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The Relationship between Regionalism and the Multilateral Trading System*

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Chapter I

INTRODUCTION

Two developments in the evolution of the world trading system have dominated discussion of policy in the last ten years. One is the extension and strengthening of the multilateral system, beginning with the initiation of the Uruguay Round in 1986, and culminating in its ratification and implementation in the World Trade Organization (WTO) in January 1995. The other is the growing number of regional and sub-regional trading groups which are emerging or proposed. Although there has always been some concern for the external effects of these, the intensity of interest can be dated to the beginning of the European Community's move towards a Single European Market, and now the European Union (EU). This started in 1985, was formally completed on 1 January 1993, and reinforced by the admission of three new members on 1 January 1995. Along with these international trends has been the growing concern about the appropriate trading policies for individual developing countries and for their trading opportunities. During the Uruguay Round, the question was raised of whether regionalisation was or should be an alternative to the international system, especially at points when the Round seemed on the point of failure. But that it has continued to develop even after the successful conclusion means that we must now ask not: regionalisation or multilateralism, but: how to reconcile and balance the claims of the two trends. The questions which inevitably arise are: whether the trends are complementary or in conflict, whether their simultaneous emergence creates problems or opportunities in their relationship with each other, and the implications for the developing countries.

In some regions and sub-regions, the share of intra-regional trade has increased strongly. This is particularly true in Asia, at least in absolute terms, although examination of the flows in detail raises the possibility that it can also be explained as a normal response of fast-growing countries which happen to be neighbours. New groups are emerging and old ones reviving. The number, economic size, and cohesion of regional trading groups appears to be increasing. An increasing number are now among the developing countries and between developing countries and industrial. Some groups may be intended to have a purely regional trading role, but others have an explicit commitment to other forms of cooperation or to increasing bargaining power at world level. The extension of the meaning of 'trade' which has come from the GATT (General Agreement on Tariffs and Trade) Uruguay Round negotiations means that both groups need to think again about what their function is and which of their activities have been overtaken by GATT or are newly regulated by it. The multilateral organisations, particularly those dealing with trade, are having to adapt to the new links among their members and, potentially, to a new international economic structure, with a structure of fewer but more diverse players. The most conspicuous new trading area is the North American Free Trade Area (NAFTA), with the United States, Canada, and Mexico as members. The most conspicuous adaptation is that the EU is a member of the WTO, although the member countries also remain members in their own right. If the new organisations prove to be more than expressions of regional good will or temporary cooperation, and particularly if they follow the example of the EU in deepening their structures, then the international organisations will face a new type of member, which is not simply a larger country. They will need to operate in a new system, dealing with a variety of levels of cooperation, and with conflicts of responsibility within and between the levels. Some of the administrative and regulatory issues which this raises are similar to those raised in the context of large firms, in particular, for international agencies, of multinational firms. This may suggest one type of solution, that the international organisations should have a strong, regulatory role in supervising the regional groups. But two prior questions are whether the new structure will be very different from the old and whether it is, on balance, favourable or unfavourable for individual countries and for development.

UNCTAD has raised these questions in the past, noting its concern in 1989 (UNCTAD 1989) that 'bilateral arrangements and regional economic integration...ensure that such schemes impart dynamism to global trade and enhance trade and development possibilities for the developing countries'. It has taken the view that 'there is no inherent contradiction between regional economic integration and the international trade system' (UNCTAD 1993, July). But it has also recognised that the new groups, and the new responsibilities which some are taking, need further investigation. Three of the main new groupings, the enlarged and strengthened EU, NAFTA, and the Mercado Comun del Sur (MERCOSUR) among Argentina, Brazil, Paraguay, and Uruguay (implemented 1 January 1995) are now in place. There is an increasing number of declarations of principle from the potential Asia groupings. The African groups are realigning following the political reforms in South Africa. It is now possible to begin to ask more specific questions about what the groups are trying to do, how this fits into other international trends as well as how it conforms to a priori expectations about the role of regional groups, and thus what actual effects they are having on development and on the international institutions. The considerations which influence these will be brought together in chapters VIII and IX, respectively.

One priority is clear definitions. In this paper, regionalism will be used as a purely descriptive term for strong and growing links among countries. This may reflect only location or common interest. The words will be used without any institutional or analytical implication that these are more than what may be explained by normal economic, political, or other forces. Regionalisation will be used for more conscious policies of cooperation or institutional links. In the Western Hemisphere and in Asia and the Pacific, groups are emerging at more than one level, with countries having stronger links at a sub-continental level than at a broader level, as well as their international or global links with the WTO and other international organisations. For convenience these will sometimes be distinguished here as sub-regional or partial regionalisation.

