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Introduction to Regional Trading Arrangements

Regionalism is in fashion. It seems that every month brings news of yet another agreement among a group of countries, or between one group and another, to strengthen their economic links, particularly by removing barriers to trade and investment among themselves.

This is certainly not the first time in history that regionalism has been on the march. There were widespread attempts at regional trading arrangements in the 1960s, which largely failed.[1] Before that, in the 1930s there was a major fragmentation of the world trading system into competing blocs, which in the standard view succeeded only too well.

There is little point in trying to identify the earliest regional trading arrangement in history. For as long as there have been nation-states with trade policies, they have discriminated in favor of some valued neighbors and against others. Regional trading arrangements have at times played major roles in political history. For example, the German *Zollverein,* the customs union that was formed among 18 small states in 1834, was a step on the way to the creation of the nation of Germany later in the century. This precedent has not been lost on those Europeans who today wish to turn the European Union into a single nation-state.

This book seeks to address three big questions regarding the current regionalism. First, how much influence are these arrangements having on actual trade flow patterns? Second, within the approach of traditional customs-union theory, which takes as given the level of trade barriers

1. That period has been called the First Regionalism, and the current period the Second Regionalism (Bhagwati 1991).

between blocs, is the within-bloc liberalization good or bad? Third, after taking into account the possible effects of regional liberalization on global liberalization, we again ask, is the trend good or bad? These three questions are addressed, respectively, in chapters 2-6, 7-9, and 10-11.

There is a geographic emphasis throughout the book. Contrary to standard analyses, it matters that a regional trading arrangement links countries that are located in a common geographic region, rather than linking an arbitrary set of countries.

MFN and Article XXIV

It is somewhat easier to identify the historical origins of the obverse of preferential trade arrangements: the principle of nondiscriminatory trade policies. The principle goes under the name of most-favored nation (MFN) policies. The United Kingdom adopted nondiscrimination as its trade policy early in the 19th century, when it undertook unilateral trade liberalization in 1846—the famous repealing of the Corn Laws (Irwin 1993, 92-95). The principle of nondiscrimination began to spread to other countries with the Anglo-French commercial treaty of 1860. This treaty incorporated a provision that "each of the contracting powers engages to extend to the other any favor, any privilege or diminution of tariff which either of them may grant to a third. . . ." (Maurel 1995). This MFN clause was then repeated in many other bilateral treaties.

But the terminology can cause confusion. Some newspaper readers today wonder why the United States decides to "favor" a country such as China with most-favored nation status, missing the point that MFN simply means treating China the same as the overwhelming majority of US trading partners. It is easier to understand how such a misleading term could have arisen once one understands that MFN clauses originally applied to a small number of trading partners.

The principle says that when a country extends trade concessions to one partner, it must extend them to all. Nineteenth-century negotiators hoped that the procedure would eliminate a potentially harmful incentive that would otherwise hamper negotiations. That is, those who negotiated early had an incentive to withhold concessions, for fear that a partner who entered negotiations at a later stage would get a better bargain, from which the early partner would be excluded. As it turned out in the late 19th century, the system based on the nondiscrimination principle worked well, as it helped reduce tariffs among an ever-growing number of countries.

After World War I, strenuous efforts of Britain and the League of Nations to reinstate the MFN clause as the basis of trading arrangements were unsuccessful. The world divided into separate blocs such as the British Commonwealth, Central Europe, and others. The victorious Allies who planned the world economic system after World War II, particularly the United States, believed that the discriminatory trade practices in the 1930s had contributed to the collapse of world trade and in turn to the Great Depression.[2] Accordingly, the MFN principle was built into the postwar trading system in the form of Article I of the General Agreement on Tariffs and Trade (GATT). The United States opposed discriminatory tariff policies, such as the British Commonwealth preferences, at the time of the GATT's founding. It soon dropped its opposition to preferences, however, in the context of European integration. The Americans considered the political desirability of peaceful European integration to be important enough to warrant an exception to the MFN principle (Irwin 1993; Finger 1993).

From the beginning, the GATT allowed for a major deviation from the MFN principle. In the form of Article XXIV, the GATT incorporated the possibility of regional trading arrangements. This article says that a group of countries may form a free trade area or customs union, dropping barriers among themselves, subject to several requirements.

