the issue of full membership of the Union to be decided on a case-by-case basis sometime in the future.[7]

The European Union also entered into free trade agreements with a number of other countries outside of Europe. In most cases, political considerations played a major role. Free trade agreements with the countries on the southern shores of the Mediterranean were favored by the European Union, in part because concerns about the potential flow of illegal immigrants from these countries heightened interest in their economic development. The agreements coupled trade with economic aid and served as instruments for encouraging internal reforms. Agreements with more distant countries (e.g., Mexico and South Africa) appear to have had more mixed motives. In the case of the agreement negotiated with Mexico (and of the failed negotiation for a similar agreement with the Mercosur customs union), the evident motive was more strictly commercial; the measure was a defensive one designed to gain preferential access to a market in which a key competitor, the United States, already enjoyed (or might enjoy) that access.

Unlike the European Union, the United States entered the 1980s with virtually no postwar record of participation in regional trade agreements.[8] It had, after all, been the champion of the principle of nondiscrimination when the new, postwar, multilateral trade regime was established. Its policymakers were long convinced that universal adherence to the principle was in the best interest of all. Indeed, the United States was the last of the industrial countries to introduce a scheme under the Generalized System of Preferences in the 1970s, partly because it objected to the violation of that same principle.

However, another generation of leaders was now in command, and a new pragmatism entered into the making of American trade policy. In the depressed economic conditions of the early 1980s, American efforts to initiate a new multilateral round of trade negotiations in order to enhance market access for its enterprises met with limited support from most other countries, and even when a new round was launched, progress was very slow. In addition, the European Community had come to be characterized in the United States as "Fortress Europe," partly because of misplaced fears about the Single Market program that the European Community was initiating. Business complaints about the difficulty of gaining access to the Japanese market were also loud and many at the time. In this climate, the U.S. administration made clear its impatience with the slow progress of multilateral negotiations and, no doubt partly to cajole other countries into responding more positively, stated its readiness to consider regional trade agreements as an alternative to multilateral trade liberalization. Besides the U.S.-Israeli free trade agreement signed in 1985, the new attitude of the United States found its early expression in the formation with Canada of the Canada-U.S. free trade agreement in 1988, and this agreement was later joined by Mexico in 1994 to form the North American Free Trade Agreement (NAFTA).[9] In addition, in 1990, President Bush proposed the formation of the Free Trade Area for the Americas (FTAA). Later, the United States also participated in the establishment of the Asia-Pacific Economic Cooperation (APEC), whose members were a group of countries around the Pacific Rim; these countries agreed in 1994 to create an open trade and investment area. (The Asian members insisted, however, that reductions in trade barriers should be on a most-favored-nation basis, so they did not intend to create a preferential trading area.)

## THE ARRANGEMENTS OF OTHER COUNTRIES

While the European Union and the United States were the largest actors accounting for the recent trend toward regional or bilateral agreements, most other countries were also active in one way or another. While their motives varied, a rough distinction can be drawn between, on the one hand, those countries that entered into agreements with either the European Union or the United States and, on the other hand, those other countries that formed arrangements independently from these two major trading centers.

### Arrangements with the European Union or the United States: Why Countries Entered into Them

Among the countries that entered into agreements with either the European Union or the United States, a strong political rationale was present more often than not. Concerns about national security or a belief on the part of governments that close, formal ties with the European Union or the United States would protect and strengthen domestic political and market-oriented reforms were evidently factors in the agreements between Central European and Mediterranean countries and the European Union and between Mexico and the United States. It was not, however, so obviously the case with regard to the agreements between Mexico or South Africa and the European Union.

The countries that entered into agreements with either the European Union or the United States also hoped for significant economic benefits. In earlier decades, the most obvious benefit expected from a free trade agreement would have been the stimulus to exports from the preferential tariff margin gained under the agreement. However, most tariffs of both the European Union and the United States had been reduced to very modest levels by the 1990s, especially since the completion of the Uruguay Round in 1994. Indeed, in the European Union, most imports from the developing countries–leaving aside agricultural products, textiles, and apparel–were duty-free. While tariffs on some products of special interest to newly industrializing countries (e.g., textiles) were still quite high, making tariff preferences on these products valuable, the greater security of market access was at least equally as important. The hope was that in the application of nontariff barriers where administrative discretion is exercised, partners in free trade agreements would receive more favorable and consistent treatment.