The conventional word for the groups, formal or *de facto*, which form at a level between country and global is 'regional', but this should not be assumed to have a geographical meaning, and certainly has not had any consistent geography. Here, 'groups' will be used at times as a reminder of this. The discussion of the conditions for 'regionalisation' in chapter III will clarify some of the issues. It makes clear that the conditions may hold among countries which are not the nearest neighbours, even if it is possible to construct a regional name, or may not hold between contiguous countries. At empirical level, the existence of organisations like the Organisation for Economic Co-operation and Development (OECD) for policy formulation for its members or of countries like Switzerland in the middle of the EU or the discussion of Chile as a member of a 'North American' association all show the limits of a geographical view. A brief recollection of economic history will call to mind how perceptions of regions have changed as other conditions for cooperation have changed (since 1989: the idea of Europe).

The focus of this paper is on trade, and on trading organisations, but this (as has been recognised by UNCTAD, July 1993) is rarely the only link, and the spread of WTO responsibilities suggests that how far the organisations move or intend to move into other areas of cooperation needs to be considered. It is notable that the groups that have endured from previous rounds of regionalisation have all had non-trade links from the beginning. The EU evolved from industrial cooperation (the European Coal and Steel Community, ECSC). The Andean Pact (now Colombia, Venezuela, Peru, Ecuador, and Bolivia) had common industrial policy as its basis in the 1960s. Some preference areas, where they were contractual rather than purely concessional, for example the Lomé agreement for the EU's associated African, Caribbean and Pacific countries, have included assistance and cooperation on non-trade issues. (This was also, of course true of the cooperation among the socialist areas in the COMECON/CMEA system.) It is only some of the now extinct areas (the European Free Trade Area, EFTA) and the new areas or proposed areas (MERCOSUR, perhaps; 'open regionalism' in the

Pacific, but this is already being questioned: see chapter V) which claim to be purely trade-based. This means that it will be necessary to raise from an early stage the question of whether purely trade organisations can exist permanently. This will arise throughout this paper, but is most specifically discussed in chapter IV.

The non-trade responsibilities of many of the groups raise problems of cooperation among the international institutions as more than one will be involved. Some have payments or credit relationships (bringing in the International Monetary Fund, IMF); all alter their members' tariff policy (often involving the World Bank in its policy advice role); labour conditions may be discussed (the International Labour Organisation, ILO). The organisations which are regional may also have relationships with the regional parts of the international system, for example, both the Economic Commissions for the various areas and the development banks. The relationships established with these may influence or set precedents for their relationships with the global system. The EU was a full member of the European Bank for Reconstruction and Development (EBRD) before it was of the WTO. The hemispheric proposals for the Americas may be dealt with by the hemispheric organisations there, although the sub-regional have not, and the Economic Commission for Latin America and the Caribbean (ECLAC) has been a leading contributor to the discussion of what 'open regionalism' might mean. In other cases, the regional groups have moved into subjects not yet, or not as extensively, covered by international agreements.

The question has been raised of whether the groups should deal with all types of cooperation within their areas, or whether 'regions' can overlap, with some groupings being appropriate for trading purposes, but others for other types of cooperation. One view is that overlap is not appropriate because of the potential for conflicting rules, but in practice this has happened in every region. Southern Africa shows different regions for trade, for payments, for customs cooperation. The European countries have a variety of organisations for economic purposes, although on the whole these are subsets of each other, and for other types of cooperation. Even the newest group, MERCOSUR, has already joined with one member of another (Bolivia) in cooperation on the river system. Where the groups are subsets of countries within the larger group which have a particular interest or which wish to move towards closer union, the problems raised are parallel with those raised by the regions within the global system, although of course they further complicate the latter. But where the two groups are different, this raises issues of whether a country can be a member of one region for one purpose, but a different one for another, and finally of whether it can be a member of more than one trading group. This is answered differently by the different groups, as discussed in chapter V.

