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Regionalism and the WTO: Should the Rules Be Changed?

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Over the past decade, many regional economic arrangements have been negotiated. The most well-known are the program of the European Union to complete its internal market reforms (EC-92); that of the United States, Canada, and Mexico to form the North American Free Trade Agreement (NAFTA); and the Asia Pacific Economic Cooperation forum (APEC). But these were only the most prominent of a rapidly growing number of preferential economic agreements that have emerged or been revitalized in recent years. The International Monetary Fund (1994) counts 67 such agreements in 1994. The phenomenon covers all five continents and most of the alphabet, from the ASEAN Free Trade Area (AFTA) and the Andean Pact (ANCOM) to the Central African Customs Union (UDEAC) and the West African Economic and Monetary Union (WAEMU). According to Gary Sampson (1996), all but three WTO members are party to at least one regional agreement.

Some pessimists see this trend as a return to the past. They believe that the world trading system is fragmenting today just as it did in the 1930s. The rules-based multilateral trading system developed under the General Agreement on Tariffs and Trade (GATT) will be destroyed as Europe, North America, and Asia become ''fortresses'' in which some trading partners obtain refuge while others are excluded. In his best-selling book *Head to Head*, Lester Thurow (1992), for example, proclaimed that ''the

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GATT is dead'' and argued that the world would shift to a tripolar system with blocs centered on Europe, the United States, and Japan that would have free trade internally but managed trade among them.

Multilateralists, such as Jagdish Bhagwati, are not willing to give the GATT its last rites but remain concerned that the expansion of regionalism will undermine the multilateral system and weaken its thrust toward liberalization (Bhagwati 1992, 1994; Bhagwati and Krueger 1995). Bhagwati fears that if some countries gain a vested interest in preferential arrangements, they will have less incentive to press for complete free trade. Furthermore, if leaders devote resources and political capital to their regional arrangements, they could be diverted from investing in the multilateral system. He concedes that regional arrangements may have helped spur the completion of the Uruguay Round. But he argues that now that the round has been successfully completed, the World Trade Organization (WTO) should be the sole locus of future trade liberalization. Bhagwati therefore calls for a more exclusive reliance on global initiatives.

There are, however, more sanguine views. Regional arrangements have also been presented as a complement and supplement to liberalization under the multilateral trading system. Indeed, this is the traditional view enshrined in GATT Article XXIV, which permits the formation of preferential trading arrangements, such as free trade areas (FTAs) and customs unions, provided they meet certain conditions. It is also the view of many American officials. By following *both* regional and multilateral approaches, they argue, world trade liberalization can proceed more rapidly.[1] Such a multispeed approach to freer trade can achieve greater gains for those willing to proceed faster and at the same time put pressure on the multilateral track to perform better.

In my view, there is a role for both regional and multilateral agreements. This is particularly the case as agreements move beyond dealing simply with border barriers and toward facilitating foreign investment and the more complex aspects of deeper international integration for which, in some cases, multilateral agreements may be neither feasible nor even desirable. [2] In addition, the motives driving agreements today are fundamentally different from those that drove them in the 1930s and that drove developing countries in the 1950s and 1960s. By contrast with earlier agreements, where the desire was for increased isolation, today countries concluding these agreements seek greater integration in the global economy.

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1. According to Mickey Kantor, the United States Trade Representative, ''Regional trading arrangements . . . can prepare developing nations for admittance to the global trading system . . . [and] . . . they can complement global trading and lubricate negotiations'' (''Global Village Gathers Speed,'' *Financial Times*, 13 October 1993, 11).

2. For more discussion, see Lawrence (1996).

On balance these agreements are positive developments. They do pose problems for the multilateral system, but these are more subtle than the cataclysmic effects some would predict. The devil lies in the details of these agreements, which could undermine multilateral liberalization that has already occurred or make further progress more difficult to achieve.

However, my beliefs and those of other academics are probably irrelevant. Regardless of what we may decide, the existing political commitments to regional arrangements make them a fact of life for the foreseeable future. Since they are here to stay, an important challenge for the World Trade Organization is to ensure that these regional agreements are compatible (or at least to limit their incompatibility) with the multilateral trading system. In this paper, therefore, I consider how well the current WTO rules and procedures actually meet this challenge. Before appraising the rules, however, a brief review of the theory of preferential trading arrangements is in order.

Trade Theory

A central tenet of international trade theory is that in a competitive global economy, complete free trade maximizes global welfare. However, theory provides a more ambiguous verdict of the welfare implications of a preferential trading arrangement, which removes the barriers between only a few trading partners.

Superficially, it appears plausible that if free trade is optimal for the world, any movement toward free trade will improve global welfare. Removing the trade barriers between a group of countries without raising barriers to other trading partners seems to be a step in the right direction. However, theory has demonstrated that such measures do not necessarily make the world better off, and do not even necessarily make those concluding such agreements better off.

As Jacob Viner (1950) emphasized, eliminating the internal trade barriers in a customs union will lead to more trade between partners, and this ''trade creation'' should add to welfare. But a customs union could also reduce trade between the members and the rest of the world. This ''trade diversion'' could misallocate global resources. If outside producers are actually more efficient than those inside the agreement, global efficiency declines when the producers within the agreement expand production and the producers in the rest of the world contract production.[3]

3. Viner's original presentation of this theory was couched purely in terms of the costs of production. As Meade (1955) and Lipsey (1957) later pointed out, the removal of tariffs also brings a benefit from less distorted consumption. Thus welfare in an FTA member country *could* rise, even though it is buying from a higher cost source, if the benefits from more efficient consumption exceed the loss of tariff revenues.

