

REGIONALISM AND TRADE

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1. Regionalism is not an easy idea. It can mean many things to many people. But it seems nonetheless to be an important concept, as it is used, albeit loosely, to describe a recurrent phenomenon in the history of political and economic alliances of nation states. In the modern debate over the nature and claimed benefits of globalization, the word “regionalism” is sometimes heard as a counterpoise, or alternative, to globalization, but again is rarely adequately defined. The purpose of this note is to propose a working legal definition of regionalism as a phenomenon within international trade, and then to assess the advantages and disadvantages of regionalism, so understood.

Regionalism: why define it in terms of trade?

2. To the casual listener, a discussion of regionalism sounds as if it should be an account of political alliances between geographically close nations. But my thesis will be that political alliances of this kind follow clearly cut economic interests. Regional alliances

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have been around for as long as there has been international trade, and this is no coincidence. The British Empire was a network of regional trading alliances. Bilateral trading agreements were common at the end of the nineteenth century. And despite its legal and institutional complexity, the European Union remains primarily a regional trade arrangement, as are NAFTA and MERCOSUR.

3. To the public choice theorist² in political science, and indeed to the cynic, no international political alliance has stability or longevity without it being in the underlying self-interest of the politicians whose ongoing consent is necessary to sustain it. When engaging in the scientific study of regional political alliances, one should therefore ask what underlying features of a given regional alliance benefit the political actors with control over foreign policy in the constituent member states, and therefore cause that alliance to persist.

4. I now seek to introduce two assumptions, neither of which hold perfectly true, but both of which are acceptable rough approximations for the development of a model to explain regionalism as a macro-political phenomenon. The first is this. To an economist, the temptation is to assume that financial incentives override all other incentives in guiding persons' behavior – in other words they are always, relatively speaking, much more important. Although almost certainly wrong as a general rule, the economist would argue that it holds true in the marginal case.³ Second, in a reasonably functional democracy, the

² Public choice theory applies the principal assumption of economics – that people act mostly in their own self-interest – to participation in political decision-making. It therefore seeks to understand political events in terms of the decisions of rationally self-interest political actors. For further details of this school of economic thought, see:
<http://www.econlib.org/library/enc/publicchoicetheory.html>.

³ That is to say, when predicting the change in a group of individuals' behavior, produced by a shift in the incentives that influence them, the principal determinant of that change will be the shift in financial

ruling political classes will have the incentive to pursue the economic interests of society as a whole. In democracies, governments get re-elected if the economy is buoyant, and voted from office if the economy is in decline.

5. It follows from these assumptions that a state's political ruler will create regional political alliances where it is in the economic interests of his country to do so. Of course this is not an invariant rule; it is an approximate generalization, useful in developing a model to explain a recurrent phenomenon. The phenomenon being explained is the persistence of regional trade pacts. If those trade pacts can be shown to be good for the economies of all their members, then this will be a persuasive explanation of the persistence of regional alliances in global politics. Therefore regionalism should be understood as the phenomenon of states grouping together for the mutual benefits of trading with one-another, granting each other advantages that they do not give to third party states outside their 'bloc' or region. The line of argument that will be pursued in the remainder of this paper is that this gives those states economic advantages, to the exclusion of economic benefits for third party states, which will sustain regional political alliances.

6. One criticism of this approach should, however, be considered in advance. It may be said that a trade-based account of regionalism fails to do justice to the twin factors, important in any regional alliance, of geographical and cultural proximity. My account does not seek to undermine the importance of those factors, but I do argue that they should be understood within a trade-based framework. Geography-based factors have historically been important in military alliances, but I would aver that history teaches us that successful and sustained military alliances are based upon prospective commercial

incentives. The "marginal case" is the individual on the cusp, whose incentives will have their balance tipped to change his behavior in consequence of the differing financial motivation.

benefits; military alliances where there is no prospective economic benefit to them are unlikely to survive. Geography is important to economic alliances because the costs of communications and shipping are lower where a trading partner is geographically closer. But in the modern world, the relative costs of these necessary incidents of trade are rapidly diminishing, and so geographical proximity is receding as a factor of economic importance: hence the US and China can be major trading partners despite their having the Pacific Ocean to divide them. Likewise, cultural proximity may make the diplomatic process of reaching trade accords significantly easier, and therefore reduce the transaction costs of reaching agreement. But I suggest that cultural proximity on its own, without economic incentives rendering those cultural ties financially valuable to their owners, will not suffice to maintain a sustainable regional alliance.

Why is international trade a good thing?

7. The theory of comparative advantage prescribes that international trade between two countries A and B will take place wherever governments allow it to, provided that A has a “comparative advantage” over B for one good X over another good Y, X and Y being in demand in both countries.