The first requirement is that ''substantially all'' barriers among the members be removed, neither stopping short at partial preferences (except in transition) nor excluding major sectors: ''A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce [with some exceptions] . . . are eliminated on substantially all the trade between the constituent territories. . . .'' The provision does not define ''substantially all.''[3] The restrictions are looser in the case of preferential trade arrangements among developing countries.

The second requirement is that trade barriers against nonmembers not be made more restrictive than before. When the members go into the arrangement with different levels of tariffs against nonmembers, a process of averaging can go on to set the new external tariffs. If the net effect is to raise some barriers in some sectors, nonmembers who are hurt by this can claim compensation.

Finally, subsequent progress toward economic integration is supposed to be expeditious. The relevant provision says that an agreement ''shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time.'' In the Uruguay Round negotiations concluded in 1994, this length of time was finally defined: it is normally not to exceed 10 years.

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2. Recently, an opposing view has held that regional trading arrangements in the interwar period in fact offered what little scope for trade liberalization existed (Oye 1992; Irwin 1995; Maurel 1995).

3. From early on, the phrase was interpreted both as liberalization covering a high percentage of total trade—80 percent in the case of the formation of the European Economic Community, or EEC, in 1957—and as liberalization occurring in most major sectors, as in the formation of the European Free Trade Association (EFTA) in 1960 (GATT 1994, 738, 766-68).

Despite its usefulness in facilitating integration in regions such as the EEC, a requirement of geographical contiguity or proximity is not mentioned in Article XXIV. Thus, GATT allows such preferential arrangements as the British Commonwealth, which will later be deemed ''unnatural'' in our parlance.

These provisions have been interpreted very loosely. No trading arrangement has ever been rejected by the GATT. In most cases, no ruling has even been made.[4] In chapter 8, we will take Article XXIV at face value and ask whether it could be expected to raise economic welfare, as compared with an alternative world of strict MFN.

The Recent Move to Regionalism

Between 1990 and 1994, the GATT was informed of 33 regional trading arrangements, nearly a third of all deals since 1948. By now there are only a few countries, including Japan, that do not belong to any formal regional trading arrangement, according to the survey of the field taken by the World Trade Organization (WTO, the successor to the GATT), on the occasion of its inauguration (WTO 1995, 27). If the Asia Pacific Economic Cooperation forum (APEC) is counted as a planned regional trading arrangement of sorts, then virtually all countries now belong to at least one such club.

The surge in regional trading arrangements over the last 10 years constitutes a break with preceding postwar history. Previous regional agreements had been neither so numerous, nor so successful, as those of recent years. Perhaps most important, where the United States once tended to oppose them, choosing to emphasize multilateral liberalization through the GATT instead, now the United States is at the forefront of some of the largest regionalist initiatives. Why the change, and why now? Developments in four essentially independent arenas seem to have come together in the late 1980s to create a movement toward regionalism: European integration, US strategy, developments in Canada, and changing attitudes toward trade in the developing world.

The Influence of Europe

The European Community (EC) took a major step with the Single Market initiative, which was adopted in 1987 and took effect in 1992. The ambitious plan was to turn a free trade area into a true common market. European integration has faced some setbacks, most notably the Septem-

4. More precisely, the GATT neither officially adopted nor rejected the relevant reports, such as those on the EEC and EFTA (see, e.g., Fieleke 1992).

ber 1992 and August 1993 crises in the Exchange Rate Mechanism, which put a crimp in the plans for Economic and Monetary Union that had been agreed at Maastricht, Netherlands, only nine months before. Nevertheless, the continued expansion of the European Community, now the European Union (EU), in terms of scope, depth, and geographical area is a truly historic achievement. This success has undoubtedly had a demonstration effect, encouraging emulation in the form of regional initiatives in other parts of the world.

The Reversal of the American Position

The second key force underlying the global move to regionalism is American strategy. Until the 1980s, European steps toward integration produced two reactions in the United States. First, Americans would override their instinctive aversion to regional trading arrangements by taking a dose of geopolitical medicine. The premier motive behind European economic integration—particularly the formation of the EEC in 1958—was the political one of assuring that no more wars, such as the three Franco-German conflicts over the preceding century, would be fought in the heart of Europe. The United States approved this logic and indeed pushed it forward. Second, American governments would respond to European actions on the regional front—that is, EC expansion—by proposing a new round of liberalization negotiations in the GATT so as to keep the momentum in the multilateral direction. This pattern played a role in the Dillon, Kennedy, and Tokyo Rounds.

