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THE CAUSES OF REGIONALISM

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ABSTRACT

The Causes of Regionalism*

The traditional explanation of resurgence regionalism nations rests on two pillars. Regionalism is: (i) due to frustration with the WTO process (thought to be too cumbersome for today's trade issues); and (ii) due to the United States' conversion from devoted multilateralist to ardent regionalist. This paper argues that the traditional explanation is inconsistent with the facts of North American and European regionalism. It also presents an alternative explanation based on a domino theory of regionalism. Namely, idiosyncratic shocks that deepen or widen regional integration trigger a multiplier or domino effect producing membership requests from countries that were previously happy to be non-members.

JEL Classification: F01
Keywords: regionalism, preferential trade arrangements, world trade system

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NON-TECHNICAL SUMMARY

In the past ten years regional trade liberalization has sprinted ahead. This paper takes up the question: 'What caused this rash of regionalism?' Perhaps the most widely-heard answer to this question focuses on two assertions (see, for example, Bhagwati (1993) and Krugman (1993)).

Assertion No. 1: Frustration-with-GATT / Regionalism-is-Easier

The first is that regional integration has prospered because it is easier, politically, than multilateralism since multilateral trade negotiations have become too cumbersome to deal with today's complex trade issues. Four common reasons are listed by Krugman. (i) The rising number of participants changes the nature of strategic bargaining in GATT Rounds. (ii) Modern trade barriers are much more varied and much less transparent than the tariffs and quotas considered in the early GATT Rounds. (iii) The reduced economic dominance of the United States makes the system harder to run. (iv) Socio-politico-economic and institutional differences between Atlantic economies and Asia (Japan in particular) make it much easier for the latter to get away with non-compliance, so Atlantic economies prefer regionalism.

Much of the first assertion's plausibility stems from events of the early 1990s. The Uruguay Round lurched from one crisis to another, yet Europe and North America signed regional schemes at a furious pace. From the perspective of the late-1990s, however, this regionalism-is-easier assertion is hard to justify. One cannot claim that regional integration schemes encountered less political resistance than the Uruguay Round in North America or Europe. In Canada, the bilateral Free Trade Arrangement (FTA) with the United States was the key (highly divisive) issue in a national parliamentary election, while the Uruguay Round enjoyed broad support. In the United States, the North-American Free Trade Agreement (NAFTA) faced much more opposition than the Uruguay Round (witness the 1992 Presidential election debate). In Europe, one cannot say whether regional or multilateral liberalizations were politically easier. Some regional initiative (e.g. EC92) caused little political problems, while the Uruguay Round's impact on the CAP brought the European Union to the brink. The Maastricht Treaty, on the other hand, created enormous political problems as evidenced by the near-miss in the French referendum and the Danish rejection.

To sum up, it is factually incorrect to say that politicians prefer regional liberalization to multilateral liberalization because regional initiatives are less difficult politically.

There is certainly some truth to the second reason why regional liberalization might be easier. Many contemporary trade issues are much more complicated than those dealt with in early GATT Rounds. However, the 'trade issues are too complex for multilateral talks' assertion has little relevance to the many shallow regional trade arrangements that constitute much of the recent resurgence of regionalism. Shallow arrangements (essentially all non-European integration schemes) are concerned mainly with old-fashioned GATT issues like tariffs and quotas. Indeed, the Uruguay Round results went further down the liberalization road than most regional integration agreements in a number of areas such as services, investment, intellectual property rights, agriculture, clothing and textiles, and government procurement.

The notion that regional deals are easier is clearly relevant to the recent deep integration schemes in Europe. There is no way, for instance, that multilateral agreement could be reached on issues such as a common competition policy, a common external tariff and a common anti-dumping regime (to say nothing of a common monetary policy). While the assertion helps explain why the EU limits deep integration to similar countries, it does not mean that Europe turned to regionalism as an alternative to multilateralism. European integration is driven by forces that have little or nothing to do with how well the GATT/WTO is working.

A common variant on the first assertion is that regionalism spread due to frustration with the Uruguay Round talks. Here again the facts just do not fit. Consider the US-Canada FTA. The political decisions to start negotiations were taken in the year before the Uruguay Round was launched. It would take a very complicated story to assert that sluggish progress on the Uruguay Round in the late 1980s prompted Reagan and Mulroney to seek an FTA in 1985. NAFTA talks did start after the Uruguay Round became bogged down, but the motives for the triggering event – the US-Mexico FTA – had virtually nothing to do with global trade. It was pursued on both sides of the Rio Grande as a means of locking in pro-market reforms in Mexico.

It is even more far-fetched to propose that European frustration with the GATT triggered the EU's Single European Act (which kicked off the recent deepening and widening of the EU). Who could believe that EU governments endorsed Jacques Delors' proposal for completing the internal market because they were unsatisfied with the Uruguay Round's progress or the GATT system in general? In any case, the Single Market programme was a done deal long before frustration with the Uruguay Round emerged.

To sum up, the frustration-with-GATT/Regionalism-is-easier argument is not applicable to the major regional initiatives in the world, namely those in Europe and North America. Europe and North America together account for two-thirds of the world's trade, and these are the nations that have always been the driving forces of multilateral liberalization. We should conclude, therefore, that the first assertion does not apply to the bulk of regionalism observed in recent years. Quite simply, assertion No. 1 is factually incorrect.

Assertion No. 2: US-Conversion

The second assertion is that the conversion of the United States from a strong backer of multilateralism to an avid participant in regional schemes has been a driving force.

This claim is based on two misguided readings of recent history. First, the claim that the United States recently converted to regionalism is false. The United States' proclivity for regional integration was shown in 1965 with the US-Canada Auto Pact. This continued in the 1970s; for example, in 1974 the US Congress (not known for giving up power frivolously) granted the President authority to negotiate a bilateral FTA with Canada (see Section 612 of the Trade Act of 1974). It continued in the 1980s with the US-Canada FTA and it continued in the 1990s with the US-Mexico FTA and NAFTA.

Second, the United States did not initiate the recent regionalism in North America – Canada and Mexico did. Hufbauer, Schott and Clark (1994) make this point at length. Whalley (1993) is more terse: 'It was Canada who initiated negotiations on CUSTA, Mexico on NAFTA'.

Moreover, when it comes to other regional arrangements in the Western Hemisphere (the Enterprise for the Americas Initiative, WHFTA, etc.), the US-attitude-as-driving-force assertion is an unsatisfactory combination of tautology and ethnocentricity. Plainly, the United States' willingness to engage in regional liberalization schemes is a necessary condition for regionalism in North America. The remarkable point, however, is not the United States' willingness to lower its tariffs against Latin American exports; the United States already negotiated away most of its swallow trade barriers multilaterally. The remarkable point is the new-found willingness of Latin Americans and Canadians to lower their trade barriers. It seems rather ethnocentric to suggest that the United States purported conversion from multilateralist to regionalist was the main reason that non-US Americans have recently embraced free trade.

Even if one could find an historian to assert that the United States was the initiator of spreading West Hemisphere regionalism, it is impossible to argue that resurgent European regionalism had anything to do with US attitudes. Anyone who follows European politics knows that the attitude of the US on trade had almost nothing to do with recent economic integration, even though Europeans do worry about US attitudes when it comes to deeper foreign and defence policy integration. Be that as it may, the timing of the US-leadership assertion is wrong. The resurgence of regionalism in Europe and the United States started at approximately the same time (with the 1985 White Paper in Europe, and the US-Canada FTA in North America), suggesting that the second part of the standard explanation also has little explanatory power when it comes to the deep integration initiatives in Europe.