The possible conflicts between apparently logical and manageable organisational structures and the actual ones which emerge is in a sense the subject of the whole paper as many of the arguments for regional cooperation hold much more strongly either for individual countries or for a global international organisation. The arguments about appropriate size differ depending on whether one is building up, from responsibilities, or down, from trying to find those groups which will make the next level up operate efficiently. In the absence of any overriding international organisation or set of rules or universally held views at the national level, there is no single answer to the question of appropriate size or appropriate composition, and no answer to the prior question of who should make the choice of level of decision-making. The system is inevitably one of bargaining, in which economic strength, political strength, alliances, and in many cases interest groups outside country governments will have a voice. It is perhaps appropriate to introduce here a concept of 'messy regionalisation': once one goes beyond either a purely individual country approach or a universal international one, any intermediate grouping or choice of level for decision-making is a compromise. This should not be surprising in view of the number of different ways in which individual countries choose to organise their own internal regions and decision-making. Many of the same questions have long been raised in this context, and remain open to debate there as well. This question can be considered in the context both of the conditions for regionalisation (chapter III) and the context of how to relate the regions to the international system (chapter IX). The paper will need first to consider how what has been happening fits into the other developments in international economic trends and the formal role for regions under the Uruguay Round agreement, and these are the subject of the next chapter. To place the discussion of trends and policies in context, it will be necessary to have two more methodological chapters, on how to measure regionalism (chapter VI) and how to measure its effects on non-members (chapter VII).

Chapter II

REGIONS AND REGIONALISATION IN THE TRADING SYSTEM OF THE LATE 1990s

How international trade is changing

Regional organisations, particularly those among developing countries, have a history of enthusiastic formation followed by dissent and either dissolution or lapsing into purely formal existence. Even the survivors, including those among the industrial countries, have gone through periods of little change. If we are to ask whether what is happening now is different from what happened in the past, we must ask whether there has been a change in the external conditions to make them more favourable or to make regional schemes more desirable. The regional conditions for successful integration will be examined in chapter III.

There is growing integration of economies (what Oman, 1994, has called 'deep international policy integration'). This may require a more contractual response to any degree of *de facto* regional trade integration than in the past. One obvious change is the greater importance of non-trade questions. Some are not yet regulated by the WTO, although they are already on the agenda of the WTO, but have appeared in some regional groups, notably the EU and NAFTA. The environment and labour conditions are examples; regulation of business organisation perhaps one that will appear sooner in practical terms. The regulatory and long-term issues which they raise cannot be met by normal trade bargaining procedures. Where the regional organisations do now cover these questions, as the EU and NAFTA do, but most others do not, the standards and regulations which they set, and implicit or explicit discrimination against or among non-members, are not subject to GATT/WTO obligations of MFN (most favoured nation) treatment, so that any adverse effects on non-members cannot be challenged. There is also no formal obligation to notify or explain them to non-members.

A second change is the increasing role of private actors in international economic relations; a third is the role of international contacts in the activities of smaller or more local economic interests than would have been affected in the past. There are now not only the traditional multinational companies doing traditional trading and investment, but new forms of international division of labour within these and an increasing number of smaller companies trading and investing abroad as part of their normal operations. The reduction of international barriers has made international trade look less exotic and more a matter of everyday economic activity. The increased importance of cross-border trade leads to other contacts, notably in the services and intellectual property areas, which in turn leads to new linkages.

The growth in foreign investment, and an increased perception of the possible choices between trade and investment, and the greater linkages implied by choosing investment are also mentioned in this context. Here, however, it is important not to exaggerate the changes. Much of the late 1980s and early 1990s 'growth' was a recovery from temporary very depressed levels, and that some of the increased regionalism seen in this may also have been a reversal of a change in the opposite direction in the early 1980s. It is the nature of the companies involved, especially some of the smaller ones now evident in intra-Asian flows, which raises new systematic questions to which regionalisation may be a response. Growth of traditional multinational companies was not on the whole a force for regionalisation in the past, and the evidence for their increased participation in trade is limited. What has been important has been the spreading awareness in smaller companies on the one hand and among trade regulatory agencies on the other (most evidently in the services negotiations of the Uruguay Round) of the complementarity and potentials for substitution between trade and investment, and therefore of the need to deal with the two together. While investment is not formally regulated by the WTO, and rarely by modern regional organisations, a variety of individual regulations under both the WTO and regional groups do impinge on it. This is true also of labour migration. Under the WTO, these appear mainly in areas which are directly trade-related (increasingly broadly defined), such as requirements for investors to meet specific trade targets, investment or labour movements necessary to meet commitments under the services agreement, regulations to reinforce rules on subsidies, etc. In NAFTA, the opening in each country to investment in the other was initially greater than to the rest of the world, but this has subsequently been largely opened to non-NAFTA members. In the EU, the opening to investment among members also predated general freeing, but has now been extended. On labour, however, the opening among members has not been extended to non-members, and in some cases the barriers to non-members have been raised in the initially more open members. This is now, therefore, a substantial discrimination against all non-members, with some elements of discrimination among different non-members, and a clear increase in the barriers as a result of regionalisation. All three of these harmful effects of a region on non-members would be regulable under a GATT-type regime for labour, but cannot be challenged.