It was thinking about preferential trading arrangements that led Lipsey and Lancaster (1956) to enunciate a more ''general theory of the second best,'' which states that reducing some distortions while others remain does not necessarily increase welfare. ''If it is impossible to satisfy all the optimum conditions [in this case, global free trade], then a change which brings about the satisfaction of some of the optimum conditions [in this case, an FTA] may make things better or worse.''[4]

As more regional agreements are concluded, the key question, as phrased by Bhagwati, is whether they are building blocks or stumbling blocks? Does the rise of preferential trading arrangements make the achievement of full multilateral liberalization more or less likely? The literature provides support for both views—that regional agreements could tilt policies toward further liberalization or toward further protection.[5]

As might be expected, predictions are sensitive to the manner in which the dynamics of trade liberalization are modeled. There are many plausible considerations leading to opposite conclusions. Naive application of optimal tariff theory, the dangers of capture by protectionist interests, increased interests of those benefiting from trade diversion in protection, the diversion of political capital, and dilution of political support all make multilateral liberalization less likely. On the other hand, reactions by other major players demanding accession or liberalization, the greater ease of monitoring and negotiating, the ability to adjust in stages and thus reduce protectionist interests, and the increased difficulties of capturing large arrangements—particularly customs unions and the desire to eliminate trade diversion by external liberalization—all make global liberalization more likely.

While the literature leads to agnosticism, it does suggest that the rules governing the formation of preferential trading arrangements could have an important influence on the dynamic path toward full liberalization. Three aspects of the rules are important. First is the question of compensation. Do nations forming an agreement have to compensate outsiders by lowering external tariffs? Kemp and Wan (1976), for example, explored the implications of a compensation rule in which countries forming a customs union are required to lower their external tariffs to keep their imports from the rest of the world unchanged. This rule guarantees that all customs unions are trade-creating. An important feature of this regime

4. If trade barriers were the only market imperfection in the world, their elimination would improve aggregate welfare. However, if not all barriers are removed, or if there are other market imperfections in addition to trade barriers, we cannot be sure that removing some barriers will be welfare-improving. The reason is that in a world in which market imperfections remain after the trade barrier has been removed, prices will not reflect social opportunity costs. Resources could therefore shift away rather than toward their optimal allocation.

5. See Frankel (1995) for a more complete survey.

is that countries have an incentive to keep expanding their membership until they reach multilateral free trade. As Kemp and Wan argue, ''An incentive to form and enlarge customs unions persists until the world becomes one big customs union, that is until free trade prevails.''

The second issue is the rules for external protection. Can members raise external tariffs? Specifically, it makes a difference if such agreements prohibit members from raising their external tariffs, as the GATT stipulates. This rule renders moot the predictions based on optimal tariff theory, which suggest that larger regional arrangements will seek higher external protection. Such factors could, nonetheless, affect incentives for additional liberalization.

A third and crucial aspect of the dynamic development of preferential trading arrangements concerns their rules for accession—particularly the requirement that they accept outsiders, albeit on a conditional basis. The dynamics of regional groups that are open to all newcomers will differ from those of exclusive or selective ones. Baldwin (1993), for example, explored how the expansion and deepening of an arrangement will increase the incentive of outsiders whose competitive positions are deteriorating to seek membership. Yi (1994) showed that if agreements are open to new members, a system of preferential agreements will eventually become full multilateral free trade.

These considerations suggest that the WTO and its rules could play an important role in the dynamic evolution of the system. In light of these considerations, let me now appraise the rules of the GATT.

The GATT Rules

Article XXIV lays out the conditions under which contracting parties may violate the GATT's key principle of most-favored nation (MFN) treatment and form preferential trading arrangements such as customs unions and free trade areas. The basic notion behind the article is that the GATT will permit discrimination but only in return for full liberalization. The price of violating MFN would be paid only if countries were willing to go ''all the way.'' GATT requires, therefore, that such agreements cover ''substantially all trade.'' In addition, countries concluding free trade areas should not raise external tariffs, and in customs unions the common tariffs of the group toward third countries should not ''on the whole'' be more restrictive than the ''general incidence of'' duties and regulations before the customs union was formed.

The rules allow these conditions to be met gradually. They allow for ''an interim agreement''—one that leads to a customs union or free trade area ''within a reasonable time''—to depart from these provisions.[6] Agree-

6. In the Uruguay Round, the agreement states that ''a reasonable length of time'' should exceed 10 years ''only in exceptional cases.''

ments among developing countries are treated more leniently; basically they are free to establish whatever types of agreements they choose.[7] Finally, the GATT requires countries to submit all agreements for examination by a working party to ensure conformity with GATT rules. It is not necessary for agreements to be explicitly approved; they may be implemented unless the working party formally objects.

These GATT rules have been assailed from several directions. Some challenge the need to allow preferential arrangements in the first place. Why not simply repeal Article XXIV? A second line of criticism is focused on the lack of theoretical rigor in the rules for ''substantially all trade'' to be covered and the absence of a requirement that third countries be compensated for trade diversion. A third concern is the GATT's tolerance of both free trade areas and customs unions and related issues of rules of origin. A fourth is the lack of a requirement that outsiders be allowed to join. Let us evaluate these criticisms and the changes that have been proposed.

Repealing Article XXIV and Outlawing Preferential Agreements

Devotees of the GATT system sometimes point out that regional agreements violate the fundamental rule of unconditional MFN and should therefore be banned. Regional arrangements are second best, and thus multilateral liberalization should be the only mechanism for liberalization. However, proponents of this view lay claim to a high ground they do not deserve. This same problem of the second best also applies to partial liberalization on an MFN basis. If a country removes only some tariffs, albeit multilaterally, it could also make itself (and others) worse off rather than better off. For example, removal of tariffs on inputs but not final products could increase effective protection and lead a country to increase production of goods that it produces inefficiently.

