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Trade Liberalization and Regional Integration: Implications for 2020

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After seven years of arduous negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT), the Uruguay Round of multilateral trade negotiations was concluded in late 1993. The United States approved the agreement in late 1994, in time for the 1995 commencement of the new World Trade Organization (WTO), which will implement the agreement and provide the major forum for future trade negotiations. Among the important accomplishments of the round is a landmark agreement to begin reforming world trade in agriculture, bringing distorting domestic policies as well as trade policies under GATT scrutiny. The final agreement regarding agriculture, however, is much more modest than originally hoped and provides for a long adjustment period before countries have to do much about reforming their domestic agricultural programs.

There have been a number of quantitative studies of the impact of world trade liberalization and of the formation of subregional free trade areas such as the North American Free Trade Agreement (NAFTA), Mercosur in South America, and the new Asia Pacific Economic Cooperation (APEC). Most of these studies focus on the impact of changes in policy, analyzing the efficiency gains and structural changes that might be induced by changes in import protection. The goal of such studies is not to project the future but to analyze the empirical mechanisms by which policy changes affect the world economy. A few studies are more ambitious, seeking both to evaluate the role of policy changes and to provide projections of how the world economy will look over the next 25 years. The task of projecting the future is the more difficult one, since it requires not only modeling the links between policy changes and economic performance but also correctly specifying the major trends that will drive the world economy.

The last decade has seen major policy reforms in a large number of countries. While the collapse of communism defines an important group of "transition" economies, many nonsocialist developing countries have also changed development strategy, reducing policy distortions and opening their economies to world markets. The future pace and scope of these domestic reforms, along with the continued evolution of regional and worldwide trading arrangements, will determine the policy environment facing countries during the next 25 years. From the perspective of world agriculture, four issues seem especially important:

- Will the developed countries be successful in their efforts to reform distorting domestic agricultural policies?
- How successful will the former socialist economies be in their transition to market economies and how will this transition affect their agricultural sectors?
- How rapidly will regional trading arrangements such as NAFTA evolve and will they move toward closer regional integration, following the lead of the European Union?
- Will there be growing tension between regional trading groups that will undermine multilateral trade liberalization and hinder continued economic integration in the world economy?

In this century, and especially in the postwar period, agricultural productivity has increased dramatically. Three trends have driven this process: mechanization, use of chemicals, and biological innovation. The result has been rapid growth of agricultural output, a steady fall in the relative price of agricultural goods, and the movement of resources, especially labor, from agriculture to industry. A major issue is whether the long-run trend of productivity growth in agriculture will continue into the future.

- How much scope is there for further dissemination of existing technologies into the poorer countries?
- With no new technologies on the horizon, can we expect a leveling off of technical change and productivity growth in agriculture.

What will happen to agriculture over the next 25 years depends on the balance of a number of forces. First, policy reform in the developed countries should reduce distortions and, all else equal, lead to less supply and higher prices. However, the developed economies certainly have the capacity to increase supply again in response to changes in world prices if world market conditions change. Second, success in the policy reforms under way in both the transition economies and the middle-income developing economies may well lead to major increases in efficiency in agriculture and hence to increased supply. Third, trade liberalization should permit specialization, efficiency gains, and increased trade in agriculture. Fourth, against these positive trends must be balanced the possibility that the long-run pace of technological change in agriculture that has dominated the postwar period may be slowing, with potentially dramatic implications for food availability and prices in the face of continued population growth.

Studies of World Trade Liberalization

Early quantitative estimates of the effects of agricultural policy reform in the industrial countries indicated that, while world trade in agriculture might fall, trade by internationally competitive producers would expand in response to increased market access opportunities. All else equal, policy reform would cause world prices for agricultural products to increase by 10-15 percent. Under the terms of the final Uruguay Round agreement, which slows the reform process, the changes in international agricultural trade and prices will be considerably smaller, at least for a long transition period. Holding other factors constant, studies indicate that slower policy reform in developed countries will allow only limited expansion of trade in agriculture by efficient exporters. The increase in world prices for agricultural commodities arising from policy reform will only range from 2 to 5 percent in the aggregate and from 5 to 10 percent for selected commodities such as wheat, sugar, and dairy products.

Among the most robust results found by multicountry models is that increased trade in both manufactures and agriculture occasioned by the new multilateral trade agreement significantly increases both the volume of world trade and world economic welfare. Increased trade leads to opportunities for increased specialization in agriculture. In this environment, many low-income, food-deficit countries benefit, especially if they pursue complementary reforms to liberalize their own trade regimes.

A few studies have focused on labor markets. In general, studies indicate that without changes in the skill composition of the labor force, growth of world trade and output tends to widen the wage differential between skilled and unskilled labor in all countries. The effect is small for the developed countries, moderate for semi-industrial countries, and large for the poorer regions, with dramatic widening of differentials expected in the low-income countries of Asia and Africa. Moderate skill upgrading would suffice to swamp the negative effects of trade on wage differentials in the developed and semi-industrial countries. In the poorest countries, however, even significant skill upgrading would not fully offset the impact of rural-urban migration, which keeps unskilled wages low.

In the poorest countries, given that the strongest force affecting wages is rural-urban migration, policies to support agriculture are very important. Adoption of more liberal trade policies in many of these countries to reduce import substitution, and thereby the frequently encountered disincentives to agricultural production and more balanced urban-rural growth patterns, might be counted upon to improve economic performance and smooth the process of structural change, including response to changes in the international trading environment.

Finally, successful development in the poorest countries depends critically upon maintaining rapid productivity growth in agriculture. Slower world growth of productivity in agriculture would greatly damage the development prospects of the poorest countries and hinder growth generally in the world economy.

Studies of Regional Trading Areas

International trade theory suggests that the formation of a free trade area improves the welfare of member countries if the total volume of trade by those countries increases; that is, if trade creation among the members exceeds the diversion of trade away from nonmember countries. Recent empirical studies indicate that the formation of free trade areas in Western Europe (European Union), South America (Mercosur), North America(NAFTA), and the Asia-Pacific region (APEC and ASEAN) should be expected to result in much greater trade creation than trade diversion (so long as formal trade barriers against nonmember countries are not increased) and hence appreciable improvements in economic welfare for member countries.

In some cases, especially for small countries that are dependent upon trade with member countries before the formation of a free trade area (for example, some Central American and Caribbean countries relative to NAFTA), trade diversion can be significant, raising an issue of possible compensation or other special arrangements for such countries. With regard to the coverage and enlargement of regional trading arrangements, in some situations individual countries might be better off to strike separate (bilateral) trade agreements with potential new entrants to a free trade agreement (Mexico and the United States under enlargement of the NAFTA). In other cases, it is to the benefit of all member countries to achieve the widest possible coverage of a regional free trade agreement (the proposed APEC free trade areas).

Finally, it is important to emphasize that recent quantitative studies generally find that global trade liberalization yields substantially larger economic benefits, including benefits to agriculture, than the proliferation of regional trading arrangements. Thus, while increasing regionalism is emerging as an important element of the current international political economy, it is not a desirable outcome in itself.

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"A 2020 Vision for Food, Agriculture, and the Environment" is an initiative of the International Food Policy Research Institute (IFPRI) to develop a shared vision and consensus for action on how to meet future world food needs while reducing poverty and protecting the environment. Through the 2020 Vision initiative, IFPRI is bringing together divergent schools of thought on these issues, generating research, and identifying recommendations. The *2020 Briefs* present information on various aspects of the issues.