In short, the standard explanation is appealing at first glance and it has won over many adherents, especially in the United States. It is not, however, consistent with the facts.

An Alternative Explanation: The Domino Theory of Regionalism

Consider a very different explanation. Baldwin (1993, 1995) presents a political equilibrium model where an idiosyncratic shock, such as deeper integration of an existing regional bloc, can trigger membership requests from countries that were previously happy to be non-members. The basic logic is simple. The stance of a country's government concerning membership is the result of a political equilibrium that balances anti-membership and pro-membership forces. Among the pro-integration forces are firms that export to the regional bloc. Since closer integration within a bloc is detrimental to the profits of non-member firms, closer integration will stimulate the exporters to engage in greater pro-integration political activity.

If the government was previously close to indifferent (politically) to membership, the extra activity may tilt the balance and cause the country to join the bloc. If the bloc enlarges, the cost to the non-members increases since they now face the disadvantage in an even larger market. This second round effect brings forth more pro-integration political activity in non-members and thus may lead to further enlargement of the bloc.

The idiosyncratic event in the Western Hemisphere was the US-Mexico FTA, which was itself motivated by the unilateral reforms undertaken by Mexico in the 1980s. The idiosyncratic event in Europe was the completion of the Single

Market. Again the timing and motives for this suggest that this regional initiative was in no way a substitute for multilateral liberalization, nor did it have anything to do with the United States' attitude towards the GATT system. Both events triggered a domino effect which explains what caused recent regionalism.

The Causes of Regionalism

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February 1997

1. Introduction

The past decade has seen regional trade liberalization spreading like wildfire. For instance, while the Uruguay Round dragged on between its 1986 agenda-setting meeting and its 1994 conclusion, the European Union: (1) greatly deepened regional economic and political integration with its EC92 programme and the Maastricht Treaty, (2) extended the single market to EFTA via the European Economic Area agreement, (3) accepted five new members, (4) signed bilateral integration agreements that go far beyond duty-free trade with ten Central and Eastern European nations, and (5) signed a series of more limited free trade agreements with several former Soviet Republics, *inter alia*.

During the same period the United States signed a bilateral free trade agreement with Canada, and then - with Mexico and Canada - formed the North American Free Trade Agreement. In addition to the European and North American regional arrangements, dozens of other regional arrangements exist. These, however, are less significant from a global perspective.[2] Some - such as most trade arrangements among less

[1] I thank Robert Baldwin, Andre Sapir and Thor Gylfason for comments. Ideas in this paper were explored in a preliminary form in Baldwin (1993, 1995a, 1995b). The Ford Foundation's MIRAGE project provided financial support.

[2]As if January 1995, the WTO had been notified of 98 preferential trade agreements as required by Article 24 and 11 developing country arrangements under the 1979 Enabling Clause. 77 of the 98 agreements Article 24 agreements involve European countries and all but 9 of the 33

developed countries - function poorly.[3] Others - such as the Australia-New Zealand arrangement - cover only a tiny fraction of world trade.

Finally, the last ten years has seen a rash of proposals for new regional agreements all over the world. Most notable being calls for (and modest progress towards) Asia-Pacific free trade, calls for a Western Hemispheric free trade area, and the recently proposed transatlantic free trade area.

Clearly, regionalism is quantitatively important. European and North American regional arrangements directly govern more than 40% of world trade. Preferential arrangements also affect trade with third countries, so it is worth noting that Europe accounts for half of world trade and North America for a sixth. Thus even without counting the many small and/or ill-functioning arrangements, two-thirds of world trade is conducted with countries that have well-functioning preferential trade arrangements with their largest trade partners.[4]

The magnitude and rapid spread of regionalism raises an obvious question: "Is spreading regionalism good or bad?" There are really to parts to this question:

(1) Do the existing regional arrangement improve living standards in the member and nonmember countries?

(2) Does the spread of regionalism threaten the world trading system and multilateral trade liberalization?

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agreements notified since 1990 involve Central and Eastern European countries. De Torre and Kelly (1993) lists 17 nonNAFTA PTAs in the Western Hemisphere, eight in Africa and eight in Asia-Pacific and the Middle East.

[3]De Torre and Kelly (1992) and Schott (1989) analyze the reasons why South-South preferential trade arrangements are typically plagued by a low rate of implementation.

[4]WTO (1995) points out that nearly all WTO members (Japan and Hong Kong are exceptions) are parties to at least one regional arrangement.

Economists who are familiar with the empirical literature on actual regional arrangements largely agree on the answer to the first question. When it comes to the major regional initiatives in Europe and North America, almost all empirical studies find a modest positive impact on member nations and a inconsequential impact on nonmembers.[3] Evidence on smaller regional arrangements is quite scarce. Nonetheless, there is very little evidence showing that any well-functioning regional trade arrangement has actually lowered the living standards of member or nonmember nations.

Economists are not united in their answer to the second question (see Winters (1996) for instance for a summary of the debate).

Some economists are happy with trade liberalization whatever form it takes and view regionalism as having a largely benign effect on the multilateral trading system (eg Summers 1991). The balance of history is on this side. For instance, the nations driving multilateral liberalization during the past 4 decades - the EU, the US and Canada - have also eagerly pursued regional liberalization since the 1965 US-Canada Auto Pact and the 1958 Treaty of Rome. In fact many scholars (see Kenen 1989 p. 220) take it as read that formation of the EEC induced the US to push for multilateral liberalization in via Kennedy Round. Thus one could argue that regionalism has promoted multilateral liberalization.

Others worry that spreading regionalism fundamentally threatens the WTO-centred world trading system. The risks usually identified with this threat include heightening the prospect of inter-bloc trade war, enhancement

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[3]For instance, Whalley (1993 p 354) states "Because the direct effects on trade and investment flows from these arrangements seems small, the impacts of discriminatory reductions in formal trade barriers, and hence concern over classical trade diversion, seem relatively minor." Yeats (1996) finds trade volume changes that suggest welfare losses in Mecosur, however trade volume changes are not a sufficient condition for welfare changes except under extreme assumptions as Baldwin and Venables (1995) show.

of the ability of hegemonic powers to impose their wills on weaker countries and dampening of large countries' enthusiasm for further multilateral liberalization. Note that the debate turns on regionalism's future impact since there is little to suggest that regionalism has hereto harmed the global trading system. For instance, despite resurgent regionalism, the Uruguay Round (the most complex and ambitious multilateral trade negotiation in world history) was completed and the WTO was founded. Moreover, the final push came from the US and Europe who had just completed or were in the midst of regional liberalizations.

This paper addresses the causes of resurgent regionalism and thereby aims to make a contribution to the second question.

Logically, there is a simple connection between regionalism and the future of the world trading system. Regionalism's impact depends on how it affects governments' future policy choices. Because there is no widely accepted positive model of government policy choice - especially one that considers the dynamics of how endogenous trade policies change - theoretical investigations inevitably involve speculation based on ill-defined premises, or precise analysis based on simplistic models that have not been tested empirically. An alternative route - the one adopted in this paper - is to try to first understand the causes of the regionalism that we have already observed. That is the aim of this paper.