Over the postwar period, the world has moved toward free trade through two second-best methods, partly at the GATT in trade rounds that successively lowered trade barriers and partly through preferential arrangements. One process entails partial liberalization but full participation; the other, full liberalization but partial participation. Moreover, considerable liberalization has been achieved through the regional channel. How many countries would be willing today to extend the tariff-free access they afford to their preferential partners? If countries were required to practice complete MFN, they might seek to renegotiate the full array of their concessions. It is by no means clear this would result in freer

7. In 1979, these GATT provisions were further weakened in the case of developing countries by the enabling clause, which in most cases allows FTAs that are concluded between developing countries to bypass Article XXIV altogether.

trade; indeed it probably would not. Therefore, regional and preferential arrangements are here to stay, and this is not necessarily a bad thing.

Eliminating the ''Substantially All Trade'' Rule

The GATT requires that its contracting parties eliminate barriers in ''substantially all'' trade. Does such a rule lead to the most efficient outcomes? From the standpoint of pure trade theory, the answer is probably not. Trade theory argues that completely eliminating internal barriers is likely to reduce welfare by more than only partially removing them would.[8] But it is quite possible that partially removing some internal barriers could actually be better than completely removing all—specifically, retaining internal barriers in sectors in which there would be trade diversion.

Even though it appears to violate the precepts of trade theory, the GATT rule makes sense. Most trade theories assume that policymakers seek only to maximize national welfare. But in reality, decision makers may have political incentives to conclude agreements that promote the interests of some groups at the expense of others, and without a GATT rule covering substantially all trade, diversion would probably increase (Grossman and Helpman 1993).

There is always a temptation for parties to an agreement to seek benefits at the expense of outsiders or those weakly represented. By requiring the removal of substantially *all* barriers, Article XXIV prevents countries from framing agreements that maximize trade diversion and minimize internal adjustment by liberalizing trade only in products where members compete with outsiders rather than each other. For example, assume Mexico makes no mainframe computers but the United States and Japan do, while the United States makes no footwear but Mexico and Korea do. An agreement between the United States and Mexico that only liberalized trade in computers and footwear would give US producers an edge over their Japanese competitors in computers and Mexican producers an edge over Koreans in footwear. Such agreements are precisely the sort that are likely when countries do not face the discipline of covering ''substantially all trade'' and when domestic firms can strongly influence outcomes.

This rule also reinforces the basic MFN principle by preventing countries from applying selective liberalization. In the previous example, Mexico was willing to trade with the United States in computers duty-free but not with Japan. The GATT seeks to confine such arrangements to

8. As noted by Meade (1955, 50-51) and Lipsey (1957), welfare is more likely to be raised if tariffs are merely reduced than if they are completely removed. The argument is that there is likely to be a second-best internal tariff rate that maximizes welfare. It could be above or below the current one. If it is above, and you make a big move, you will clearly reduce welfare. If it is below and you make a big move, you could move past it.

cases where there is an intense political commitment, as reflected by the partners' willingness to undertake significant structural adjustment.

Finally, trading areas, like nation-states, are natural units of the GATT. Once countries remove all internal barriers—particularly when they form customs unions—they can legitimately be considered the equivalent of nation-states. After all, the initial GATT membership reflected a world divided into nation-states largely by historical accident.

Maintaining External Tariffs

The GATT also insists that preferential arrangements not be used as an opportunity to renege on previous tariff bindings. In the case of free trade areas, none of the partners can raise their tariffs. Following this stricture poses problems for new customs unions. When the European Community was formed, for example, countries moved to the simple arithmetic average of the rates prevailing in each of the members. This raised average tariffs for Germany and Benelux and reduced them for Italy and France. Obviously, some outsiders were helped and others were hurt.

Again, this rule is not clearly supported by trade theory since it, too, ignores the distinction between trade diversion and trade creation. The preferential treatment given to a partner in the agreement may reduce the demand for products from nonmembers even if external tariffs are not raised. However, the GATT makes no mention of such trade diversion and ignores the impact such arrangements might have on outsiders even when they do not raise external tariffs.

One explanation for the GATT rule is that the signatories do not understand this notion and/or are unwilling to confront powerful members with demands for compensation that the GATT might be incapable of enforcing. Indeed, as I will discuss in greater detail below, the record of laxity with which the GATT has enforced even its weaker conditions underscores the problems it might face if it pressed for trade-diversion compensation.[9]

Compensation

An alternative rule would eliminate trade diversion by insisting that preferential agreements leave outsiders at least as well off as they were before the agreement. This could be achieved by lowering external tariffs to maintain levels of imports from outsiders.[10] By eliminating the effects

9. The GATT has been extremely tolerant of special regional arrangements and never rejected one. According to Schott (1989), GATT has never censured an agreement and only four have formally been declared to be GATT-compatible. The experience with the European Community is illustrative. Its precursor, the European Steel and Coal Community, clearly violated Article XXIV, but GATT nonetheless gave it a waiver.

10. See McMillan (1993) for such a proposal.

of trade diversion, this proposal would confine the effects of preferential arrangements to trade creation and also would encourage countries to continue enlarging their agreements until all trading partners were included.

However, this prescription confronts both practical and conceptual problems. In principle, countries should know what kind of compensation they would have to pay before entering an agreement. But beforehand there will inevitably be considerable uncertainty about the extent of trade diversion that is likely. Moreover, after the agreement comes into effect, it will be difficult to separate the effects due to the trade-diverting aspects of the agreement from other economic changes. Indeed, the debates over the magnitudes of trade creation and trade diversion due to the formation of the European Common Market remain today.

A reduction in imports from the rest of the world does not necessarily indicate trade diversion. For example, take the case in which an agreement removes nontariff barriers. Assume that country A is a more efficient producer than country C but that a quota originally constrained imports from country A to country B and thus B met its needs by buying from C. A free trade agreement between A and B that removed the quota would allow A to increase its sales at the expense of C, but this would represent trade creation rather than diversion. The same would be true for many measures relating to behind-the-border barriers that increase efficiency and thus improve the competitiveness of a preferential arrangement's members.[11]

Finally, if preferential arrangements have dynamic effects that enhance investment and growth, outsiders could gain from imports induced by higher income if they lost as a result of imports that were deflected through trade diversion. In fact, given the impracticality of the requirement for compensation, the current GATT rule actually seems to make sense as a minimum restriction on new preferential arrangements.