In 1982, this pattern changed. Trade Representative William Brock encountered European resistance to American proposals at a GATT ministerial conference in Geneva for a new round of multilateral negotiations. He responded with regional initiatives (see, e.g., Destler 1995, 212). He let it be known that the United States was ''willing to dance'' with interested partners. The swift outcome was the US-Israel Free Trade Agreement and the Caribbean Basin Initiative. (Negotiations with Canada took longer.) Where the Americans had previously reacted multilaterally to European actions on the regional front, now they reacted regionally to European actions on the multilateral front. The logic—''if the multilateral road is obstructed, then we will just have to explore these other roads''—continued to hold, at least until the Uruguay Round's conclusion in 1994.

The new willingness to consider departures from multilateralism carried over from the Republican administrations to the Democrats. Lawrence Summers (1991), later to become President Bill Clinton's deputy secretary of the treasury, gave what has come to be seen as a statement of administration policy: that there should be a ''rebuttable presumption in favor of all the lateral reductions in trade barriers, whether they be multi, uni, tri, plurilateral.'' All the ''lateralisms'' are viewed benignly. In other words, any progress toward removing trade barriers is progress. This has remained the policy even after the successful conclusion and implementation of the Uruguay Round and the establishment of the WTO.[5]

If one seeks a deeper historical significance to the new US policy, it might be found, like so many other recent developments, in American concerns with declining economic and political hegemony. In this view, a nondiscriminatory global trading regime, enforced by an institution such as the WTO, is an international public good. That is, the nondiscriminatory regime benefits everyone, but the support to initiate and maintain it will not be provided if each country acts to maximize its self-interest under the assumption that it is too small to affect the actions of others. In this view, the cooperation to support such a regime will only be forthcoming if there exists a hegemonic power—that is, a power large enough to recognize the effect its actions have on the global system and therefore large enough to organize the others into collective action (see, e.g., seminal works by Keohane 1980; Kindleberger 1973; Krasner 1976; Olson and Zeckhauser 1966).

Great Britain was the necessary hegemon in the 19th century. The absence of a hegemon in the interwar period exacerbated the collapse of trade and income in the Depression. The United States has been the necessary hegemon since World War II. Over the last half-century, however, the US share of gross world product has fallen from nearly one-half to close to one-quarter. American perceptions of the decline in economic status are even worse than the reality, particularly in the trade arena. In response, the United States may in effect have decided to ''circle the wagons''—that is, to abandon active support for the nondiscriminatory regime in favor of pursuing its own regionalist agenda. In doing so, it would be repeating the pattern of Britain 50 years earlier, when the declining hegemon instituted imperial preferences. In other words, in the face of lost confidence and possible new claimants to superpower status, the United States wishes to guarantee dominance of its own region.

Canada Enters the Picture

Israel and the Caribbean are too small to constitute a major trend in US policy by themselves. Indeed, it is possible that Brock did not realize he was initiating a long-term shift in American policy in 1982. But the US frustration with the lack of multilateral progress happened to coincide with an independent development—the third link in the chain: Canada instigated negotiations on a free trade area with the United States. In

5. The language was recently repeated (Summers 1995, 48): ''. . . it is important that the march towards lower trade barriers—unilaterally, regionally, and multilaterally—continues.'' See also Council of Economic Advisers (1995, 217-31).

doing so, Canada reversed over 100 years of explicit rejection of proposals for such links with its larger neighbor. An important motive was the developing view among Canadian businesspeople that their domestic market was too small to exploit economies of scale.[6] The new American willingness to consider regional agreements was certainly a necessary component of the bilateral deal, which was completed in 1988 (e.g., Schott 1988, 1989; Kahler 1995b, 13; Krueger 1995, 1, 23-24). But so was the change in Canadian attitudes. That the initiative came from the Canadian side is borne out by the fact that the US allocation of negotiating resources was low-level and, in some key respects, last-minute (P. Wonnacott 1987; Schott and Smith 1988).