The plan of the paper follows the advice of Sherlock Holmes in the Hounds of Baskerville. Holmes tells Watson: "It is a capital mistake to theorize before one has all the facts. Inevitably one twists the facts to fit the theory, rather than the theory to fit the facts." Following this advice, the next section, section 2, sets the stage with the examination of the facts of recent regionalism. This includes a discussion of the two types of recent regional initiatives (deep and shallow integration arrangements), the size of various regional arrangements, and the timing and motives behind European and North American regionalism. Section 3 describes and critiques the standard explanation of spreading regionalism. Section 4 argues that an alternate explanation, the domino theory of regionalism, better fits the facts of recent regionalism. Section 5 contains a summary and concluding remarks.

2. Recent Regionalism: The Facts

2.1 Two Types of Recent Regionalism: Deep and Shallow Arrangements

International integration agreements are contracts that restrict the ability of national governments to set policy unilaterally. Shallow integration schemes deal primarily with statutory border measures, eg tariff and quantitative restrictions. Deep integrations involve restrictions that go far beyond this, affecting policies that are considered purely national concerns in most nations.

Deep Integration Schemes The EU's common market and the EC92 programme are archetypical deep integration agreements. The common market provide for free labour mobility in addition to duty-free trade in all goods EC92 deepened this to include, *inter alia*, free movement of capital and services as well as providing mutual recognition (with minimum harmonization) of product standards and industrial regulation, harmonization of VAT rates, strengthening of a common competition policy and restrictions on state aids (subsidies), and guaranteed rights of establishment for EU-based firms. Except for the Australia-New Zealand Closer

Economic Relations Trade Agreement (ANZCERTA), all deep integration schemes are in Europe. In particular, in addition to the EU, the European Economic Area (EEA) agreement extends single market access to three members of EFTA (Norway, Iceland and Liechtenstein), and the so-called Europe Agreements commit 10 Central and Eastern European countries to approximating their economic policies, laws and practices to EU standards.

It is important to note that West-European deep integration initiatives (EC92, Maastricht, and EEA) did not expand regional integration. They merely deepened existing schemes. Before the EC92, West European regional integration was marked by two-concentric circles. The outer circle, which encompassed all EU and EFTA members, was a 'virtual' free trade area for industrial goods. The confluence of the Treaty of Rome, the Stockholm Convention (EFTA's founding document) and bilateral EU-EFTA free trade agreements ensured duty-free treatment for industrial trade between every pair of these countries. The inner circle consisted of the EU's common market. EC92 and the European Economic Area agreement (EEA) deepened the extent of integration in both the inner and outer circles. The 1986 EU enlargement brought one new country (Spain) into the system and moved another (Portugal) from the outer to the inner circle. The 1995 EU enlargement switched three countries (Austria, Finland and Sweden) from the outer circle to the inner circle.

Shallow Regional Integrations Most of the other recent regional schemes - such as the US-Canada FTA, the US-Israel FTA, the North American FTA (NAFTA), Mecosur, and the revivals of old regional schemes in Latin American and Africa - involve fairly shallow integration phased in over long periods.

The US-Canada FTA, which directly covers only 6% of world trade, will have eliminated all tariffs on most industrial trade between the two nations by 1998. It also relaxed some restrictions on government procurement and cross-border direct investments. Service trade is not substantially liberalized since most existing restrictions were 'grandfathered'. Interestingly, many of the most difficult issues addressed in the Uruguay Round proved insurmountable in the bilateral FTA talks and were therefore dropped. Hufbauer, Schott and Clark (1994), for instance, state that "various sticking points remained unresolved, most notably in subsidies, government procurement, energy sector investment, transport services, and intellectual property rights." The agreement has not changed US-Canada trade flows dramatically since bilateral trade was already quite free. Prior to the FTA, the average Canadian tariff on US goods was 1% with 80% of bilateral trade already duty-free.[6]

NAFTA covers only 1% more of world trade than does the US-Canada FTA. This arrangement provides for elimination of most tariffs and many nontariff barriers with Mexico over a 10 to 15 year period (US-Canadian liberalization is still governed by their bilateral FTA). NAFTA liberalizes many investment flow restrictions among its three members. This involved Canada, and especially Mexico, liberalizing their anti-foreign capital policies (the US had very few restriction to begin with). In particular, NAFTA commits its members to granting national treatment to NAFTA-based investors (with some excepts notably in the energy sector). In all, the investment component of NAFTA goes beyond those agreed in the Uruguay Round. The trilateral arrangement also partially liberalizes trade in financial and telecommunications services. In contrast to deep integration schemes, NAFTA does not, *inter alia*: (1) guarantee the free mobility of labour or capital, (2) rule out the use of dumping, countervailing duties and other instruments of contingent protection, (3) provide mutual recognition of

[6]Whalley (1993 p 355).

health, safety and product standards, industrial regulation, (4) guarantee rights of establishment, nor (5) provide for common surveillance and enforcement of state aids or competition (i.e. anti-trust) policy. Furthermore, NAFTA is not a customs union so complicated rules-of-origin are imposed. Krueger (1993) argues that the NAFTA rules-of-origin have been used as protectionist devices.

2.2 The Size of Regional Integration Arrangements

Size is the second point of fact. In terms of the volume of trade affected, West European schemes dominate all others. Table 1 shows that the about a third of world merchandise exports take place within the European Economic Area (EEA). This figure is almost five times larger than the next biggest arrangement, NAFTA.[7] All of the other successful regional initiatives are tiny. De Melo and Panagariya (1993) considered all regional integration arrangements in the world (well over one hundred in number) and defined as successful only those for which intra-arrangement trade was at least 4 percent of the members' total exports on a sustained basis. As they point out, this is a very permissive definition of successful. Table 1 shows that none of the other arrangements covers even as much as 1 percent of world trade. Several of them cover less than one tenth of 1 percent of world trade.

The main point is that in terms of the volume of world trade covered, the European and North American regional integration schemes are really the only important ones. Wolf (1994 p. 13) sums up the situation concisely:

[7]Under NAFTA, tariffs and other border measures are to be phased out between 1994 and 2009, so it is hard to know how much trade it will cover. The figure in the table shows the sum of exports between Canada, Mexico and the US in 1990.

Table 1: Size of Various Regional Integration Schemes

1990 data	Intra-regional exports ($ billions)	Intra-regional exports as share world exports
West Europe free trade zone (EU+EFTA)	1128.5	33.9%
of which: EU12	821.8	24.7%
NAFTA	237.9	7.1%
ANZCERTA	3.8	0.1%
ASEAN	26	0.8%
Andean Pact	1.4	0.0%
CACM	0.5	0.0%
LAFTA	12.0	0.4%
ECOWAS	1.2	0.0%
PTA	0.6	0.0%

Sources: IMF Direction of Trade Yearbook 1992, EFTA Trade 1991, and De Melo and Panagariya (1993) for smaller arrangements.
Note: 0.0% indicates less than one tenth of one percent.
ANZCERTA is the Australia-New Zealand arrangement, ASEAN is the South-east Asian arrangement, the Andean Pact is an FTA among South American nations, CACM is the Caribbean common market, LAFTA is the Latin America FTA, ECOWAS is the West African arrangement and PTA is the Eastern and Southern African preferential trading area. Many of the last six arrangements cover substantially less than all commodities, so the figures in the table are overestimates of the trade affected directly.