Some of the economic, but non-trade, linkages within regions are subject to global regulation by other international institutions, notably monetary arrangements by the IMF; air and shipping services by the relevant shipping and air organisations. The criteria of these organisations, however, are different from the MFN and non-discrimination ones operated by the GATT/WTO, and the procedures for challenging potential harmful effects on excluded countries are less direct. There has been no explicit recognition in the other organisations, as there is in the GATT/WTO of regionalisation as a force which requires a response.

The elimination of trading barriers makes other differences in market conditions more apparent, both as barriers to trade and as 'unfair' differences between firms in different countries. At a regional level, this phenomenon helps to explain the transformation of the European Community into the Single European Market; at global level, the new responsibilities attached to the WTO. The inclusion of services, investment, intellectual property, non-trade subsidies, and the other new issues in the WTO offers evidence that countries are finding these non-trade barriers to trade more important and the existing mechanisms for regulating them unsatisfactory. Those areas where trade or other links are greater than the average will find this force more powerful, potentially leading to a need being felt for regional cooperation or regulation. This could explain why a smaller increase in regional trade than in the past could be enough to trigger a policy response, and could imply that regional organisations may prove more stable than in the past. But it also suggests that exclusion may be more painful than in the past.

International, often regional, links among groups other than countries should also not be ignored, as the discussion in chapter III of the non-economic conditions for regionalism will make clear. Professional groups and non-governmental interest groups of all types have greatly increased their contacts, formal and informal, partly because of the increase in the importance of trade which has made them identify common interests, partly because of greater ease of communications. Such interests may also see a need for greater regional trade to be accompanied by more formal institutional structures than in the past.

These arguments cannot explain why groups may emerge where there is no apparent above-average increase in regional contacts. But there may be other reasons. The difficulties of the Uruguay Round of trade negotiations led both to a search for alternative ways of lowering barriers and to a desire to create groups with greater negotiating power within the international framework. The strengthening and the formation of some regional groups reinforced this influence, leading to a cumulative, even competitive growth of new groups. The SEM initiative of the EC was itself in part an attempt to increase its economic power and competitiveness against the larger industrial countries, the United States and Japan, while NAFTA was in part the response of the US to the SEM.

MERCOSUR can, in this context be seen as in part a response to NAFTA, and the circle continues with the EU now establishing links with both Mexico and MERCOSUR to limit the importance of NAFTA. The Pacific groups, some with and some deliberately without the US, and the sub-regional Asian groups, some with and some without Japan, also illustrate this impact of regional groups on each other.

It is important to recognise that these two forces, of deeper integration and of bargaining power, have very different implications for the future. The first suggests a stable and strengthening trend towards greater regionalisation. The second, an unstable and fluctuating pattern. As each new group itself represents another new potential partner for existing groups and countries, this leads to a regionalisation equivalent of the export strategy of 'niche marketing', i.e. finding a special advantage, rather than seeking a more profound one in the form of competitiveness. It is thus the reverse of the original impetus of the SEM, of using integration to promote its competitiveness against the world as a whole. It also goes against one of the arguments for both regionalisation and global agreements, that of increasing the certainty and predictability of international arrangements. Each new group alters the relative preferences of all the existing members of each of the groups directly involved and all those which themselves have agreements with those involved, while the potential for this to happen itself devalues the value of all preferences, as it does of the MFN system. Those with non-contractual preferences, in particular members of GSP schemes, may be worst affected because they have no control on the process.

Which pattern will prevail will depend on the internal characteristics of the groups (discussed in chapter III). It will also depend on the economic performance of the region (whether or not this is attributable to the regionalisation). As ECLAC 1995 notes, the EC's assessment of the effects of the SEM did not take into account the possibility of a serious recession in the late 1980s, as in fact occurred. The result of recessions is often to make countries more protectionist; for a region, the effect is the same, even if the means to do so are different.

Another change which needs to be noted is the unilateral reduction in tariffs of many developing countries. Although this makes regionalisation easier, it also reduces the incentive for purely trade-based regionalisation.