Developing Countries' Abandonment of Import Substitution

The fourth component of the new regionalism, and the one that has made it a worldwide phenomenon, is the spread of serious regional initiatives to the developing countries. Most dramatically, in 1990 Mexican President Carlos Salinas de Gortari reversed 150 years of active resistance to the *yanqui* embrace and asked to follow the Canadian precedent in forming a free trade area with the United States. The resulting North American Free Trade Agreement (NAFTA) was concluded in 1992 and ratified in 1993. But there has also been a simultaneous proliferation of regional trading arrangements among developing countries themselves, far more serious than failed attempts along these lines in the past. In 1991 alone, Mercosur was inaugurated among the four countries in that part of South America east of the Andes (Argentina, Brazil, Paraguay, and Uruguay); Venezuela and Colombia reinvigorated the Andean Pact in the northwestern part of that continent, agreeing to establish a common market within two years; and Southeast Asian countries agreed to form the ASEAN Free Trade Area (AFTA). Many more agreements followed as well, in virtually all parts of the world. They are recounted in detail in appendix A, and summarized in table 1.1. Even confined to Latin America alone, the web of agreements is by now dense, as figure 1.1 illustrates.

For some developing countries, keeping a preoccupied United States engaged in their part of the world has been a motive for regional arrangements. President Salinas feared that, after the fall of the Berlin Wall, northern capital might be diverted from Latin America to Eastern Europe. He sought NAFTA in part as a way to counteract that threat. For many East Asians, APEC is a way of keeping the United States involved in the Pacific region, militarily and otherwise.

There was a logical prerequisite for successful regionalism among developing countries. The prerequisite was that countries in Latin America

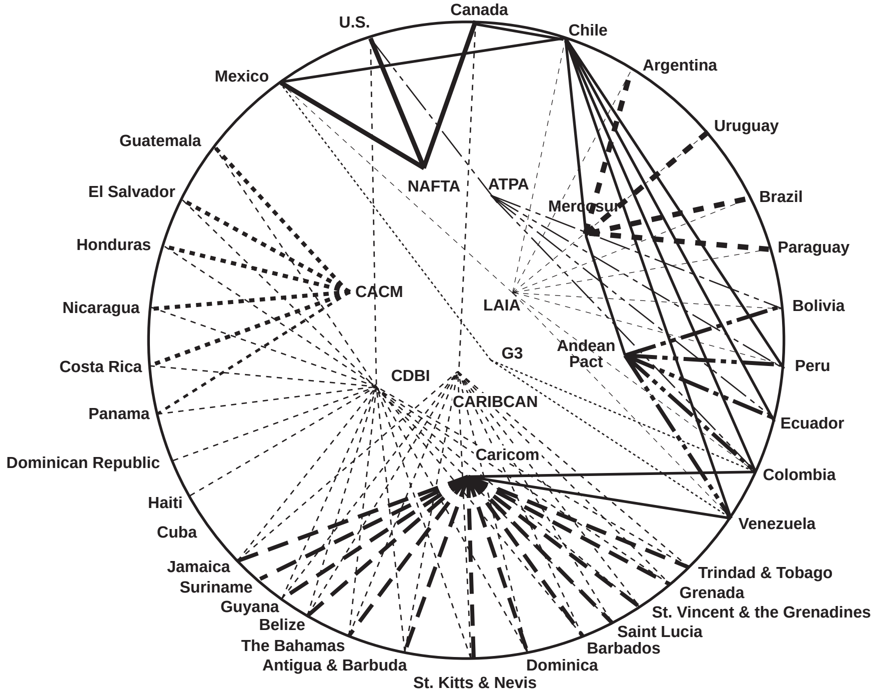
6. Economists also propounded this view (e.g., Wonnacott and Wonnacott 1967; Harris 1984, 1991).