"By now, no fewer than 85 regional trade arrangements are in existence, 28 of which have been set up since 1992 (see GATT, 1993c). Yet the world has only two significant trade blocs, defined as zones of preferential trade. One is western Europe and the second is north America. The North American Free Trade Agreement does not create much change in the 'bloc' that existed beforehand, the United States itself. The addition of Canada, whose gross domestic product is only 9 per cent of that of the United States, and Mexico, whose GDP is only 5 per cent, will make little difference to the rest of the world. Meanwhile, Asia is not a bloc and shows little sign of becoming one."

2.3 The Timing and Motivation of Regional Arrangements

The facts about the timing and motives behind spreading regionalism are absolutely critical. We focus on North American and European regionalism.

2.3.1 North American Regionalism

On the US side, interest in a free trade agreement started with the 1965 US-Canada Auto Pact. This interest continued in the 1970s. For example, Section 612 of the Trade Act of 1974 granted the US President authority to negotiate a free trade agreement with Canada. Interestingly, this came soon after an ambitious agenda had been agreed for a new multilateral trade negotiations, the Tokyo Round, and coincided with the first EU enlargement (then called the EEC). Also in the Trade Agreements Act of 1979, section 1104, Congress authorized a study of the possibility of regional trade arrangements in North America. Moreover, during his 1980 Presidential campaign Ronald Reagan espoused a North American free trade.[8]

This manifest US interest in broad regionalism was rejected by both Canada and Mexico until the mid-1980s, although Canada did liberalized merchandise trade with the US. The 1965 US-Canada Auto Pact, for instance, eliminated tariffs on bilateral trade in cars and parts, and GATT

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[8]See Hufbauer, Schott and Clark (1994) pp 97-101 for more detail.

Rounds lowered tariffs more generally. Despite this, a free trade agreement with the US has long been a *bête noir* in Canadian politics, given Canadian fears of fearing economic domination by its much larger neighbour. In fact, Canada systematically implemented policies aimed at thwarting US involvement in Canadian industry, natural resources and media. This fear of US domination is even more deeply-rooted in the Mexican political scene. Until the debt 1980s crisis forced a radical turn around, Mexican trade policy was firmly based on the idea of import substitution. This involved very high tariffs and severe restrictions on inward foreign direct investment, aimed *de facto* at US multinationals.

US-Canada FTA Canada provided the spark for the US-Canada FTA in September 1985 when Prime Minister Mulroney proposed a bilateral FTA.[9] Reagan formally announced his intention to negotiate this FTA in December 1985 and the US Congress granted fast-track negotiating authority in April 1986. Despite the high degree of economic and institutional similarity between the two economies, the success of the 1965 bilateral Auto Pact, and the fact that US and Canadian formal trade barriers were already quite low, the US-Canada talks proved quite difficult.[10] The final agreement came into force only in January 1989.

US-Mexico FTA Mexico was the driving force behind the US-Mexico FTA, which as later trilateralized into the North American FTA.[11]

Until the 1980s, Mexico pursued highly protectionist, anti-foreign direct

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[9]According to Schott (1988 p. 11), the germ of this initiative was a March 1985 summit meeting between President Reagan and Prime Minister Mulroney. According to Hufbauer, Schott and Clark (1994), the change in Canadian attitudes was encourage by their 1983 and 1985 national commissions, which strongly endorsed a bilateral FTA with the US.

[10]See Bello and Winham (1992) for a history of the negotiations.

[11]On this assertion see, for instance, Hubauer, Schott and Clark (1994 p.100) and Whalley (1993 p.369).

investment policies. The Mexican debt crisis of the early 1980s lead to a *volte-face*, which extended to the adoption of liberal trade policies. Mexico's new found liberalism was not first directed towards regional integration. Starting in 1985, Mexico unilaterally cut its tariffs on an MFN basis and phased out most nontariff barriers such as its restrictive import licensing regime. Mexico joined the GATT in 1986 and locked in many reforms with three bilateral agreements with the US and Canada.[12]

GATT membership provided some assurances that Mexico's trade liberalization would remain in place. For instance tariff bindings enforced by the possibility of trade partners' retaliation would make it hard to completely undo the liberalization. However, the market-oriented Mexican policy-elite sought greater 'irreversibility'. Since the US has the economic and political strength to hold Mexico to its promises, a bilateral FTA with the US was an obvious "commitment technology"

In June 1990, Mexican President Salinas proposed an FTA with the US. According to Whalley (1993), Mexican objectives were to improve and lock-in access to the US market (recall that Mexico was unilaterally removing its own tariffs) and to lock-in its domestic economic reforms with an aim of attracting foreign direct investment. US President Bush rapidly agreed to the bilateral.

The US motives for this initiative had little to do with the US's desire to liberalize trade. In 1990 US exports to Mexico accounted for only 7.2% of its total exports, so it seems highly unlikely that the US viewed this politically exacting, yet commercially unimportant initiative as a substitute

[12]Understanding on Subsidies and Countervailing Duties 1985, Framework of Principles and Procedures for Consultations Regarding Trade and Investment, 1987, and Understanding Regarding Trade and Investment Facilitation Talks 1989. Ten agreements were signed with Canada in March 1990.

the global trade liberalization and the Uruguay Round. The chief US aim was to foster stability in Mexico by boosting growth and locking in its unilateral pro-market reforms.

NAFTA The push for merging of the US-Mexico FTA talks into the trilateral NAFTA talks came entirely from Canada. In particular, Canada was concerned that the US-Mexico FTA would lead to harmful supply-switching (trade diversion to use an imprecise term, see Box 1) especially in automotive parts. As Schott and Hufbauer (1992 p.63) and Hufbauer and Schott (1992, p.24) point out, the US-Mexico and Enterprise for the Americas Initiative "confronted Canada with the choice of either joining the "hub" (i.e. engaging trilateral negotiations) or becoming just a "spoke" in the US FTA system." Consequently, just 18 months after the US-Canada deal (which lead to a nation-wide political fight), Canada requested that the bilateral US-Mexico talks be broadened into a trilateral negotiation.

After Canada provided assurances to the US that it would not hinder completion of a US-Mexico accord, the President Bush US and Mexico agreed to a trilateral negotiation. Announcement of the talks came from President Bush in February 1991. US fast track authority was granted in May and negotiations began in June 1991. NAFTA was signed in December 1992 with enter into force in January 1994.[13]

Box 1: Trade Creation and Diversion: Outdated Concepts

For a competitive economy, tariff liberalization has two welfare effects.[14]

[13]See Hufbauer and Schott (1992, 1993) and especially Hufbauer, Schott and Clark (1994) for a more detailed chronology.

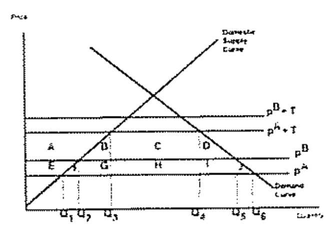
[14]See Kowalczyk (1990) or Collier (1979) for criticism of the Vinerian terminology.