Customs Unions and Free Trade Areas

Article XXIV allows for both free trade areas and customs unions and, as noted above, focuses on prohibitions against raising tariff barriers against nonmembers. By concentrating only on tariff barriers, the GATT rules may miss a potentially powerful source of trade diversion that may occur when free trade areas are formed—namely, restrictive rules of origin. Members of free trade areas differ in their external tariffs, and this poses a problem. Without rules of origin, imports from outside the free trade area could be brought into the low-tariff countries and then shipped

11. Also, although the presumption is that this member's terms of trade will decline, as Corden (1972) notes in his survey of customs union theory, the rest of the world might even see its terms of trade improve and thus not require compensation.

duty-free to members with higher tariffs. Rules of origin that define eligibility for duty-free access between members of a free trade area provide an opportunity for raising barriers against outsiders while leaving tariff levels unchanged. The most notorious example in NAFTA is the requirement that certain apparel products be 100 percent North American to qualify for duty-free movement across NAFTA member countries. This creates a disincentive against the use of non-NAFTA fibers, yarn, and fabric.

Anne Krueger (1993) has argued that the extensive use of rules of origin in free trade areas is likely to raise protection with respect to outsiders. In addition, she argues that rules of origin that protect insiders are likely to give firms a vested interest in maintaining the protection and thus reduce the FTA members' willingness to liberalize externally. If this is true, then the GATT should permit only customs unions in its rules for preferential arrangements.[12]

The problem with this prescription, however, is that countries concluding an agreement could no longer conduct independent trade policies. Since many countries might be unwilling to give up this important dimension of sovereignty, this stricture might avert FTA agreements that would be welfare-enhancing. Had a customs-union-only rule been in effect, the NAFTA would never have been concluded, since it is hard to imagine any of the three countries being willing to give up their trade policy independence or directly contravene the GATT. However, once the agreement was negotiated, the drive to more inclusive regional extensions has continued. These extensions would have been far more difficult had the members been negotiating a customs union.

In addition, this requirement ignores an important advantage of free trade areas—namely, that members can actually mitigate the harmful effects of trade diversion by lowering their barriers toward the outside world. Indeed, since trade diversion is harmful not only to outsiders but also to FTA members, countries have an incentive to do precisely that.

It is true that customs unions have some important advantages. They avoid the crazy-quilt complexity, expense, and inefficiency that occur when countries join several free trade areas simultaneously. In addition, even if rules of origin are not protectionist, their existence requires customs officials to inspect all products crossing the internal borders of a preferential arrangement's members.

Customs unions are not without their own problems, however. They can increase the market power of their members, and they could change their antidumping rules in a way that raises external barriers. For example, the market power of the European Union is considerably greater than

12. An even stricter rule would be to allow only customs unions but to require that participants adopt the lowest tariff of any of the partners. This rule would lead to less trade diversion than the current rule, but it would also make countries with low tariffs less attractive partners.

that of its members acting alone. Players with such bargaining power may see advantage in using it either to increase protection or to impose unilateral concessions. Europe has used such power in demanding voluntary restraint agreements and applying antidumping provisions. Indeed, just as the NAFTA used rules of origin as a protectionist tool of industrial policy (for example, the stipulation that certain processes in the production of televisions be performed in North America to qualify for duty-free treatment), the European Union has used the requirement that the diffusion process for semiconductors be performed in Europe to escape antidumping actions.

Rules of origin are an important problem, but dealing with them by banning free trade areas is too extreme. Article XXIV does state that members concluding an agreement should ''not raise barriers to the trade of other members.'' This could be interpreted to include measures other than tariffs. It would surely be preferable to constrain free trade areas' ability to tailor these rules to meet the protectionist demands of particular industries.

The ongoing discussions at the WTO relating to rules of origin should focus on this issue. One approach would be to forbid industry-specific rules of origin and to allow free trade areas to remain GATT-legal only if a single rule of origin is used for all products. The logic is similar to the rule requiring removal of ''substantially all'' internal trade barriers. A single rule might not be the most efficient rule of origin for all products, but this stricture would curtail use of these rules for political purposes.

Open to Outsiders

A final issue concerns rules of accession. Some have argued that preferential arrangements should automatically be opened to other WTO members seeking to join on the same basis as those already participating. This would provide outsiders with a ready means for mitigating any trade diversion.

This approach, which has been proposed as a means to achieve open regionalism in APEC by the Eminent Persons Group (1994), is attractive from an economic standpoint. Indeed, it could set up a powerful momentum toward multilateral liberalization. But as free trade areas become increasingly intertwined with deeper economic integration measures that GATT does not cover, this ''open regionalism'' becomes less feasible.

Regional agreements reflect complex negotiations. Sometimes countries grant concessions in areas not covered by GATT to gain trade concessions. They may be unwilling to extend these to outsiders. It is hard to imagine how the GATT could force open membership in agreements when the partners were not willing to admit outsiders and not hard to imagine members defining conditions for access that would inhibit outsiders from joining.

Implications

The real challenge for the WTO over the medium term, therefore, lies not in trying to change the rules of Article XXIV. These seem reasonable. Instead, the challenge lies in other GATT rules, in ensuring that the rules of Article XXIV are actually followed, and in speeding the process of global multilateral liberalization.