Table 1.1 Chronology of selected major regional trading arrangements, 1957-95

Year	Africa/Mideast	Europe	The Americas	Asia Pacific
1957		1957 Treaty of Rome creates European Economic Community (EEC)		
		1959 European Free Trade Association (EFTA)		
1960		1960 EFTA formed		
1965				1965 Australia and New Zealand sign limited FTA (CER)
		1967 EEC, European Coal and Steel Community, and Euratom institutions merged		
		1968 Customs union completed		
			1969 Andean Pact originally enters into force	
1970				
1975	1975 Economic Community of West African States (ECOWAS) formed			
				1978 ASEAN implements limited preferential trade area (PTA)
		1979 European Monetary System formed		
1980	1980 Southern African Development Coordination Conference (SADCC) formed to counter South Africa			
				1983 CER agreement expands previous FTA

1985				1985-87 Association of Southeast Asian Nations (ASEAN) PTA expanded
		1986 Single European Act enters into force		
			1988 Canada-US FTA signed	1988 CER expanded to include services
	1989 Arab Maghreb Union (AMU) formed			
1990				
	1991 African Economic Community treaty signed; AMU launches integration drive	1991 EC and EFTA agree to form European Economic Area (EEA)	1991 Mercosur formed	
	1992 SADCC becomes Southern African Development Community (SADC)	1992 Maastricht treaty signed	1992 North American Free Trade Agreement (NAFTA) negotiations begin	1992 South Asian Association for Regional Cooperation launches SAPTA
	1993 AMU postpones integration	1993 Maastricht treaty enters into force		1993 Seattle summit sets free trade goal for Asia Pacific Economic Cooperation (APEC)
	1994 AEC agreement enters into force, South Africa joins SADC	1994 EEA enters into force	1994 NAFTA enters into force; FTAA initiative launched at Miami summit.	1994 ASEAN ministers set AFTA date at 2003.
1995	1995 EuroMed FTA discussed between EU and other Mediterranean countries	1995 EU membership expanded to 15	1995 Mercosur implements CET	1995 First round of SAPTA tariff cuts
			1996 Andean Pact becomes Andean Community	

Figure 1.1 Western Hemisphere trade agreements[a]



a. FTAA and some smaller blocs have not been included in this figure. FTAA would include all countries shown except Cuba.

and elsewhere had to ditch the import-substitution model, which had dominated thinking in the 1960s and 1970s, in favor of the market liberalization model. The origins of this sea change are outside the scope of the book, though the widely-watched examples set by the phenomenal success of the East Asian dragons on the one hand and by the collapse of the Soviet system on the other were certainly key factors. Whatever explains the pro-market philosophical shift in the 1980s, it preceded the craze for free trade agreements chronologically and was even more sweeping and fundamental as a movement.[7]

That outward orientation is generally a prerequisite for successful free trade agreements can be seen in the failures of attempts in Latin America and elsewhere under the import-substitution philosophy of the 1960s. As long as the goal was to find regional markets for favored industries that could not compete on world markets, and as long as each country tended to favor the same industries (steel was a typical favorite), the enterprise was doomed to failure. But when the goal is to make industries better

7. References on the trade and growth literature are given in Frankel, Romer, and Cyrus (1995). See also Sachs and Warner (1995).

able to compete internationally, regional arrangements are more likely to succeed (e.g., Lawrence 1995).

A Trend toward Continent-Sized Blocs

In the 1990s, political leaders are talking about expanding the geographic scope of regional free trade agreements within their respective continents. The Bush administration proposed bilateral deals throughout the Western Hemisphere under the Enterprise for the Americas Initiative in June 1990. Concretely, NAFTA contains provisions to add other Western Hemisphere countries, and Chile has been anointed to be first. At a hemispheric summit in Miami in December 1994, President Clinton proposed, and the other leaders accepted, the idea of forming a single bloc. It was given the inelegant name, Free Trade Area of the Americas (FTAA).

A similar expansion is under way in Europe. The European Economic Area (EEA), an arrangement of (relatively) free movement in goods, services, and labor comprising 17 countries, came into being in January 1994. Meanwhile, and more important, three new members joined the European Union in 1995, bringing its total membership to 15 (all of them also members of the EEA). Other countries from Central and Eastern Europe hope eventually to join their western neighbors in the European Union. German Chancellor Helmut Kohl told the citizens of Poland, that they would be able to join by the year 2000, though a later date appears more likely.

Explicit free trade agreements are much less popular in Asia than in the Americas or Europe, but many observers see an East Asian bloc forming nonetheless. The Association of Southeast Asian Nations (ASEAN) admitted Vietnam in 1995 and decided to admit the other countries of Indochina in the future, perhaps in 1997 (and eventually into AFTA). Malaysian Prime Minister Mahathir bin Mohamad had already proposed expanding the group further, into an East Asian Economic Group, which has become the informal East Asian Economic Caucus. A second, still-less formal version of the putative East Asian bloc is a network founded on links among businesspeople who are ethnically Chinese. A third possible version is the yen bloc that Japan is reported to be establishing in the region.