The first stems from trade volume changes: When a good's domestic price exceeds its border price (the price paid to foreigners), increasing imports lowers the cost of consumption and thus raises national welfare. The second stems from border prices (i.e. trade price) changes. When a country is a net importer of a good, a drop in the border price is beneficial (domestic producers lose less than domestic consumers gain), while the opposite holds when the country is a net exporter.

A nation that joins a preferential trade area (PTA) lowers its tariffs on a discriminatory basis. Typically, the nation sees a shift in its volume-of-trade pattern, i.e. "supply-switching" from suppliers outside the PTA to a PTA-based suppliers. A border price change typically accompanies the quantity changes: If imports came from the lowest cost supplier prior to preferential liberalization, any switching from non-PTA suppliers to PTA suppliers tends to raise the average import price paid and this tends to lower welfare.

Jacob Viner, the first modern economist to describe the supply-switching and border price effects, gave them a joint name - trade diversion. While it is a shame that Viner gave a single name to the trade volume and trade price implications of discriminatory liberalization, it is understandable.

Figure 1



Viner wrote at a time when tariffs were still the main barriers to trade, and if tariffs are the only barriers being liberalized, the two effects go hand in hand. In modern times, however, tariffs are much less important in developed countries. WTO (1995 p.2) states that 43% of developed countries' industrial trade from MFN origins will be duty-free when the Uruguay Round results are implemented. The average tariff will be 6.6% on the remainder.

The necessity of distinguishing between supply-switching and the trade price effects shows up clearly when considering deep integration schemes that lower 'frictional' barriers rather than tariffs (frictional barriers, or technical barriers to trade inhibit imports without generating trade rents such as tariff revenue - unharmonized product standards are a good example). The point can be made in the classic trade-diversion diagram (figure 1). The small home country can buy from A (low cost supplier) or B, but initially applies an MFN frictional barrier (whose tariff equivalent is T), so it buys all from A. The effective border price is p^A+T. Now home removal of the barrier on imports from B only leads to supply switching from A to B: This supply-switching (what might be called trade diversion) improves home welfare unambiguously since it lowers the border price to p^B (The gain equals areas A+B+C+D).

Following the US-Canada FTA and (especially) the US-Mexico FTA, many smaller regional initiatives were launched, re-launched or seriously discussed in Latin America. For instance, Chile, Brazil, Argentina, Uruguay and Paraguay, formally or informally approached the US to begin bilateral FTA talks. Moreover, interest in President Bush's Enterprise for the Americas Initiative boomed in 1991 with 26 countries signing so-called Framework Agreements. These facilitate discussion of means to eliminate impediments to trade and investment. Effectively, the Framework Agreements commit countries to making unilateral concessions on investment restrictions to the US in exchange for the promise of closer US trade and investment relations leading eventually to an FTA.[15]

2.3.2 European Regionalism

[15]See Chapter 7 of the CEA (1991).

European integration has a long history, but recent European regionalism was sparked by the Single Market programme.[16] In 1985 Jacques Delors took office with the intention of rekindling European integration. His strategy was to embark on a massive liberalization that would turn the common market into a single market. The first formal step towards the Single Market programme was a June 1985 White Paper by Lord Cockfield. This listed 282 measures necessary to complete the single market. The treaty implementing these measures (along with many other changes) - the Single European Act - was signed in February 1986 by EU heads of government. In the same year Spain and Portugal acceded to the EU after six years of membership negotiations.

The Single Market programme harmed the competitiveness of EFTA-based firms by lowering the costs of their EU-based rivals, as Krugman (1984) points out. The Vinerian term 'trade diversion' might be used to describe this, but the considerations of imperfect competition make it a much more complicated effect. CEPR (1992) calls it the strategic disadvantage of nonmembership. Whatever it is called, EFTA governments decided that they must react.[17]

The idea of countering the threat (to EFTAns from EC92) with a new plurilateral agreement was first suggested at a meeting of EFTA and EU ministers in Luxembourg in 1984, even before the White Paper was published. This produced the so-called Luxembourg Declaration. This regional integration, however, proved enormously difficult, eg even more difficult than the Uruguay Round. From the Luxembourg Declaration to

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[16]See Wallace (1994) for the history. CEPR (1992 chapter 1) for the role of EC92.

[17]Anderson and Blackurst (1993 p.2) also explain the revival of European in terms of these forces.

entry-into-force, the EEA took 10 years - 2 years more than the Uruguay Round.

The intrinsic difficulties of agreeing to such deep economic integration without political integration, and the EU's preoccupation with the Single European Act and the Maastricht Treaty led to long delays. Indeed very little was done until January 1989 when Jacques Delors proposed the European Economic Area agreement (initially called the European Economic Space agreement). Talks on the EEA began informally in 1989, continuing more formally in 1990 and 1991. The first version of the EEA, signed in 1991, was rejected by the European Court of Justice as inconsistent with EU law. Negotiations were reconvened and the second version of the EEA was signed 2 May 1992 in Oporto, Portugal. This was acceptable to the European Court, however, Swiss voters rejected it in a December 1992 referendum. Since the EEA formally included all EFTAns, this required a technical rewriting of the agreement. More important, since the EEA obliged the EFTAns to make financial transfers to poor EU regions, the withdrawal of Switzerland also forced a renegotiation of the size of these transfers. The final version of the EEA was signed in 1993, with implementation starting in January 1994.

EU's Fourth Enlargement The depth of EC92 integration made it difficult for the EU to extend the Single Market to nonmembers. In particular, EC92 constrains many economic policies that are not traditionally viewed as trade policy. It requires supranational surveillance and enforcement of competition policy (antitrust policy), state aids to industry, national public procurement policies, and the behaviour of state owned monopolies. The member states of the EU can accept this sort of supranational control by the European Commission since the Commission itself is controlled by national political leaders via the Council of Ministers.

Since nonmember governments cannot vote or attend the Council of Minister meetings, the EEA agreement involved 'regulation without representation' for the EFTA side.

This so-called influence deficit made the EEA a relatively unpalatable means of offsetting potential discrimination from EC92. As it turned out, virtually none of the EFTA governments were willing to live with the EEA. Even before the final version was adopted, all the EFTAns (except Iceland and Liechtenstein, which have a combined population of 0.3 million) had applied for full EU membership. Obviously, the end of the East-West conflict in Europe was also critical to this membership drive in that it removed traditional resistance to the EU. Applications were received from Austria (July 1989), Sweden (July 1991), Finland (March 1992), Switzerland (May 1992) and Norway (November 1992). For these countries, the EEA was viewed as a transitional arrangement, not a long term solution. Note that the EU froze the Swiss application in response to the negative outcome of their EEA referendum. Accession talks for the four EFTAns, were concluded in 1994 with entry to occur in 1995 subject to national referendums. Austrian, Finnish and Swedish voters responded positively in 1994. Norwegian voters said no.

The collapse of Communism also opened the Central and Eastern European countries (CEEC). The EU and EFTA (separately) signed bilateral free trade agreements with 10 of these countries in the early 1990s.[18] Since nearly all industrial trade in West Europe is duty free and West Europe is the dominant market for the exports of Central and Eastern European nations, these bilateral free trade agreements were essential to levelling the playing field for CEEC exporters. Most CEECs have applied

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[18]Poland, Hungary, the Czech Republic, the Slovak Republic, Bulgaria, Romania, Estonia, Latvia, Lithuania and Slovenia have signed agreements.

or plan to apply to become full EU members and the EU Heads of State have agreed that they will eventually be admitted. The EU's agreements with the CEECs are far more than free trade agreements. In particular, the commit the CEECs to approximation of EU laws and economic policies such as competition policy and state aids.