Rules of Origin and Dumping

The major abuses perpetrated by the emerging regional arrangements relate to their use of rules of origin and antidumping provisions. Both sets of rules need to be reformed. First, the use of sector-specific rules of origin should be illegal in free trade areas. One approach would be to allow only one rule for all products (see, e.g., Snape, forthcoming). Parties could choose a certain percentage of value added or a definition relating to substantial transformation but would not be allowed to tailor rules to the demands of specific industries.[13] Second, antidumping rules need to be radically restricted—ideally replaced by competition rules.[14] At its Singapore ministerial in December 1996, the WTO should pledge to prepare for negotiations on these issues.

Enforcement

The weak enforcement of Article XXIV is symptomatic of weak GATT enforcement more generally. According to Sampson (1996, 90), of the 80 working parties that have been formed, only one—convened to examine the Czech and Slovak Republics' agreement to form a customs union—found an agreement in conformity, and none have been found not in conformity. Further confounding the enforcement problem is the fact that measures in some regional agreements are inconsistent with existing GATT commitments.

GATT enforcement must be made more effective and credible. In particular, working groups should police agreements far more actively. The single most important reform would be to have working parties reach

13. Another approach to simplifying rules of origin is that of Hufbauer in Wonnacott (1996), who would eliminate rules of origin when external tariffs are within two percentage points of each other and when neither quotas nor other nontariff barriers limit trade with countries outside the FTA. This rule would allow countries to eliminate some rules of origin by aligning their tariffs with those of their trading partners.

14. Editor's note: While sympathetic to this view, Messerlin (Chapter 13) argues that reform of the antidumping rules is unlikely and recommends instead an overlay to those rules to block potential anticompetitive effects of penalty duties.

definite conclusions on the conformity of agreements. This would force the development of a more complete set of interpretations about what the Article XXIV provisions actually mean in practice. It might be hoped, for instance, that tougher and more explicit meanings could be applied to ''substantially all trade.''

There are other clarifications that merit consideration. The WTO should make clear that the ''substantially all trade'' criterion must include agriculture. In addition, agreements among developing countries should be brought under the same disciplines as those applied by developed countries. Differential treatment that allows developing countries to deviate from the ''substantially all trade'' rule is no favor to developing countries. It should at least be made clear that the free trade agreements between developed and developing countries, such as those between the European Union and the Mediterranean countries, should meet this criterion.

The same is true for the differential treatment of services, which should also be brought under the discipline of ''substantially all trade'' (although this might require new negotiations). In particular, despite the widespread recognition that regional arrangements were increasing at the time the Uruguay Round was concluded, the rules for regional integration laid out in the General Agreement on Trade in Services (GATS) are considerably weaker than the GATT's. That is, no liberalization in services is actually required for an agreement to be acceptable—a simple standstill on existing measures is sufficient.[15]

One explanation is that the GATS has been worded with a view to ensuring that existing regional arrangements would be consistent with it. However, in the GATT, countries are required to meet more demanding conditions of liberalization to qualify for preferential trading arrangements (PTAs). The same should be true of the GATS—certainly for new agreements. At a minimum, instead of drawing up rules that all existing agreements could automatically meet, the GATS should have grandfathered existing arrangements and adopted a rule requiring the listing of sectors that are not covered by liberalization—that is, NAFTA's negative-list approach would have been far preferable because it would have made the restricted sectors readily apparent.

The WTO decided in December 1995 to establish a committee to examine new regional agreements. This should lend an overall coherence to the appraisal process that is lacking when working groups act in isolation.

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15. Such agreements must have ''substantial sectoral coverage,'' a condition that is more lenient than ''substantially all trade'' for goods. Second, they are to eliminate existing discriminatory measures *and/or* prohibit new or more discriminatory provisions. In other words, a mere standstill agreement may be sufficient. Third, such agreements are not to raise the overall level of barriers to trade in services originating in other GATS members within the respective sectors compared with the level before the agreement. This description relies on Jackson and others (1995, 928).

In addition, the WTO should develop enhanced analytic capabilities. It should be instructed, and given increased financial resources, to carry out investigations of all regional trade agreements (not just customs unions such as the European Union) just as it now operates its Trade Policy Review Mechanism. These reviews should point out any provisions in existing agreements that fail to meet Article XXIV standards. The WTO should also work out a set of best-practice prototypes for rules of origin and other aspects of regional agreements to help countries design agreements that minimize the effects on outsiders and that help make such agreements more transparent.

Global Liberalization

The best way to ensure that preferential trading arragements do not divert trade is to eliminate all trade barriers. Once the goal of eliminating all border barriers is achieved, only the behind-the-border or deeper integration aspects of regional agreements will be relevant. In this respect, regional agreements have demonstrated that many countries, both developed and developing, are prepared to pledge themselves to complete free trade with large numbers of countries by a certain date. This has been achieved both in the agreements for the Free Trade Area of the Americas, starting in 2005, and in APEC's Bogor Declaration. Indeed, in conjunction with their commitments to open regionalism, APEC members have already implicitly accepted such a commitment. The WTO should, as soon as possible, obtain a similar commitment from all its members.[16]

It is true that when the details of such commitments are actually spelled out, they bring all the major political battles over liberalization to a head at one time. The GATT's incremental approach traditionally has allowed its contracting parties to pick the moment to take on the most sensitive issues. As the example of the Multi-Fiber Arrangement reforms in the Uruguay Round demonstrates, delaying sensitive liberalization to the latest fixed date can mitigate some of these political problems. If it were politically possible, however, a multilateral commitment to open regionalism might actually speed up regional liberalization, as countries sought to take advantage of temporary preferences, and it might also help ensure that these arrangements actually do represent building blocks for global liberalization.

Concluding Comments

Regionalism is here to stay; the key issue is what can be done to keep these arrangements from damaging nonmember countries. Proposals to

16. For a proposal, see Bergsten (1996).

change Article XXIV by requiring compensation or allowing only customs unions are impractical. In any case, the major risk in the evolving regional arrangements is that they could implement new forms of protection, not by erecting new tariffs but by implementing rules of origin and administering antidumping and countervailing duties with protectionist effects. While Article XXIV may have deficiencies, none of the proposed alternatives are without problems.