All this regional activity leaves some observers concerned that the world is dividing into three continental trading blocs, one in the Americas centered on the United States, one in Europe centered on the European Union, and one in Pacific Asia, centered on Japan. This book considers regionalism at two levels: both the formal regional trading arrangements that are already in effect and these broader continent-sized groupings that are under discussion. There should be an *a priori* presumption that the existing formal arrangements are more likely to have already had substantive economic effects than are the broader, informal groups, but the latter have also generated a lot of interest.[8]

In chapters 2, 4, 5, and 6, we examine the statistical evidence on how much effect these blocs have had on actual trade patterns, before going on to consider whether the observed trends are good or bad. We make operational an evaluation of the famous trade-off between trade creation and trade diversion by arranging the parameters in our analysis along a geographical dimension.

The geographical dimension would seem indispensable in an analysis of ''regional'' trading arrangements, but in the past it has been relatively neglected. Traditional customs-union theory pays no attention to the physical location of a union's members. This book does. The key result in the theoretical part of the book is that the desirability of regional trading arrangements depends on whether the extent of regionalization exceeds an optimal level that is determined by the magnitude of transportation costs between regions.

This exercise, however, takes the extent of multilateral liberalization as given. Ultimately, a judgment on the desirability of regionalism hinges on whether regional agreements are more likely to build political support for liberalization more generally or to undermine it—that is, whether trade blocs are building blocs or stumbling blocs for global free trade. The arguments are considered in the last few chapters. The balance of the evidence seems to support the first view: that regional trading blocs can be stepping stones toward worldwide liberalization. On these grounds, the ultimate verdict is in favor of regional trade arrangements.

First, some terminology.

Key Terms

Formal regional trading agreements can cover a spectrum of arrangements, from small margins of preference in tariffs to full-scale economic integration. Five levels can be distinguished: preferential trade arrangements, free trade areas, customs unions, common market, and economic unions.[9]

Preferential Trade Arrangements

The loosest type of arrangement is the granting of partial preferences to a set of trading partners. As already noted, if preferences are less than 100

8. Another possibility is that the East Asians and North America form a transoceanic bloc via APEC, dividing the world into two: APEC and a Europe-centered bloc. In part to counter this possibility, some European leaders in 1995 proposed a second transoceanic bloc in the form of a Trans-Atlantic Free Trade Area (TAFTA). We will also consider these prospective blocs.

9. Concise definitions are offered by Balassa (1987).

percent, then the discrimination against nonmembers in general violates GATT Article XXIV. But such partial preferences are common nonetheless. If the concessions are one-way, we term this a *preferential trade arrangement*. Where the concessions are granted by an industrialized country to less developed countries (LDCs), which is the usual case, they have been widely tolerated by the GATT. Examples include the Lome preferences that European countries granted to African, Caribbean, and Pacific countries and the United States' Caribbean Basin Initiative (CBI).[10]

If the concessions are reciprocal, we may apply the term *preferential trade area* (PTA) to describe the club of countries covered. Much of the econometric and theoretical analysis in this book will treat potential regional trade blocs as PTAs.

Free Trade Area

If the members of a preferential trade area go so far as to eliminate all tariffs and quantitative import restrictions among themselves—100 percent preferences—then they form a *free trade area* (FTA). Typically, they retain varying levels of tariffs and other barriers against the products of nonmembers. Uncompetitive industries in the more highly protected member countries may have sufficient clout to prevent their shields from being lowered to the same levels as in the less-protected member countries.

While terminology is ''only a question of semantics,'' semantics can often have a subtle but material effect on the political debate. Words such as ''discriminatory'' and ''free trade'' come with ready-made connotations. If PTAs and FTAs were routinely called ''discriminatory trading arrangements,'' the immediate connotation might be pejorative, conjuring up images of racial or other discrimination.