3. The Standard Explanation of Regionalism's Resurgence

The standard explanation of the recent spread of regional liberalization focuses on two assertions.[19]

Assertion #1: Frustration-with-GATT / Regionalism-is-easier
According to this part of the standard explanation, regional integration has prospered as an alternative to multilateralism because regional liberalisation is easier than multilateral liberalization. Krugman (1993 p. 73) phrases this assertion as a series of questions:

> "So we need to ask why such blocs are in fact emerging. This comes down to asking why nations may feel that they are able to negotiate more at a regional than at a global level. Or to put it more pessimistically, what are the problems of the GATT that lead countries to turn to their neighbourhood instead?"

Krugman goes on to list four reasons why regionalism is easier than multilateralism. (i) The sheer number of participant in multilateral trade negotiations changes the nature of strategic bargaining. This involves a reduction in the costs of non-cooperation (a key consideration in cooperative

[19]See for instance, Bhagwati (1993) and Krugman (1993); De Melo and Panagariya, (1993) provide a synopsis.

game theory) and greater rigidity in negotiations. (ii) Modern trade barriers are much more varied and much less transparent than the tariffs and quotas considered in the early GATT Rounds. This makes bargaining more difficult (since there are so many variants to consider) and renders more difficult the monitoring of any eventual agreements. The latter point again makes cooperation a less likely outcome. (iii) The reduced economic dominance of the US made the system harder to run (theory of hegemonic stability). (iv) Socio-politico-economic institutional differences between Atlantic economies and Asia (Japan in particular) make it much easier for the latter to get away with non-compliance. Anticipation of this makes the Atlantic economies reluctant to bargain on an MFN basis.

Assertion #2: US-Conversion The second assertion is that the conversion of the United States from a strong backer of multilateralism to an avid regionalist is an important force behind spreading regionalism. Bhagwati (1993), for instance, goes so far as to say: "The main driving force for regionalism today is the conversion of the United States, hitherto an abstaining party, to Article XXIV."[20]

Some analysts, such as Bhagwati (1993), link the two assertions by asserting that frustration with the GATT process is the cause of the US's conversion.

3.1 Critique of the Standard Explanation

3.1.1 Assertion #1 is Factually Incorrect

Much of the first assertion's plausibility stems from events of the early 1990s. While the Uruguay Round talks lurched from one crises to another,

[20]Article 24 is the GATT clause sanctioning the discriminatory liberalization of FTAs and customs unions.

Europe and North America were setting up regional integration schemes at a furious pace. From the perspective of the mid-1990s, however, this regionalism-is-easier assertion is hard to justify.[21] One cannot claim that regional integration schemes encountered less political resistance than the Uruguay Round in North America, Europe or Asia. In Canada, the bilateral FTA with the US was the key and highly divisive issue in a national parliamentary election, while the Uruguay Round enjoyed broad support. In the US, NAFTA faced much more opposition than the Uruguay Round (as evidenced, for example, by the 1992 Presidential election debate).

In Europe, one cannot say whether regional or multilateral liberalizations was politically easier. Some regional initiative (eg EC92) caused the EU members little political problems, while the Uruguay Round's impact on the CAP brought the European Union to the brink. In contrast, the Maastricht Treaty created enormous political problems as evidenced by the near-miss in the French referendum and the Danish rejection. For the EFTAns, the EEA caused enormous political problems, but the Uruguay Round was relatively uncontenous. Even now, European integration continues to divide several major political parties in the UK, Norway, Switzerland and Sweden among others, yet apart from a few narrow issues (cultural trade and food trade), the WTO enjoys strong support from all European parties except those on the far left and far right.

To sum up, it is factually incorrect to say that politicians prefer regional liberalization to multilateral liberalization because regional initiatives are less difficult politically.

Deep-versus-Shallow Arrangements There is certainly some truth to the second of Krugman's reason why regional liberalization might be easier. Many contemporary trade issues are much more complicated than those (eg

[21]See Cable (1994) on this point.

tariff liberalization) dealt with in the early GATT rounds. However, we need to keep the deep-versus-shallow distinction firmly in mind when considering the relevance of this.

Plainly this "trade issues are too complex for multilateral talks" assertion has little relevance to the many shallow regional trade arrangements that constitute much of the recent resurgence of regionalism. Shallow arrangements (essentially all non-European integration schemes) are concerned mainly with old-fashioned GATT issues like tariffs and quotas. Indeed, as WTO (1995 p.62) points out the Uruguay Round results went further down the liberalization road than most regional integration agreements in a number of areas such as services, investment, intellectual property rights, agriculture, clothing and textiles, and government procurement. The US-Canada FTA and NAFTA agreements, for example, are mainly limited to such border measures. They did go some distance beyond the Uruguay Round agreement on a few issues (eg investment), however in many ways the Uruguay Round successfully tackled many issues that were much more difficult than those addressed in recent North American regional initiatives. For instance, it promises to dismantle the Multi-Fiber Agreement - a byzantine quota system affecting most of world trade in clothing and textiles. It slipped the wedge in on agriculture protection, forced reforms of antidumping practices and procedures and it established a credible dispute settlement process.

In sharp contrast, the notion that regional deals are easier is clearly relevant to the recent deep integration schemes in Europe. There is no way, for instance, that multilateral agreement could be reached on issues such as a common competition policy, a common external tariff and a common antidumping regime (to say nothing of a common monetary policy). While the assertion helps explain why the EU limits deep integration to similar countries, it is not help us explain the resurgence and spread of European integration. As argued above, European integration is driven by forces that are entirely indigenous to the Old World.

A slight variant of the first assertion is that regionalism spread due to frustration with the Uruguay Round talks. Here again the facts just do not fit. Consider the US-Canada FTA. The political decision to start negotiations were taken in the year before the Uruguay Round was launched. One would have to tell a very complicated story about American and Canadian motives to assert that sluggish progress on the Uruguay Round in the late 1980s, prompted Reagan and Mulroney seek an FTA in 1985. The US-Mexico FTA talks and NAFTA were started after the Uruguay Round talks bogged down. However, the motives for the triggering event, the US-Mexico FTA had virtually nothing to do with global trade. It was pursued on both sides of the Rio Grande as a means of locking in pro-market reforms in Mexico.

It is even more far fetched to propose that European frustration with the GATT was what triggered the Single European Act. European economic integration in the post WW II period was and is driven by mainly by geopolitical motives -- the desire to make European war unthinkable. Who could believe that EU governments endorsed Jacques Delors' proposal for completing the internal market because they were unsatisfied with the GATT? Two historical facts back up this assertion. Even when the GATT multilateral process was widely perceived as well-functioning (in the 1950s and 1960s), West Europe continued to proceed with regional integration. Also, the Single Market programme, which sparked most of the other deeper integration schemes, was proposed and adopted long before frustration with the Uruguay Round emerged.

