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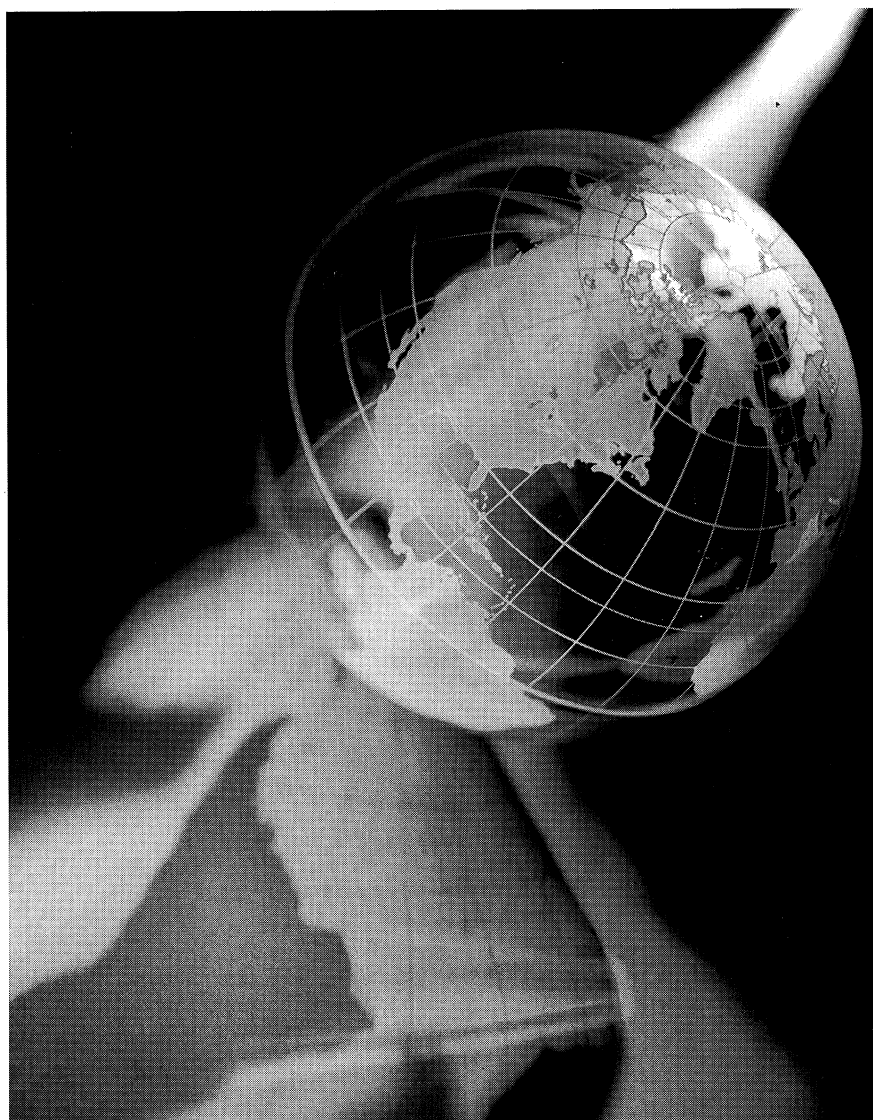
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# **ECONOMIC INTEGRATION IN THE WESTERN HEMISPHERE**

**Edited by Constanza Valdés and Terry Roe**

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## SESSION 2. WESTERN HEMISPHERIC INTEGRATION AND THE WORLD TRADING SYSTEM

### **Regionalism versus Multilateralism in the World Trading System** *David Blandford, Organization for Economic Cooperation and Development<sup>1</sup>*

The formation of regional groupings to promote freer trade between groups of countries has been common in recent decades. A total of 108 regional agreements have been notified to the GATT since its inception. The 1990s have been a particularly active time for regional initiatives; 33 have been signaled to the GATT since 1990.

The growing interest in such arrangements, naturally raises questions about their relationship to multilateralism, which has been the cornerstone of international economic relations in the post-war period. This paper addresses the implications for the world trading system of the apparently growing trend towards regionalism. It focuses on general issues, but also makes a few remarks specific to agriculture and agricultural trade.