In contrast, the term ''free trade area'' has a meritorious sound to it. Almost all professional economists are in favor of free trade in general. A good majority of the American public and its politicians consider themselves philosophically disposed toward it as well. Even aggressive trade

10. The GATT grants LDCs exceptions in two areas: (1) preferences from other countries in the form of ''more favorable treatment to developing countries'' and (2) preferential trade arrangements in the form of ''regional or global arrangements entered into amongst less-developed'' countries are both allowed by the Enabling Clause of the Decision of the Contracting Parties of 28 November 1979 (paragraphs 1 and 2(c), respectively). There is no requirement for elimination of barriers on substantially all trade. The first provision forms the legal basis for the Generalized System of Preferences (GSP) and the second for such arrangements as ASEAN, LAIA, Mercosur, Sparteca, and the Gulf Cooperation Council. Before 1979, EC preferences toward developing countries under the Lome Agreement were justified by Articles XXIV-XXVIII of the GATT, which sets a principle of nonreciprocity between developed and developing nations but does not allow regional arrangements. A few other systems of preferences, such as CBI, have been justified under a waiver voted by a two-thirds majority, as allowed under Article XXV.

policy speeches begin: ''I am in favor of free trade. *But* . . .'' (It is never: ''Let me tell you why I am philosophically a protectionist. . . .'') Thus, free trade has a positive connotation.

Jagdish Bhagwati has suggested using the term preferential trading area in place of FTA. He is fully aware that ''free trade areas'' has the same positive connotation as ''free trade'' and thinks that the name should be changed precisely for this reason. While a leading proponent of true free trade, he considers FTAs (and PTAs) harmful, for reasons that will be discussed later. We adhere to standard definitions here, as the distinction between partial preferences and complete elimination of barriers is important.

A bit more terminology is necessary before we leave FTAs. Those who design FTAs fear that, in the absence of special provisions, imports from outside will come into the member country with the lowest tariff and then be reexported to the higher-tariff members, thus obviating the goal of retaining higher barriers in the latter. The special provisions that are thought necessary to deal with this problem are called *rules of origin*. They generally prevent goods reexported from the lower-tariff country to the higher-tariff country from receiving the FTA preferences. The protrade temptation would then be to administer a little value added to the imported good in the low-tariff country so that it can be reexported in the guise of a domestic product. This could be the assembly of a product out of imported parts or, in an extreme case, a simple affixing of labels and packaging. Rules of origin prevent this, typically by specifying how much value added is needed before the product can genuinely be classified as domestically produced. They get very complicated. The antitrade temptation is to specify that any product with less than 99 percent domestic value added in the low-tariff country cannot be exported to the high-tariff member.[11]

Rules of origin also allow the development of a set of FTAs that would otherwise make little sense: a hub-and-spoke system (P. Wonnacott 1996; Kowalczyk and Wonnacott 1992). This would be the outcome if the United States were to negotiate separate FTAs with a number of other countries. Such a hub-and-spoke system seemed a possibility in 1990, after the CBI,

11. Rules of origin take up 194 pages in the NAFTA document. During the 1993 NAFTA debate in the United States, Pat Choate challenged the economists who had signed a letter supporting ratification to say whether they had read the entire document. They were unsure how to answer, since the truth in most cases was ''no.'' A good answer might have been to agree that legal documents tend to be too long and complex these days and to suggest that the agreement be replaced with the sentence, ''There will be free trade between Mexico, the United States, and Canada.'' Most of the rules of origin and other complicated provisions are put into such agreements for political reasons: to buy off sectors that would otherwise oppose the agreement. Without the political opposition of the anti-NAFTA forces, these provisions would not have been necessary. Some free trade economists would be happy to have goods transshipped from low-tariff members to high-tariff members.

US-Israel FTA, and Canada-US FTA were in place and talk turned to adding new partners in Latin America and East Asia. In this case, each partner would be able to export freely to the United States, but not to the other partners. Rules of origin could turn out to prevent importers in the hub from reexporting goods from one spoke into another. As events unfolded in the early 1990s, the United States instead chose the route of bringing Mexico, Chile, and possibly other Latin American countries into the North American FTA. But North America would be a hub with three huge spokes if APEC, FTAA, and a trans-Atlantic bloc all came into being. As a more modest example, Mexico currently belongs to a number of FTAs (figure 1.1).