To sum up, the frustration-with-GATT part of the argument is not applicable to the major regional initiatives in the world, namely those in Europe and North America. Recall that Europe and North America together account for two-thirds of worlds trade, and these are the nations that always have been the driving forces behind multilateral liberalization.

We should conclude that the first assertion is does not apply to the bulk of spreading regionalism observed in recent years. Furthermore, since this assertion is only conditionally relevant to North American regionalism, we should reject the assertion as an important cause of regionalism.

Quite simply, assertion #1 is factually incorrect.

First, the claim that the US recently converted to regionalism is false. The US proclivity for regional integration was shown in the 1965 with the US-Canada Auto Pact. It continued in the 1970s. For instance, in 1974 the US Congress (not known for giving up power frivolously) granted the President authority to negotiation a bilateral FTA with Canada (see Section 612 of the Trade Act of 1974). It continued in the 1980s with the US-Canada FTA and it continued in the 1990s with the US-Mexico FTA and NAFTA.

Second, the US did not initiate the recent regionalism in North America - Canada and Mexico did. Hufbauer, Schott and Clark (1994) make this point at length. Whalley (1993) is more terse: "It was Canada who initiated negotiations on CUSTA, Mexico on NAFTA."

3.1.2 Assertion #2 is Factually Incorrect

The second assertion claims that a principal force behind recent regionalism is the conversion of the US from devoted multilateralist to ardent regionalist. This claim is based on two misguided readings of recent history.

First, the is not a recent convert to regionalism. US proclivity for regional integration was shown in the 1965 with the US-Canada Auto Pact. It continued in the 1970s. For instance, in 1974 the US Congress (not known for giving up power frivolously) granted the President authority to negotiation a bilateral FTA with Canada (see Section 612 of the Trade Act of 1974). It continued in the 1980s with the US-Canada FTA and it continued in the 1990s with the US-Mexico FTA and NAFTA.

Second, the US attitude toward regional had little to do with North American regionalism. Quite simply, the US did not initiate the recent regionalism in North America - Canada and Mexico did. To quotes Hufbauer, Schott and Clark (1994), "While the political will for free trade negotiations was apparent in the United States as early as 1974, Canada was slow to welcome negotiations." They go on to say: "Movement toward US-Mexico economic integration proceeded slowly in the 1960s and 1970s. The debt crisis in the early 1980s led to a dramatic reorientation of Mexican economic priorities, including trade policies...In June 1990, President Carlos Salinas of Mexico proposed free trade negotiations with the United States; this initiative soon prompted Canada to join the talks as well." Whalley (1993) is more terse in making the same points: "It was Canada who initiated negotiations on CUSTA, Mexico on NAFTA."

Moreover, when it comes to other regional arrangements in the Western Hemisphere (the Enterprise for the Americas Initiative, WHFTA, etc.), the US-attitude-as-driving-force assertion is an unsatisfactory combination of tautology and ethnocentricity. Plainly, the US's willingness to engage in regional liberalization schemes is a necessary condition for regionalism in North America.

However, the remarkable point is not the US's willingness to lower its barriers against Latin American exports. It is the willingness of Latin

Americans to lower theirs. After all, the US already has negotiated away most of its trade barriers multilaterally, so (Canada apart) FTAs with the US in the Western Hemisphere entail asymmetric liberalization, with the Latin Americans doing most of the tariff-cutting. Thus the big change lies in the attitude of Latin American governments, which until recently, resisted all forms trade liberalization - unilateral, regional or multilateral. It seem rather ethnocentric to suggest that the US's conversion from multilateralist to regionalist is the main reason that politicians in South American capitals have recently embraced regional and multilateral free trade.

A more likely cause is the poor growth performance (relative to East Asia) and the debt crises of the 1980s.

Even if one could find an historian to assert that the US was the initiator of spreading West Hemisphere regionalism, it is impossible to argue that resurgent European regionalism had anything to do with US attitudes. Anyone who follows European politics knows that the attitude of the US on trade had almost nothing to do with recent economic integration, even though Europeans do worry about US attitudes when it comes to deeper foreign and defense policy integration. Be that as it may, the timing of the US-leadership assertion is wrong. The resurgence of regionalism in Europe and the US started at approximately the same time (with the 1985 White Paper in Europe, and the US-Canada FTA in North America), suggesting that the second part of the standard explanation also has little explanatory power when it comes to the deep integration initiatives in Europe.

These lines of argument should be enough to reject the second assertion in the standard explanation. The US's conversion is not what explains recent regionalism in North American or Europe.

4. The Domino Theory of Regionalism

The standard explanation is appealing at first glance and it has won over many adherents, especially in the US. It is not, however, consistent with the facts. Baldwin (1993, 1995) proposes a very different explanation of the cause of recent regionalism. Idiosyncratic shocks that produce a new regional initiative (say, deeper integration of an existing regional bloc or an new bilateral FTA) can trigger a multiplier, or domino effect producing membership requests from countries that were previously happy to be nonmembers. The basic logic is simple. The stance of a country's government concerning participation in a regional arrangement is the result of a political equilibrium that balances anti-membership and pro-membership forces. Among the pro-integration forces are firms that export to the regional bloc. Since closer integration within a bloc is detrimental to the profits of nonmember firms, closer integration will stimulate the exporters to engage in greater pro-integration political activity. If the government was previously close to indifferent (politically) to membership, the extra activity may tilt the balance and cause the country to join the bloc. If the bloc enlarges, the cost to nonmembers increases since they now face a cost disadvantage in an even greater number of markets. This second round effect will bring forth more pro-integration political activity in nonmembers and thus may lead to further enlargement of the bloc. The new political equilibrium will involve an enlarged regional trading bloc. Meanwhile it would appear that regionalism was spreading like wildfire.

The recent idiosyncratic event in the Western Hemisphere was the US-Mexico FTA, which was itself motivated by the unilateral reforms undertaken by Mexico in the 1980s. Announcement of the US-Mexico FTA destroyed the *status quo* of trade relations in the Americas. Other countries in the region, which are heavily dependent on the US market, were faced with a *fait accompli*. Mexico-based producers would gain preferential access to the US market, thereby increasing the competition facing third country exporters and diverting foreign investment to Mexico. Despite continuing domestic opposition to its first regional liberalization - the US-Canada Free Trade Agreement - Canada decided that it had to be at the negotiating table. Other countries in the Hemisphere, such as Chile, Brazil, Argentina, Uruguay and Paraguay enquired about the possibility of bilateral FTA with the US. Faced with a flood of requests for bilateral FTAs, the Office of the US Trade Representative encouraged South American countries to form regional groups among themselves before applying *en groupe* for an FTA with the US.[22] Similar pressures explain the booming interest the Enterprise for the Americas Initiative. Note the closer integration of Brazil and Argentina (via Mecosur) seems to have triggered its own domino effect among the Southern cone countries.

The idiosyncratic event in Europe was the completion of the Single Market. Again the timing and motives for this suggest that this regional initiative was in no way a substitute for multilateral liberalization, nor did it have anything to do with the US's attitude towards the GATT system. This event triggered a domino effect. Austria, which had been previously restrained from joining the EU by pressure from the Soviet bloc, applied for EU membership in 1989. The deepening of the EU and pending enlargement of the EU to include several large EFTA countries made the potential loss of competitiveness even more threatening to EFTA nations that chose to remain outside the EU. That is, each EFTA nation individually faced the prospect of losing in the EU-12 markets and in the

[22] I have not found documents supporting this assertion, however while working for the Council of Economic Advisors in 1990-1991, I participated in meetings where USTR staff made such assertions.