Another significant economic benefit that partner countries expected was a greater inflow of foreign capital. Among the countries linked to the European Union, substantial official economic aid was associated with most agreements. More broadly, countries also expected the inflow of private capital to increase. The grounds for such hope were that the multinational corporations would want to take advantage of the developing countries' lower wage levels and of their free access to the large market of the more developed partner. In the past, this expectation certainly appears to have been realized in some countries. For instance, after joining the European Community in 1973, Ireland achieved a rapid diversification of its productive structure, with the consequence of substantial gains in its standard of living. While the flow of official funds to Ireland helped, the inflow of foreign direct investment played the major role in this transformation. Mexico hoped for a similar enhancement in the inflow of foreign direct investment as a consequence of its membership in NAFTA, and the flourishing maquiladora (free trade zones) that it had initiated along its border with the United States gave its some grounds for optimism. However, for partner countries generally, it was an open question whether in a world where the tariff levels of the major countries were now very low, tariff preferences in the major markets would be a major influence in the decisions of multinational corporations about where to locate their production facilities. It was true, however, that foreign investors might be reassured by the investment provisions often included in these free trade agreements. In some agreements, moreover, provision was made for easier access to certain service sectors (e.g., financial services and telecommunications) in the partner countries—a separate inducement to foreign investment.

Not all countries entering into trade agreements with the European Union or the United States have been primarily motivated by the prospect of political or economic benefit. For some, the motivation has been more the fear of economic loss, arising from the fact that their neighbors, being exporters of competing products to the same market, had already gained preferred access through a free trade agreement. This was most evidently the case with the countries in the Caribbean region that suffered losses when Mexico joined NAFTA and replaced them as a cheaper source of supply. A World Bank study suggested that as much as one-third of the Caribbean Basin's exports to the United States could suffer from such trade diversion.[10] The Caribbean countries responded by appealing to the United States for "NAFTA parity," and in May 2000, the U.S. Congress passed an act that augmented the list of exports from these countries that would receive preferential treatment in the U.S. market.[11]

### Mixed Motives in Other Arrangements

The motives of the many countries entering into regional trade arrangements that had no connection with the European Union or the United States were likewise mixed. Some were responding to the perception that the major trading powers were forming trading blocs that might become exclusionary, that might intensify trade rivalries, and that could cause multilateral cooperation to recede. The clearest instance of such a response occurred when the member countries of the Association of Southeast Asian Nations (ASEAN) signed an agreement in 1992 for the gradual introduction of free trade. In commenting on the agreement, Indonesia's foreign minister pointed to several warning signals: the European Community's Single Market initiative, NAFTA, and the regional and bilateral trading arrangements in Latin America and Central Europe.[12] More recently, ASEAN entered into discussions with Australia and New Zealand on establishing links with the latter's free trade area. China, Japan, and South Korea also began annual consultations with ASEAN on trade and financial issues, and Japan, so long a firm advocate of the multilateral principle of nondiscrimination, began actively pursuing some form of preferential trading arrangement with Chile, South Korea, Singapore, and Mexico.[13]

For other countries, regional trading arrangements have been strongly influenced by economic considerations. In the 1960s and 1970s, a number of developing countries recognized that the small scale of their domestic markets was a constraint on the growth and diversification of domestic industry. In Africa, Asia, and Latin America, several customs unions or free trade areas were formed. However, these earlier trading arrangements generally failed to take root. Developing countries that were still largely agricultural or mineral producers traded little with each other. They lacked the industrial bases that create the possibilities for specialization and trade. Moreover, they experienced severe distributional conflicts as they vied with each other for the establishment of the same new industries in their respective territories. In the late 1980s and 1990s, however, interest in regional trading arrangements revived quite strongly in parts of the developing world. The same motive of promoting industrialization through integration of regional markets was evident. The difference was that countries were more industrialized than before and had greater possibilities for specialization and trade. Mercosur, the customs union embracing Argentina, Brazil, Paraguay, and Uruguay, quickly came to constitute one of the most advanced of these arrangements, though several others also emerged in Africa, Asia, and Latin America (as well as in Oceania, where Australia and New Zealand implemented an extensive free trade agreement).[14]