Customs Union

The next level of integration occurs when the members of an FTA go beyond removing trade barriers among themselves and set a common level of trade barriers vis-a-vis outsiders. This at a minimum entails a common external tariff. Under the terms of Article XXIV, as already noted, the level of the common external tariff can be no higher than an average of the previously existing tariffs of the member countries, or else the group must offer compensation to adversely affected nonmember countries. A full *customs union* would also harmonize quantitative restrictions, export subsidies, and other trade distortions. Indeed, it would set all trade policy for its members as a unified whole. It would, for example, engage in any future trade negotiations with other countries with a single voice.

The distinction between *trade creation* and *trade diversion* is crucial to the classic theory of the welfare effects of customs unions, while also applicable to other kinds of preferential trade arrangements.[12] We shall not review the literature here. Despite the ubiquity of the terms, they do not have standard definitions that are entirely agreed upon. We will use the term trade creation to describe an increase in trade between members of a PTA that occurs as the result of the preferences and trade diversion to refer to the decrease in trade between members and nonmembers that occurs as the result of the preferences. Trade creation is good because a more efficient supplier is substituted for a higher-cost domestic supplier. Trade diversion may be bad because a less efficient supplier in another PTA member is substituted for a lower-cost nonmember supplier.

The presumption that trade creation and trade diversion can be identified with the good and bad effects of PTAs, respectively, is oversimplified for a number of reasons. Trade diversion can under certain circumstances

12. The seminal reference was Viner (1950), followed by Meade (1955) and Lipsey (1960). Reviews are available in many places, such as Bhagwati and Srinivasan (1983), Bhagwati and Panagariya (1995), and Wonnacott and Lutz (1989).

be beneficial. This can happen, for example, when fellow members introduce imports into the domestic market that reduce distortions in consumers' patterns of consumption (Meade 1955; Gehrels 1956; Lipsey 1957). It can also happen when economies of scale allow producers to operate at lower cost (Corden 1972; Venables 1987). Or when the new competition reduces the market power of inefficient domestic monopolies. Some economists have defined trade diversion so as to rule out such beneficial effects, but others reasonably point out that this flirtation with tautology would make the terms less useful (R. Wonnacott 1994, 1996). The distinction between trade diversion and trade creation also omits other important effects, particularly those on the terms of trade—that is, the relative prices of countries' exports. This effect is beneficial for members of the PTA, but harmful to nonmembers (Mundell 1964).

Common Market

Each of the stages considered so far—PTA, FTA, and customs union—falls within a range that the Brookings Institution has recently characterized as *shallow integration*. The direct effects of such arrangements lie exclusively within the realm of international trade. More advanced stages, which we now consider, constitute *deep integration* (Lawrence 1995; Lawrence, Bressand, and Ito 1995).

Beyond the free exchange of goods and services among members, a *common market* entails the free movement of factors of production: labor and capital. The dividing line is admittedly sometimes blurred between the free exchange of services and the free movement of factors: labor includes services such as construction or consulting, and capital includes banking and other financial services. The free movement of capital applies to portfolio capital as well as to foreign direct investment (FDI), which is the purchase and sale across national boundaries of real estate, plant, and equipment. This is deep integration in that it impacts some laws and institutions that could have been preserved as domestic prerogatives even with a high level of trade integration. Examples include policies governing the licensing of providers of professional services, such as doctors, lawyer, and architects, and antitrust or competition policy. Migration is, of course, an especially difficult and sensitive subject in many countries.

Economic Union

Going beyond the free movement of goods, services, and factors, *economic union* involves harmonizing national economic policies, including typically taxes and a common currency. Belgium and Luxembourg formed an economic union in 1921, for example. The decision of the European Community to change its name to the European Union in 1994 represented a determination to proceed to this higher stage of integration. The full unification of economic policies typically would in turn require political federation.

Country groups often choose names that are far too ambitious, or are otherwise unsuited, for the kind of integration or cooperation that they are actually prepared to undertake. Neither the members of NAFTA nor (especially) the members of the ASEAN FTA expect to literally eliminate all interior barriers to trade, as the name ''free trade area'' would imply. The European Community adopted the phrase common market as a goal in the Treaty of Rome, long before its members accepted serious plans to integrate trade and factor movements fully. Typical of more extreme examples is the Central American Common Market, which has yet to aspire to become an FTA, let alone a customs union or common market. Nevertheless, in this book we shall allow groups to call themselves whatever they choose.