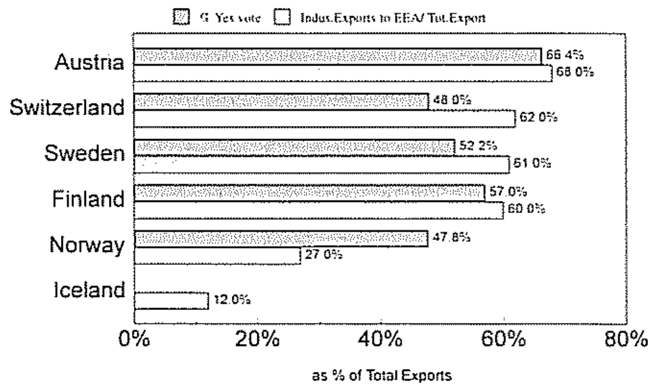
markets of those EFTAns acceding to the EU. Since the combined EU and EFTA markets on average account for three-quarters of EFTA exports, the pressure on the hold outs mounted. Sweden put in its application in 1991 and Finland, Norway and Switzerland requested EU membership in 1992. The Icelandic government, which gave much thought to joining in the early 1990s, was deterred by the EU's common fishery policy. By the time Iceland changed its mind in 1994, it was told by the EU that it was too late to participate in the 1995 EU enlargement, so Iceland did not put in an application.

Baldwin (1995) was completed before the accession negotiations for the EU's fourth enlargement were finished. However, additional evidence for the domino effect can be found in the ordering of the four referendums. Leaders of Austria, Finland, Sweden and Norway agreed to sequence the national votes in order of descending of EU popularity. The heavily populated eastern part of Austria was occupied by Soviet forces until 1955, so intrinsic resistance to joining the West via EU membership was quite weak in Austria. Also, Austria is the EFTA country most heavily dependant on the EU market for its manufactured exports. Due to this, it was decided that Austria should go first. Finland held its vote next. Parts of Finland were lost to the USSR in WW II and the country was 'Finlandized' during the Cold War, so as with Austria, EU membership promised significant non-economic gains. Sweden came after Finland and before Norway. It was hoped that the widely anticipated positive results in Austria and Finland would tilt the fine balance in Sweden towards the 'Yes' side. Norway was last. Norway's current exports are dominated by oil and so are not threatened by the Single Market programme. Norwegian exports of manufactured goods (SITC 5-8) to the EU account for only 19% of its total exports. The figure rises to 27% when manufactured exports to other

EFTA nations (mainly Sweden and Finland) are included.

Figure 2

Importance of Manufactured Trade with EU and EFTA and Referendum Results



As figure 1 shows, there is positive correlation between the fraction of the population voting for EU membership and the importance of manufactured exports to the EU plus EFTA area as a share of total exports. The exception, of course, is Switzerland whose voters rejected even the EEA although about 60% of its exports face discrimination from EU92.

Asymmetric Lobbying: Losers Lobby Harder The political economy forces driving this domino effect are strengthened by a peculiar tendency of special interest groups. They usually fight harder to avoid losses than they do to secure gains. In this light it is important that joining the regional integration in Europe and North America would allow countries to avoid damage as well as to gain new commercial opportunities. While there may be many explanations for this asymmetric phenomenon, Baldwin (1993) proposes a simple economic interpretation based on sunk costs.[23]

Entry into most industries and markets involves large unrecoverable investments in product development, training, brand name advertisement and production capacity. In such situations, established firms can earn positive profits without attracting new firms only in as far as these profits constitute a fair return on the entry investments. Another way to say this is that sunk costs create quasi-rents. In such industries, consider the incentive to lobby. If a country's exporters obtain additional access to foreign markets, their sales and profits will typically rise. The increase in pure profit, however, will attract new competition, so the size of the gains must be limited. In the extreme, entry continues until all pure profit disappears.

Correspondingly, the incentive to lobby for new export opportunities will be limited, and in the extreme will disappear altogether. Next consider the reaction of an established firm to an unanticipated policy change (such as the 1992 program, or the US-Mexico FTA) that would reduce its relative competitiveness and profitability. (Note that supply switching almost always harms those excluded from preferential agreements since it means these countries will sell less for less to the in the PTA markets). To be concrete, suppose that the change would wipe out half its quasi-rents. Since it would not actually be losing money, the firm would not shut down. More to the point, the firm should be willing to spend up to half its quasi-rents on lobbying for membership, if doing so would reverse the loss of relative competitiveness.

[23]Available from the author upon request Baldwin@hei.unige.ch. Also see the extensions by Grossman and Helpman (1996) and Baldwin and Baldwin (1996).

5. Summary and Concluding Remarks

This paper argues that regionalism does not reflect a WTO failure nor the US's conversion from devoted multilateralist to ardent regionalist. GATT Rounds have always been long, have always been slow and have always been difficult. And the US embraced preferential trade in the 1960s, 1970s and 1980s. Indeed resurgent regionalism does not even reflect a systemic phenomenon. I propose that the current wave of regionalism stems from two idiosyncratic events -- one in the New World and one in the Old -- that have been multiplied many times over by a domino effect.

If this explanation of the causes of regionalism is accepted, much of the worry about the implications of regionalism are misplaced.

For instance Baldwin (1994 Chapter 3) proposes a model of the dynamics of trade liberalization in which reciprocal trade liberalization begets more liberalization. The idea is that reciprocal liberalization systematically raises imports and exports, and this systematically strengthens the power of pro-trade forces (exporters) and weakens the power of anti-trade forces (import competitors). The implication is very much in line with Larry Summers' argument that all the "ism" are good for trade liberalization. Any liberalization makes further liberalization easier as long as it raises imports and exports.

The implications for North-South preferential arrangements is even more important, since such preferential agreements are perhaps the best way of changing the line-up of pro-trade and anti-trade forces in developing nations. To see this, consider how episodic GATT rounds triggered a powerful liberalization dynamic in industrialized nations. Announcement of reciprocal trade talks strengthens pro-trade forces (by arraying the political power of exporters - normally are largely indifferent to domestic protection - against the political power of protectionists) without increasing the power of anti-trade forces. The new political equilibrium involves more liberal domestic and foreign import policies. As the liberalizations are phased in, export interests get stronger as they expand output and employment. Import-competitors get weaker as they scale back output and go out of business. A few years down the road another GATT Round is launched and the cycle is repeated at a lower initial level of import barriers.

The developing countries, however, were exempted from this dynamic due to the notion of "special and differential" treatment. That is, following the logic of import substitution (widely supported by trade economists at the time), developing countries were not required to make tariff "concessions", yet they benefitted from OECD import liberalization. In other words, special and differential treatment meant GATT Rounds had almost no impact on the line-up of pro-trade and anti-trade forces in developing nations.

Here is where North-South FTAs come in. To be GATT legal, FTAs require all members to bring their tariffs to zero on substantially all trade; Special and differential treatment is not allowed in FTAs. Thus we do see the export interests of developing countries lobbying their governments to lower import protection in the context of FTAs; We do not see this in the context of multilateral trade talks.

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