#### **Multilateralism and Regionalism**

Few would argue that the signing of the General Agreement on Tariffs and Trade on October 30, 1947 and the series of rounds of multilateral trade negotiations that subsequently took place had a major impact on the post-war international economic environment. The signing of the Uruguay Round Final Act at the end of the eighth round of negotiations in 1994, and the establishment of the World Trade Organization represent milestones in the post-war history of international economic relations. Following the divisive and destructive experiences of economic nationalism in the pre-war period, these relations have been founded on multilateralism -- the use of a cooperative multicountry approach to economic problems and issues, including agreed procedures and disciplines. The International Monetary Fund, the World Bank, and indeed the organization for which I work, the OECD, all have their origins in this multilateral approach.

At the same time, however, there has been an important parallel development of regional economic arrangements. Following the establishment of the European Coal and Steel Community in 1952, the Treaty of Rome in 1957 launched the European Economic Community, which has since grown from six to fifteen members. The Single European Act, the creation of the European Union through the Maastricht Treaty, and EU agreements with the central and eastern European countries have contributed to a major development of economic relationships throughout Europe. In North America, closer economic ties between Canada and the United States were heralded by the signing of the Canada-United States Free

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Trade Agreement (CUFTA) in 1988. Ties between these two countries and Mexico were expanded with the entry into force of the North American Free Trade Agreement (NAFTA) in 1994. Elsewhere, a major expansion of interest in regionalism has led to other arrangements, such as MERCOSUR in Latin America, and APEC in Asia.

It is important to consider the reasons for the expanding and deepening interest in regional integration and the impact this has on participating countries, on outsiders, and on the multilateral trading system.

### **Reasons for Regional Integration**

No single factor explains the drive for regional integration. Typically, both political and economic considerations play a part. Political motivation has clearly been an important driving force in Europe. In the aftermath of the Second World War, a prosperous Europe was seen as necessary to create a bulwark against the threat of Soviet communism in the East. The establishment of the European Coal and Steel Community had political and strategic objectives in bringing under one supra-national authority the coal and steel industries of France and Germany. The establishment of the European Economic Community had a more clear economic motivation to promote expanded trade and the economic growth that this would bring, but was still understood by most to be part of a political process of European integration. Both political and economic factors have continued to play a role in the subsequent enlargements of the Community and its development into the European Union.

Both economic and political factors played a role in the formation of the North American Free Trade Area, Canada and Mexico saw commercial advantages for their economies from an agreement with the United States. For Mexico there was a desire to ensure that the process of economic liberalization was anchored in an international treaty. NAFTA provided a further opportunity following Mexico's accession to the GATT in 1986, to show it was ready to graduate to the status of an industrialised country. This was confirmed by Mexico's subsequent membership of the OECD in 1994.

Several other considerations, ranging from the promotion of democracy to the control of pressures for migration have had an impact on trends towards regional integration. In several instances, accession to a regional agreement has been stimulated by the aim of securing a privileged trading relationship with a large trading partner in order to eliminate the threat of contingent protections such as antidumping and countervailing duties. This is illustrated by the European Economic Area. Some countries may wish to go faster and deeper in an integration process than possible at the time under multilateral trade disciplines. Deeper integration through regional and multilateral integration is increasingly perceived as a policy response to the desire to sustain economic growth and prosperity.

To sum up, it is important to view regional agreements in terms of their political and strategic importance, as well as their impact on the multilateral trading system. However, it is also important to initiatives, as illustrated by growing regional economic integration in the Asia-Pacific region where no formal agreement exists. Policy initiatives to promote regional integration are unlikely to succeed if they are not supported by fundamental economic forces.