Instead, the GATT procedures for overseeing implementation of the rules need to be strengthened. In particular, members should not be allowed to adopt sector-specific rules of origin. In addition, the antidumping rules should be reformed. Eventually, these should be replaced by an international competition policy.

The most important thing the WTO can do to ensure that regional agreements do not fragment the world trading system is to achieve credible commitments for, and accelerate the movement toward, multilateral liberalization. Ironically, perhaps, such a commitment could actually speed up liberalization in APEC and the Americas, as countries seek to benefit from preferences that would be only temporarily available. Furthermore, certain provisions in existing agreements, relating to rules of origin in the NAFTA and the European Union's administration of antidumping, should be revised and made less distortionary.

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Comment

Noboru Hatakeyama

It is my pleasure to put forward here my personal idea: the Asia Pacific Europe Economic Cooperation, or APEEC. As we look at the agenda of the forum for Asia Pacific Economic Cooperation (APEC), we see that a key outstanding issue is the decision on whether the fruits of liberalization should be extended to non-APEC countries. On the one hand, since its inception APEC has stressed the importance of ''open regionalism,'' which appears to mean giving nondiscriminatory most-favored nation (MFN) status to nonmember countries. There are strong voices among APEC member countries to extend this status to nonmember countries. In addition, discrimination against any WTO member country in terms of tariffs and quantitative restrictions would violate WTO obligations. On the other hand, there are also voices that oppose giving a ''free ride'' to nonmember countries by extending the benefits of trade and investment liberalization that APEC countries realize as they implement their action plans.

Therefore, the language APEC adopted at Osaka in 1995 for extending MFN status to nonmember economies was ambiguous:

> The outcome of trade and investment liberalization in the Asia-Pacific region will be the actual reduction of barriers not only among APEC economies, but also between APEC economies and non-APEC economies.

This language is almost exactly the same as that in the Bogor Declaration, announced on 15 November 1994. The members could not solve the impasse between ''open regionalism'' and the ''free ride.''

For the time being, this impasse is not so serious. Some developing countries will have to liberalize their trade and investment restrictions

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unilaterally anyway in order to attract foreign investors. China started its ''Reform and Open'' policy in 1978. Since the spring of 1992, when Deng Xiaoping visited southern China, the country has intensified its market-opening policy for foreign investors by strengthening its special economic zones, where economic restrictions are minimal. Meanwhile, Malaysia and Thailand had started welcoming foreign companies well before China did. In addition, such countries as Indonesia and the Philippines, in order to compete with China, have started voluntarily reducing barriers to foreign investors, such as investment regulations and custom tariffs. Thus, a new era has dawned in which companies can select target countries on the basis of merit; this stands in stark contrast to the old era, when countries selected companies through investment licenses. Therefore, unilateral reduction of trade and investment barriers is almost guaranteed, even without international negotiation, at least to the extent that countries change the levels of trade restrictions to make them equal to those of competing countries.

Thus the outcome of liberalization will be extended automatically, even to nonmember countries. However, if member countries harmonize their tariff rates or restrictions with those of more developed countries, the question is whether they can liberalize beyond that level without compensation from nonmember economies such as the European Union? If the European Union takes a free ride on the outcome of liberalization achieved by APEC economies, would this not reduce the European Union's motivation to liberalize more?

A Personal Idea

This is where my personal idea comes in for resolving the impasse between open regionalism and avoiding free riding by outsider economies. Ideally, it would be desirable to maintain open regionalism while preventing the main nonmembers, including the European Union, from getting a free ride. Is there a way to do this? I believe there is.

First, after most APEC countries have liberalized their markets on a par with most developed countries, APEC should consult with the European Union before member countries implement further trade or investment liberalization plans, to find out whether the European Union is willing to implement similar plans.

Second, if the European Union is willing, then both APEC and the European Union should implement further liberalization plans, thus avoiding any free ride by the European Union or APEC.

Third, APEC should implement liberalization plans even if economies other than the European Union are not in a position to implement similar plans. In other words, the rest of the world, other than the European Union, would enjoy the fruits of APEC's liberalization free of charge. This

would, without question, verify APEC's claim to being committed to open regionalism.

Fourth, APEC would ask the European Union to give a free ride on EU liberalization plans to the rest of the world, other than APEC economies. Of course, such EU liberalization plans would not necessarily entail comprehensive existing or future plans, but rather any plan the European Union comes up with to match APEC liberalization plans. Even so, if this request were accepted by the European Union, it would certainly change the basic structure of the European Union from just a customs union to a union based on open regionalism, at least in part.

A Precious Gift

India, Pakistan, Brazil, and Argentina are the ''other countries'' to which many APEC and EU countries don't want to give free rides. However, by the time APEC and the European Union agree with my idea, India and Pakistan will have become members of APEC, and Brazil and Argentina will have been included in NAFTA and possibly even APEC. So these four countries will already be on the right side of the river.

Which countries then could remain outside the circle, taking free advantage of APEC and EU liberalization? The answer is the former communist countries, such as Russia and the central Asian countries, and the African countries. The former are struggling to convert their economies from command to market structures, and the latter are struggling to modernize their economies from scratch. So, if both APEC and the European Union were to give them free rides, this would constitute a very precious gift to these countries.

APEEC

I call this mechanism for consultations between APEC and the European Union APEEC, which stands for Asia Pacific Europe Economic Cooperation.

Would APEEC undermine the WTO multilateral system? Of course not. As I said before, even if APEC countries were to implement their liberalization plans, outside countries other than the European Union could enjoy the outcome of such liberalization free of charge.