8. To understand the concept of “comparative advantage”, start with the concept of “absolute advantage”. Absolute advantage takes three variables: two countries and one type of goods. A has an “absolute advantage” over B in the production of X if A is more efficient at producing X than is B. (It may help to think of efficiency, in simple terms, as unit product divided by labor required to produce it.) So:

$$\text{Abs. Adv. (A,B,X)} \quad \text{iff} \quad \text{Eff.A(X)} > \text{Eff.B(X)}$$

9. Comparative advantage, by contrast, takes four variables: two countries and two types of goods. It is an efficiency advantage in the production of one good X compared to production of another good Y. A has a comparative advantage over B in goods X relative to goods Y if the ratio of the efficiency of A's production of X compared to B's production of X is greater than the ratio of efficiency of A's production of Y compared to B's production of Y. Or:

$$\text{Comp. Adv. (A,B,X,Y)} \quad \text{iff} \quad \frac{\text{Eff.A(X)}}{\text{Eff.B(X)}} > \frac{\text{Eff.A(Y)}}{\text{Eff.B(Y)}}$$

10. Assume that price is proportionate to efficiency.⁴ Therefore the theory of comparative advantage predicts that if:

- (1) A can make X more efficiently than B but B can make Y more efficiently than A;
or
- (2) A can make X and Y more efficiently than B, but the degree by which A is more efficient than B is higher for X than it is for Y;

then international trade will occur in both directions.⁵ This is because, in either case, a person can buy X in A, and sell it for more in B than he bought it for in A. He can use the

⁴ Given perfect competition, economics predicts that prices of things will tend to reflect the marginal costs of producing them.

money so obtained to buy B, and take it back to A where he sells it; his net profit will be proportionate to the difference between the ratio of the prices of X and of Y. The closer the ratio, the less the profit from trade per given capital outlay.

11. International trade will be fettered, or halted altogether, if the incidental transaction costs of engaging in it approach, or are greater than, this ratio. Often the most significant transaction cost is an import or export tariff: the government of A may, for example, say that all imports of Y into its territory will attract a 10% import duty. If the price ratio is less than 10%, then the profit from international trade of Y will evaporate and trade will cease.

12. So far we have established that international trade will in fact happen, if import / export tariffs are sufficiently low. The next stage is a normative argument for trade: trade between A and B, it will be shown, is good for the economies of both A and B. This argument proceeds in several stages. First for an importing country, the price to consumers goes down, as product supply increases; for an exporting country, the sales (and therefore profits) of producers goes up, as product demand increases. Second, because the theory of comparative advantage predicts that both countries will be exporters and importers, both these advantages are felt by both countries. And third, because, for each country, production resources are freed up for the goods for which that country does not have a comparative advantage (domestic producers of the goods in which a country does not have the comparative advantage cannot compete with foreign producers of the same goods), those resources can instead be directed to production of the

⁵ There is a host of hidden assumptions in this assertion, perhaps the two most important of which are that (i) international shipping, transaction costs and other export/import costs are zero; and (ii) the currencies of A and of B are not freely exchangeable. It takes some complex exchange rate theory analysis to show that the result is the same where the two currencies are freely exchangeable.

goods in which each country does have the comparative advantage. The net result is that, in the long term, both countries will experience economic benefits, felt by both consumers and producers. Therefore, tariffs in goods should be reduced, to facilitate international trade to the maximum degree possible.

What does regionalism do to trade?

13. The General Agreement on Trade and Tariffs (GATT), first promulgated in 1947 but given a new lease of life with the formation of the World Trade Organization (WTO) in 1995, seeks to capture the benefits of trade described above in a legally binding international treaty. It provides for maximum tariff levels for each of a range of goods. But its prescriptions are universal; preferential trading arrangements between groups of countries, of the kind implicit in regionalism, are expressly disavowed. Article I (the “MFN clause”) of GATT provides:

With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation ... any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

14. The net result of this is: if A lowers its tariff on X for B, it must lower its tariff to the same level for C, D, E and F. Therefore a regional trade arrangement, in which A and B grant one-another favorable trading preferences to the exclusion of those external to it, is

prohibited. However, Article XXIV GATT, the “free trade areas exception”, carves out a caveat to this general rule. Section 5 of that article says:

... the provisions of this Agreement shall not prevent, as between the territories of contracting parties, the formation of a customs union or free trade area ...

15. A free trade area is subsequently defined in GATT as a group of countries with no customs duties between them; a customs union is defined as a free trade area in which all member countries have common tariffs for goods originating in third countries. Therefore a regional trade bloc is permissible, under WTO law, provided that the agreement establishing it eliminates all tariffs within the trade bloc. A “halfway house” arrangement of the sort commonly found in nineteenth century bilateral trade agreements, providing for partial reduction in tariffs but not their complete extinction, is impermissible; a completely level playing field, of the kind found in the EU (a customs union) or NAFTA (a free trade area), is acceptable.

16. The reason one might enter into a regional agreement, rather than a global tariff reduction in the course of WTO negotiations, is that the transaction costs of reaching agreement increase exponentially with the number of parties involved. Hence WTO negotiations stumble, and regional trade agreements flourish. This is a very important point about regionalism: it arises as a phenomenon not because it is the best arrangement for the parties, but because the transaction costs of reaching regional agreements is lower than the transaction costs of reaching broader agreements. Regionalism is a form of second-best.