### **Impact of Regional Integration**

The areas of economic relations that are covered by regional agreements vary substantially. Such variations reflect differences in the objectives of agreements and in their approaches to integration. There are several

free trade agreements between two countries which involve the gradual elimination of tariffs on bilateral trade but each country maintains its separate customs tariff for trade with third parties. In contrast, the arrangements underpinning the European Communities provide for a common market and, more recently, foresee full economic union. They address such areas as tariffs and non-tariff measures, as well as structural and regulatory impediments to trade. In effect the Treaty of Rome provides for a common market in goods, services, labor and capital, known as the "four freedoms". The EU adopts an approach which intrudes into national sovereignty in a significant manner through the adoption of common policies or mutual recognition of national policies. It has supra-national enforcement mechanisms. Some more recent free trade agreements have tended to be even more comprehensive in scope. For example, in NAFTA, additional areas of obligation include financial services, intellectual property protection and national treatment to services. Such differences among agreements make it difficult to make a detailed assessment of their effects. However, it is possible to make some generalizations.

Because a regional trade agreement provides preferential market access for its participating countries, it is inherently discriminatory for third parties. With the large number of these agreements, there are some who fear that regional arrangements may lead to increased regionalization of the international economy, in other words that they may stimulate growth in trade and investment within regions at the expense of trade and investment between regions.

Experience with the European Union, and more recently with NAFTA, suggests that trade between members is indeed stimulated by regional arrangements. In fact, if this were not the case, it would be difficult to argue that such arrangements have a positive effect on economic activity. The proportion of intra-regional trade in total trade tends to increase, at least initially. Various studies of the European Union have shown that the accession of new members has resulted in a rise in the share of intra-trade which subsequently declined as trade with the rest of the world expanded. With the important exception of agriculture, expansion of the Union has not prevented the growth in imports from non-member countries. Although empirical studies have their limitations, most seem to indicate that countries outside regional arrangements are likely to experience small welfare gains from the effect of such arrangements on overall trade volumes. The welfare gains will depend on the trade composition of particular countries outside the agreement and the extent to which the agreement stimulates growth in the member countries. It has been estimated that the EU's Single Market program will boost its GDP by 0.6 percent annually as a result of the associated efficiency gains from increased competition.

Trade, of course, represents only one part of the picture. Investment flows are also influenced by regionalization. The evidence from Europe tends to suggest that investment is accelerated by regional arrangements, but that both investment inside and outside the region are affected positively. Thus, for example, investment in the EU quadrupled between 1985 and 1989, largely due to the single market program, but European investment in North America also quadrupled, and investment in Asia grew strongly. The evidence of the impact of regionalization on investment flows in North America is less clear, and intra-regional investment has grown rapidly in East Asia despite the lack of any formal arrangement in the area.

What is clear is that the strategies of businesses are an important element in determining effect of regional arrangements on investment. Corporate strategies have become global and this is reflected in investment figures. Many firms no longer have a national or regional strategy, but aspire to a global presence. Many firms in Europe, for example, have viewed cross-border mergers and acquisitions within Europe as a first step towards a global strategy rather than the last step in a regional strategy.

To conclude, on balance, there is little evidence from trade and investment flows that the regionalization of the world economy is occurring. There has been an increase in regional trade and investment but this has gone hand in hand with international increases. Consequently, it is not possible to conclude that regional growth would not have occurred without regional integration. Greater intra-regional trade is often a product of economic growth, and the continuing trend for production to shift from high cost to low cost countries.

### **Regionalism and Multilateralism: Competition or Coherence?**

Whatever their impact on economic activity, a number of important questions are raised by regional agreements. Are such agreements a distraction at the expense of multilateral negotiations or is there synergy between them? Do regional agreements contribute to liberalization by removing national barriers? Is regional integration resulting in aggressive blocs ready to abuse enhanced market power, or do they contribute to a more predictable environment than one in which national policies prevail?

### **Regional Agreements and Multilateral Negotiations**

Experience thus far seems to suggest that there is a high degree of synergy between regional and multilateral processes. In fact, both regional and multilateral initiatives share a similar objective of trade liberalization through the reduction in tariffs and other barriers to trade, within their respective spheres of application. Let me briefly highlight, five major dimensions to such synergy.