Therefore, the nondiscrimination principle, which is the essential principle of the WTO, is assumed in APEC. The next question is, what would motivate APEC countries to propose the concept of APEEC to the European Union? The answer is, APEEC holds many advantages for APEC countries. Let me explain them.

First, APEEC would allow APEC to put pressure upon the European Union to increase the openness of its market to the rest of the world. Second, APEC countries can at the same time prevent the European Union from free riding on the trade and investment liberalization plans they implement. Third, APEC can maintain its motto of open regionalism because it will grant MFN status to the rest of the world other than the European Union. Fourth, if APEEC is realized, the consultation process of the Trans-Atlantic Free Trade Area (TAFTA) will be absorbed into APEEC, thereby possibly preventing NAFTA and the European Union from formulating the world's largest free trade area (FTA)—one that might discriminate against the rest of the world.

TAFTA, the proposed merger of NAFTA and the European Union, has two basic aspects. First, the two sides would consult with each other to expand liberalization. Second, they could formulate an FTA.

However, the three NAFTA members are also members of APEC. Therefore, if we were to realize APEEC, which is a consultation process between APEC and the European Union, it certainly should replace the consultation process between NAFTA and the European Union.

And what would happen to the formulation of a free trade area? Frankly, I believe in the good consciences of the leaders in NAFTA and the European Union. If consultation is handled under the auspices of APEEC, they will not dare to formulate an unprecedentedly large FTA that discriminates against the rest of the world and undermines the multilateralism of world trade.

APEEC includes the United States, which was excluded from the Asian European Meeting (ASEM). Although it was not explicit, the United States must not have been too happy with ASEM. Of course, Asian countries, including Japan, and the European Union have the right to maintain ASEM, as the United States and the European Union have the right to exclude the Asian countries in the trans-Atlantic market. However, the US economy has a huge impact upon the other economies, so it is not only in the interest of the United States but also in the interest of the other APEC and EU countries to include the United States in crucial economic decisions.

Thus, APEEC offers many benefits to APEC countries. Will the European Union take an interest in APEEC and agree to participate? My feeling is yes, for the following reasons.

First, through APEEC the European Union gains an institutional framework for relations with APEC. The European Union must have felt left out ever since APEC was formulated seven years ago and as it has continued to grow. So APEEC is an ideal opportunity for the European Union to formulate an institutional relationship with APEC, home of the world's economic growth center.

Second, if the European Union rejects APEEC, this would encourage APEC to formulate an FTA. An APEC FTA would be a nightmare for the

European Union because it would discriminate against the rest of the world, including the European Union.

Of course, APEC countries don't have any intention to formulate an FTA right now, nor are they ready to do so in reality because, for example, of the confrontation between the United States and China over MFN.

However, if the European Union rejects APEEC, then APEC will be more inclined to formulate an FTA, as this would be the only way consistent with the WTO to avoid giving the European Union a free ride. I think that the EU leaders will be smart enough not to give APEC a reason to formulate an APEC FTA.

I should also mention that the establishment of APEEC would likely prompt Switzerland to join the European Union, out of fear of missing the bandwagon.

Conclusion

In one of Japan's most respected nationwide newspapers, I noticed an encouraging article, in which Amnuay Viravan, deputy prime minister of Thailand, told reporters the following: ''The EU should also liberalize its trade and investment by establishing a target year, as is the case with APEC'' (*Asahi Shimbun*, 14 February 1996). I think this statement might be the start of a long process toward the founding of APEEC.

Asia, America, and Europe are playing an interesting game in which different combinations of two exclude the third. Namely, Asia and America have formulated APEC, excluding Europe; Asia and Europe have started ASEM, excluding America; and America and Europe have agreed upon a trans-Atlantic market, excluding Asia. Each of these three always leaves the third side in a not-so-happy position. APEEC, however, would include all three, making each region happy. In addition, if APEEC liberalization efforts were extended to other countries free of charge, the rest of the world would be much happier as well.

Comment

Mari Pangestu

Chapters 1 through 3 provide a good overview of where things stand and where they should be going. I would like to comment on some of the themes that emerged.

First, both Jeff Schott and Gary Hufbauer make the point that, despite the progress made in reducing traditional cross-border barriers such as tariffs and nontariff barriers under the Uruguay Round as well as unilateral liberalization efforts, high protection still exists in certain sectors in both developed and developing countries. The challenge is how to ensure that liberalization continues in these sectors, which are sensitive because of political-economy considerations. Part of the answer, as they pointed out, is that the costs of protection need to be highlighted and the creation of an independent monitoring unit can go some way toward addressing the issue. However, the reality is that ''independence'' will be difficult to achieve in many countries, and given the political-economy considerations, it is another matter as to whether these independently derived results can counter vested interests (which include the government) and ''political'' considerations.

Therefore, external pressure through multilateral commitments—such as through the ''built-in'' agenda for the WTO, regional efforts such as APEC, and the various free trade area agreements—should still be pursued, even in these ''traditional cross-border'' areas. In addition, since typically these sectors are the less efficient ones, a strategy to reduce protection would ideally be accompanied by some sort of restructuring and retraining plan.

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The second theme is the need to prevent the emergence of further barriers to trade once cross-border barriers come down. It is true that progress has been made in many areas in reducing the abuse of certain instruments—antidumping, subsidies, countervailing duties, and, importantly, the dispute settlement mechanism, as Jeff Schott discussed. However, the old ghosts, such as misuse of antidumping actions, continue to haunt us.

Under the Uruguay Round, improvements were made in implementation of antidumping, building on the 1979 Antidumping Code. In essence, the improvements aimed at greater transparency for antidumping actions and established new methodological and procedural rules for national governments undertaking antidumping actions. It is generally recognized that, despite these improvements and given the inherent arbitrariness of antidumping actions, misuse of antidumping measures has not been eliminated.