### THE EFFECT ON MULTILATERAL TRADE COOPERATION

How did all this activity in the spread of regional and bilateral trading arrangements appear to have affected multilateral trade cooperation? The worst possible consequence would have been an intensification of political and economic rivalry among nations in seeking to gain preferential access to the markets of third countries. This possibility was reflected in the fear, so often expressed in the late 1980s and early 1990s, that the world was fragmenting into three trading blocs centered on the European Union, Japan, and the United States. But though the number of preferential trading arrangements certainly multiplied, this did not happen. The fundamental reason it did not was that the two major trading powers, the European Union and the United States, were at no time willing to pursue policies that seriously risked their access to each others' markets; their economies had continued to become increasingly integrated, not only because of expanding trade flows, but even more because of a dramatic increase in mutual cross-border investment. The European Union and the United States each granted preferential status to third countries in their own markets, but that did not cause any significant diversion of import demand from either to the third country. Their tariffs were generally low, and the third countries were not, for the most part, exporting competing products. What could have been more irksome was the preferential status that the European Union and the United States each gained in the markets of the third countries. The trade barriers of the third countries were generally considerably higher, and the margin of preference that each enjoyed in their markets was therefore greater. For instance, in the early 1990s, the unweighted average tariffs of Egypt, Morocco, and Tunisia, with which the European Union negotiated free trade agreements, stood at 34, 23.4, and 28.5 percent (see Pelkmans and Brenton 1999, 106). But since the trade links of most of the third countries were, in any case, predominantly with one or other of the two major partners, diversion from the other was probably minor. In addition, if a free trade agreement threatened to divert trade from one or the other of these powers, there was always the possibility that the adversely affected power could also enter into an agreement (as the United States did with Israel and as the European Union did with Mexico). This placed both the European Union and the United States in a preferred position vis-à-vis other industrial exporters, most notably Japan and other Asian countries. Finally, there was the compelling reason that most of the preferential arrangements into which the European Union or the United States entered either had the active political support of the other or, at very least, were politically inoffensive.

Historically, it appears broadly true that states have quietly accepted the emergence of regional or bilateral trading arrangements among their trading partners when the perceived intent of the arrangements has been closer political alliance or economic integration. It has been the formation of preferential trading arrangements exclusively for commercial advantage that has provoked the trade rivalries dangerous to multilateral cooperation. It is, of course, always a matter of judgment whether or not particular trading arrangements are exclusively commercial. But economically successful customs unions or free trade areas have generally shared quite distinctive characteristics. They have normally been composed of contiguous countries, usually with roughly similar levels of per capita income and with sufficiently diverse productive structures to allow mutual specialization.

While this is not the place to assess the economic rationale of the many recent trade arrangements, some of those favored by the leading economic powers did not conform to the pattern just described and aroused misgivings.[15] Particularly suspect was the kind of "hub-and-spoke" network of bilateral free trade agreements drawn up between one or other of the leading economic powers and several weaker countries in a region. The separate free trade agreements drawn up between the European Union and the different Central and Eastern European countries were of this kind; they threatened to divert the latter's trade with neighboring countries to the European Union.[16] Concern about the emergence of this kind of relationship in Asia was expressed in the early 1990s. Australia feared that the United States might seek to negotiate a series of bilateral trade deals with Asian countries offering preferential access to NAFTA, partly to gain a competitive advantage over Japan; in 1992, the then Australian prime minister, Paul Keating, warned the United States of "accumulating resentment and resistance."[17] It was also alleged that in proposing the formation of a Free Trade Area for the Americas, the United States initially suggested a series of negotiations with individual countries (beginning with Chile); however, the United States later accepted simultaneous, collective negotiations.

Some have argued, with good reason, that the existence of regional or bilateral trading arrangements, whether actual or proposed, has sometimes served to advance multilateral trade cooperation.[18] The launching of the Kennedy and Uruguay Rounds certainly owed something to concerns that regional arrangements might otherwise become exclusionary. The claim can also be made that regional trade arrangements have sometimes set precedents in establishing new rules for trade conduct that have later been followed in multilateral negotiations. However, the recent proliferation of regional and bilateral trade agreements tugged in the opposite direction, too. For one thing, it can only have multiplied the instances of trade diversion. Though the evidence suggests that the adverse economic effects of trade diversion were, in general, not substantial, they were sometimes significant for particular countries or exporters. In any case, at issue was not only loss in economic efficiency but also the damage that discrimination caused to external relations.[19] Most obviously, such agreements allowed the more powerful countries to differentiate among their weaker trading partners on political grounds when pursuing commercial policies. Further, they added to the complexity and opaqueness of customs procedures, since it became important to determine the country of origin of imports. Many imported products contain materials or components that come from third countries, so it becomes necessary to apply rules about how much local content there should be in a product before it qualifies for preferential treatment. Such rules—being applied administratively and often differing among trade agreements—have been a fertile source of friction.[20]

It was fortunate for multilateral trade cooperation that the recent proliferation of regional and bilateral trading arrangements took place in a period of relatively buoyant economic growth in most areas of the world. In more difficult economic conditions, the pursuit of these arrangements might have degenerated into more nationalist rivalry.