First, regional integration contributes to an *acceptance of the need for international rules* on the part of national governments and interest groups. The distinction between trade and domestic policy is becoming increasingly blurred, and an awareness of interdependence is a precondition to finding ways to accommodate divergent national approaches in areas such as competition policy, product standards, labor policies and environmental policies.

Second, regional integration has *contributed to a learning process* in international policy formulation for governments, regulators and interest groups. Regional agreements have provided an opportunity for these players to come to terms with the kind of tradeoffs that may have to be made when trade and domestic policies clash. The experience and expertise gained may then be employed in wider multilateral negotiations.

Third, regional agreements serve as *"test beds" for approaches* which enable trade diplomacy to deal with the new complexities of international interdependence. Services, intellectual property protections, competition policy, and the treatment of technical barriers to trade are all areas which have benefited from approaches pioneered in various regional agreements.

Fourth, negotiations on regional agreements often generate a *cross fertilization of ideas* with multilateral negotiations. Work on the Uruguay Round agreement benefited from work underway regionally in such areas as government procurement, capital controls, and trade in services.

Fifth, with the conclusion of the Uruguay Round and the establishment of the WTO, the multilateral negotiations have gone further than regional integration agreements by *extending multilateral trade disciplines* in a number of areas across all WTO members. Under the GATT, some disciplines were unevenly applied since membership of the various Tokyo Round Codes, such as those for subsidies and antidumping, was voluntary. The WTO has also been provided with a strengthened dispute settlement

system as well as a monitoring function which together will bring increased transparency and predictability to trade and economic policies.

### **Regional Agreements and Liberalization**

A central question for countries outside a regional agreement is what impact it has on access to markets. Advocates tend to argue that agreements allow concrete measures to be taken among like-minded countries and thus promote the removal of trade barriers. Opponents stress the potential for trade diversion and the shifting of adjustment costs to countries outside an agreement.

There are many examples in which regional agreements have resulted in concrete liberalization, particularly of non-tariff barriers to trade. The harmonization of national policies and practices affecting the trade in goods and services, and investment flows within regions reduce the protection of national markets previously provided by national policies. However, there are two potential difficulties.

First, regional agreements inevitably result in liberalization from members which exceeds that achieved multilaterally. The degree of *regional preference*, and how this is maintained, can raise concerns in third countries. Transparency in the provisions implementing regional agreements is important to ensure that the interests of third countries or parties are respected.

Second, regional agreements may contribute to the creation of *market power*. If this simply balances the power of countries with very large markets, then regionalism may not pose a particular problem. Indeed a balance of market power can be used in a positive way to liberalize trade multilaterally. However, there is more scope for protectionist measures in regional entities with important markets. The Common Agricultural Policy of the European Union provides one example in which regional integration has been accompanied by protectionist policies. Beyond such specific cases, it cannot be said that regional entities are fundamentally more protectionist than large national economies. But there would be a real danger to multilateralism if large entities (national or regional) were to direct their attention to concluding preferential agreements which best fit their trading relations, rather than contributing to more broadly-based trade liberalization.

While regional preferences and enhanced market power may be potentially negative implications of regional agreements for multilateral liberalization, there are a number of potentially positive factors.

Regional agreements appear to result in a net reduction in the *degree of political discretion* in the application of trade policy instruments. Increased codification at the national level reduces uncertainty and contributes to more competitive markets by reducing the scope for national and sub-national intervention. This benefits local industry and third countries alike. Particular progress in this regard has been made in the development of regional competition policies and the harmonization of technical regulations.

Regional agreements appear to have contributed to a convergence on the need for *more adjudication* rather than negotiation in the settlement of trade disputes. This helps to streamline the settlement of disputes. Greater acceptance of adjudicative means in Europe has contributed to a multilateral consensus on more effective dispute settlement procedures in the GATTs and the WTO. Regional integration agreements have also expanded the remedies available to private parties in Europe and North America.