17. The trade consequences of regional arrangements are analyzed by economists into two categories: “trade creation”, which is perceived to be good, and “trade diversion”, which is seen as undesirable. Trade creation is the increase in trade with efficient suppliers within the regional trade bloc engendered by removal of tariffs; trade diversion is a shift in trade from efficient suppliers outside the bloc to inefficient suppliers within to take advantage of the absence of tariffs. To understand trade diversion, consider the following scenario. Before NAFTA, assume that the US imposed a 50% tariff on the import of all widgets, whatever their source. Mexico produced those widgets for \$100 (making the import price after application of the tariff \$150); India produced them for \$80 (making the import price \$120); and so US consumers purchased Indian widgets. After NAFTA, the tariff for Mexican widgets fell to zero, meaning that US consumers would buy Mexican widgets (with an import price now of \$100) rather than Indian widgets (with the same pre-NAFTA import price of \$120). This is trade diversion: the free trade area creates a distortion from the most efficient result.
18. It is important to note that while trade diversion is a bad thing generally, the harm is all loaded upon those who are not members of the trade bloc. In the example above, US consumers get a better deal, because they get cheaper widgets. Mexican producers likewise get a better deal, because they get a new market, the US, that did not previously exist. The harm is all suffered by India. Regionalism will generally be good for its members, but bad for the rest of the world. It will also create a net worse effect compared to the scenario in which trade liberalization is global, because global trade liberalization also yields trade creation but does not produce any trade diversion.
19. Regionalism therefore has the potential to create a prisoners’ dilemma: individual states are forced into regional trade blocs, even though global GATT-based agreement would

be preferable for them, because if they do not enter into one their competitor nations will, to their detriment.⁶ Regionalism is fostered by a culture of eat-or-be-eaten in international trade; hence the proliferation of regional trade blocs since the advent of the GATT in 1947. In practice, the prisoners' dilemma scenario can be seen to be acted out most sharply in the seemingly endless rounds of US-EU trade wars over tariff levels and trade preferences.

Is regionalism inevitable?

20. Regionalism is not as good as global tariff reduction for the global economy. Is it better, globally, than whatever pre-regional arrangements existed? In principle its effects even relative to that are ambiguous: there seems not to be any obvious *a priori* answer as to which of trade creation and trade diversion will outweigh the other. But in practice, the argument goes, regional trade blocs may have an expansionary dynamic, and help in setting common technical standards that will reduce barriers to trade: witness the recent success of the EU in both these areas.⁷

21. Prisoners' dilemmas are stable equilibria, but can be broken if a sustainable agreement, on which it is rational to rely, is reached between all the parties to the dilemma. Therefore regional trade blocs can, in principle, agree to abolish themselves in favor of a worldwide reduction or extinction of trade tariffs, and this will be better for every country involved.

The WTO rounds of negotiations are attempts to achieve that result. But the transaction

⁶ For the arguments presented in this paragraph I am indebted to Paul R. Krugman, *Is Bilateralism Bad?*, in *International Trade and Trade Policy* 9, Helpman & Razia, ed.s, 1991.

⁷ See Robert Z. Lawrence, *Emerging Regional Arrangements: Building Blocks or Stumbling Blocks?*, in *Finance and the International Economy*, 23, O'Brien, ed., 1991.

costs of reaching an agreement to which one hundred-plus parties are to subscribe may well be so high that agreement is frequently elusive: witness the failures of recent WTO negotiation rounds to achieve results.

22. The difficulty in reaching global trade agreements is often exacerbated by a prevailing theme in the domestic political economy of trade issues in democratic societies. Producers will be more powerful than consumers on the domestic political stage, given the concentration of finances (and therefore political voice) in the hands of relatively few, compared to consumers, whose economic interests may be collectively as great but are spread more thinly over the entire population. Inefficient producers will argue against removal of tariffs, because by assenting to them they will be exposing the domestic sectors in which they operate to collapse. (The line of argument producers offer usually relates to loss of jobs; the inefficient producers do not, of course, highlight that more jobs will be produced than will be lost by trade liberalization, as labor shifts to the new industry in which the country has the comparative advantage.)

23. As regional trade blocs create common economic interests, common political interests will follow. The power of an economic bloc, and therefore the value of the bloc to its individual members, depends upon its market share, and therefore its economic strength. And each member must maintain economic and political independence in order to continue to possess the proper incentives for continued participation in the trade bloc. Therefore members of a trade bloc have a common interest in their fellow members remaining strong and not susceptible to external political influence. All the members also have a common interest in ensuring that potential future members do not fall under the economic yoke or political influence of one's trade adversaries from other regions. Hence

we see the world being divided up into spheres of influence: Latin America for the US, eastern Europe and the former Soviet States for the EU, east Asia for China.

24. Although regional blocs may have expansionary dynamics, as they expand, they also gain market power, and so may become more unrelenting in their confrontations with other trade blocs. One recalls George Orwell's account, in his novel *1984*, of huge regional powers engaged in permanent warfare with one-another. The regime of economic incentives necessary to propagate such a dystopia seems to exist in the modern world; whether that is in fact the direction in which global international relations are heading, I leave as a final teasing question for armchair speculation.

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