In fact, the recent trend is toward increased dumping investigations by developing countries (World Bank 1996). Therefore, developing countries, which have only recently begun to be initiators rather than just victims of antidumping, must also heed the oft-repeated warnings about antidumping as disguised protection.

It is illustrative to outline three major issues that the Indonesian government is facing in setting up a mechanism for dumping investigations after legislation was introduced that allows for antidumping. First is the institutional issue of the committee itself. The main issue is whether and how to set up a permanent committee that is backed by the supporting institutions and staffed full time by qualified people. A second and related issue is funding. Investigations of dumping are costly and time-consuming. The third issue is the need for many more implementing regulations relating to technical aspects of dumping investigations. If implementation in spirit is to avoid becoming a tool of disguised protectionism, then it will be important to establish clear guidelines and a transparent process. Under the Dispute Settlement Understanding, GATT challenges of antidumping actions are allowed only against specific abuses of the national administering agency. Therefore, it is imperative for the administering agency to function in accordance with international norms.

Expanding the WTO agenda to new issues is imperative, but it is also a question of timing, approach, and whether the issues should be discussed under the WTO umbrella. These are early days for the WTO, and it will be challenging enough to ensure that what has already been agreed upon in the Uruguay Round is implemented and to consolidate its role in the world without the additional burden of these potentially difficult issues. Developing countries are also concerned that the introduction of new issues is another guise for protection as cross-border barriers fall. Given these considerations, and the fact that these are potentially controversial issues, a careful and well-thought-out approach is needed.

An argument can conceptually and empirically be made for discussing trade and environment and trade and competition policy in the WTO. However, it will be important to delineate which particular aspects under the two broad topics need to be discussed under the WTO because they are ''trade-related'' or have cross-border implications so that there is a need for a multilateral or international agreement. In other words, the WTO is clearly not the place to discuss all aspects of environment and competition policy. Once such issues are introduced, the WTO will need expertise in these areas.

On the other hand, the case for linking trade and labor is conceptually and empirically weak. The ASEAN member nations opposed demands to include the social clause in the mandate of the WTO, as did many other developing economies, and this position has been repeated by individual ASEAN leaders as well as in various ASEAN forums. However, developing economies such as the ASEAN members should also be aware that domestic political-economy pressures in the developed countries will ensure that the debate continues. Moreover, even though the French and US initiative to include the social clause in the WTO mandate failed, it was agreed that the preparatory committee of WTO should discuss it.

Thus, it remains in the interest of ASEAN and other developing economies to raise concerns about linking trade policy with social issues such as labor standards, not just because of the direct effect on some of the countries' industries, but also because of the potential for the social clause being used as disguised protection and generating numerous labor-related trade disputes. Furthermore, ''harmonizing up'' to some predetermined level could encroach on national sovereignty, especially given that the social clause can widen beyond labor standards. More than environment, labor standards is a North-South issue that can affect global trade liberalization if it is not handled properly. Therefore, developing economies need to understand the debate and be able to formulate a response to the challenges of entwining the social clause with trade policy.

One of the main questions is whether the issue of trade and labor should in fact be addressed under the WTO. Putting it on the WTO agenda implies that it is a trade-related issue. If trade is not the root of the problem of lower social standards, then trade policy action will rarely be the best solution. If the issue at hand is ensuring higher labor standards worldwide, especially for the psychological benefits of the developed economies, then the proper forum may be the International Labor Organization (ILO), which has been involved with labor standard issues for the last 75 years.

If the carrot and stick argument is used, then the developed countries can provide the carrot in the form of continued market access, as agreed upon in the Uruguay Round. Of course, then the question arises of whether a ''stick'' is needed, since the domestic constituency in the importing country is not going to be satisfied with goodwill statements that the

highest efforts to raise labor standards in the developing countries are being made. It is difficult to imagine what kind of ''stick'' would be acceptable, however. One way out would be to first agree on a minimum set of acceptable universal labor standards or principles that are in fact part of human rights. This then needs to be followed up by thinking on effective ways to ensure enforcement.

The ILO is more suitable for these tasks because agreement on basic labor rights can be achieved by consensus. ILO conventions apply only to countries that have ratified them, except for the conventions related to the freedom of association and collective bargaining, which apply to all ILO members. There is no enforcement mechanism for compliance; instead ILO's approach is based on consultation and assistance (technical and other) mechanisms to persuade and help national governments enforce standards and peer pressure.

The theme of Robert Lawrence's chapter is that regionalism is here to stay, and he appropriately points out that there is a role for both regional and multilateral agreements. Other than ensuring that Article XXIV is enforced and that other GATT rules such as those governing dumping and rules of origin are not violated, it is also important to emphasize the synergy between regional and multilateral processes. This is especially important for what are termed the ''deeper integration'' issues, such as investment and competition policy, on which it will be difficult to get agreement on a multilateral basis.

Experience with the APEC process indicates that agreement on principles and approaches in difficult areas can be achieved; the APEC nonbinding investment principles are an example of this. Introducing these principles to the multilateral agenda will be the next step, and this can be achieved either through their direct effect on future multilateral negotiations or indirectly, through the countries' ''leading by example''—the idea of open regionalism. This approach relies on peer pressure in APEC—working to prod countries to go beyond their Uruguay Round commitments unilaterally and offering extension of these principles to other countries on most-favored nation basis.

Experience with AFTA and ASEAN cooperation also indicates that what happens in multilateral and other regional agreements can push further regional and unilateral liberalization. When it started in 1992, AFTA's goal was to reduce tariffs to 0 to 5 percent in 15 years, and agriculture was excluded. Four years later, influenced by developments in both WTO and APEC, the target is now 0 to 5 percent in 10 years, and agriculture is included. Furthermore, a GATS-plus framework of services liberalization is being formulated, and an intellectual property rights agreement is also being considered.

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