The establishment of regional agreements does not happen in isolation from multilateral disciplines. Article XXIV of the GATT, in effect, provides for the creation of customs unions and free trade agreements since it is recognised that these can contribute to trade liberalization and benefit the world community without necessarily adversely affecting the interest of third countries. Under the GATT, regional agreements were subject to certain requirements, including notification; that they should not raise trade barriers in the whole to other members; and that they should cover substantially all trade between members.

Multilateral disciplines dealing with regional agreements were reinforced with the conclusion of the Uruguay Round. The Understanding on Article XXIV clarifies several aspects which, in the past, had been the cause of tension. The General Agreement on Trade in Services (GATS) has provisions for regional agreements which are in certain ways similar to those for goods. The Agreement on rules of origin also provides for enhanced transparency of rules of origin for free trade areas.

Agriculture in the context of regionalism and multilateralism. Despite progress made in other areas, such as tariffs on industrial products, until very recently multilateral trade agreements had little impact on reducing barriers to trade in agricultural products. Until the conclusion of the Uruguay Round of negotiations under the GATT, agriculture was largely left untouched by multilateral efforts to liberalise trade. Similarly, regional agreements either focused on maintaining the protection of agriculture at a regional level, as in the case of the European Community, or largely exempted agriculture from reductions in tariff and non-tariff barriers to trade, as was the case for the Canada-United States Free Trade Agreement. Little progress was achieved in reducing agricultural support and protection.

More recently, developments at both the regional and multilateral levels have begun to show more promise. The NAFTA agreement, for example, includes far more reductions in barriers to agricultural trade, than its predecessor, CUFTA. Moves to expand the membership of this and other regional groupings, may lead to greater reduction of a wider range of agricultural trade barriers, and may promote adjustments in the domestic agricultural policies that are the underlying cause of trade distortions.

In this regard, the signing of the Uruguay Round Agreement makes a major contribution by bringing domestic agricultural policies and export subsidies under multilateral disciplines and in capping tariffs on agricultural products. Although impacts on trade and policy may be limited, particularly during the early years of its implementation, the Agreement incorporates a number of highly significant and beneficial systematic changes to the trading system for agricultural products. In the longer run, these changes promise to make a significant contribution to the reform of domestic agricultural policies, reductions in barriers to trade, which in turn will lead to improved resource allocation and efficiency gains. In the specific context of regional groupings, the binding of national agricultural tariffs under the Uruguay Round Agreement should contribute to the application of lower common external tariffs by some countries in future regional arrangements.

## **Conclusions**

In the last five years, some 33 regional agreements were notified to the GATT. Given the inherent discriminatory nature of these agreements, it is legitimate for countries who are not party to such agreements to raise concerns about the potential weakening of the multilateral trading system. However, the most ambitious round of multilateral trade negotiations has also been concluded recently, which considerably strengthens multilateral trading rules and disciplines over a wide range of issues and sectors,



including the disciplines concerning the establishment and enlargement of free trade agreements and customs unions.

Under the GATT and the WTO, free trade agreements and customs unions are a permitted exception to the principle of non-discrimination because it is recognised that such agreements have similar trade liberalisation objectives, and have the potential for further economic integration without necessarily adversely affecting the interests of third countries.

The evidence and experience thus far with regional agreements suggest that there is a considerable degree of synergy and complementary between regional and multilateral approaches to trade and investment liberalisation. With the possible exception of agriculture, there is little evidence that regional agreements have contributed to protectionism. Regional agreements have often liberalized faster and deeper than would have been possible at the multilateral level. In several cases, regional agreements have been laboratories for approaches and techniques which have subsequently found application in multilateral negotiations. Conversely, multilateral disciplines have gone further than most regional agreements in a number of areas, complementing the process of regional liberalisation and extending disciplines across current and future trading partners on a global basis.

This does not mean that more should not be done to improve the functioning of multilateral rules and procedures on regional integration agreements. A number of possible measures which could be used to achieve this include; review by WTO members of such agreements before they enter into force; improved transparency through an enhanced system of WTO surveillance of performance and effects; and the introduction of new provisions to increase the protection of third country interests. There is still room for further strengthening of multilateral trade disciplines in order to ensure the full compatibility of free trade agreements and customs unions with multilateral principles.