<u>Institutional changes</u>

The expanded WTO seems at first sight a force against regionalisation. Not only does it remove the argument that regionalisation is needed to compensate for the absence of progress on global trade reform, but its new responsibilities greatly reduce the apparent scope for forming regional groups to negotiate coordination in areas which are not covered or covered inadequately under the international system. In trade terms, there are fewer 'niche markets' for regulation and for tariff reduction which regional groups could fill. The long debate, for example, over whether international investment should be regulated at OECD or international level continues, but now countries outside the OECD are too important as both host and home countries to be excluded from an agreement, and the framework for discussion exists within the WTO. There is no realistic option at any purely geographical level. The investment provisions of NAFTA have been overtaken by those of the WTO, and also by changes unilaterally by Mexico, as have those of many other bilateral agreements. On tariffs, the average level of tariffs, of 4-5% for industrial countries and 10-20% for developing, leaves little for a regional free trade area to offer, while the substantial changes already on the table in the more controversial areas of agriculture and textiles and clothing have left only the most difficult concessions for regional groups to make if they wish to go further.

The new system also offers, as the GATT did not, the possibility of continuing negotiation so that it no longer necessary to use other organisations in order to make further progress between Rounds. On some subjects, particularly among the services and in the other new areas, there is already provision for renewing the negotiations, immediately, or in two, or five years. The review of financial services is now due for completion. On any of the others, negotiations can be initiated at the ministerial meetings which will now occur every two years. The system of allowing credit to countries in future negotiations for concessions already offered creates the technical method of conducting negotiations on one subject at a time. The world trade system is no longer one of a simple set of rules, open to negotiated change at long intervals, but a framework of setting, changing and enforcing rules. The new trade policy reviews and the dispute settlement procedures offer the opportunity for a much more continuous role of the WTO in trade policy debates than in the past, although it remains to be seen how much difference these will make in practice.

There are also new limits on regional groups in the WTO. In the past, GATT treated regional groups in a fairly tolerant way. The implicit assumptions were that they promoted their members' interests, that the impact on other countries was limited (and could be calculated and compensated for in the same way as any change in tariffs), and that there were not many of them. Those among developing countries were treated particularly leniently, in the context of permissible preferential arrangements, the 'special and differential treatment' for developing countries embodied in the GATT. The formal regulations, in Article XXIV of the GATT, were also flexible, with the provision that they lead to substantially universal free trade among the members in a reasonable length of time largely undefined and unenforced. The only major agreement, the EC, had been accepted as beneficial by the US, the only power capable of challenging it when it was formed. All these considerations have changed. The SEM and then NAFTA, along with doubts about the two most recent enlargements of the EC (to southern Europe and in 1995 to Austria, Sweden, and Finland) brought the assumption of limited effect on the rest of the world into question.

The Uruguay Round Agreement specifically noted that 'customs unions and free trade areas have greatly increased in number and importance since the establishment of the GATT 1947 and today cover a significant proportion of world trade' and used this as an argument for including a new 'Understanding' on Article XXIV (GATT 1994). This reiterates the basic rule that such groups must either provide completely free trade among members or be in a state of transition to that, i.e. that agreements freeing only some sectors are normally not allowed, and it tightened the rules for calculating whether any move to a common external tariff raises average barriers to the rest of the world. The new understanding specifies the 'reasonable length of time' within which the transition to full internal free trade is to be completed as normally not more than 10 years, and provides for regular reviews and reports to WTO on progress. It requires fuller notification of the details and in particular of the schedule of transition, and empowers a WTO working party to make recommendations and to approve the schedule. This will in practice be supplemented by the regular reports occurring under the Trade Policy Reviews. In contrast, in the entire history of GATT, almost no working group on a regional area reached an agreement on its validity.

There are now more countries which might challenge any regional group, and those formed in recent years have faced such challenges, notably MERCOSUR and NAFTA, while older ones like the Lomé agreement between the EU and the ACP countries have faced renewed challenges. The new groups, and other association agreements, for example those of the EU with the eastern European countries, have been written with the provision for eventual free trade explicitly included to meet these new requirements. The new international awareness and regulations will make it more difficult to form partial agreements, requiring a stronger initial commitment on the part of their members than some old groups had (for example the EFTA on manufactures only or some of the Asian groups based on lists of goods to be included).

The services agreement, although more flexible than the goods agreement in allowing exemptions from most favoured nation treatment for existing arrangements, is even stricter for new regional agreements, requiring that any opening not available to all other countries be part of a move to fuller integration. The first example of this having an effect is the request that the 1995 enlargement of the EU be investigated under this provision.

The changes in the WTO do not, however, entirely eliminate the scope for regional groups, particularly those which wish to move into new areas. In particular, the process of 'deep integration' has already moved ahead of the WTO, with the involvement of non-governmental groups in international transactions as well as the growing importance of non-trade integration. Both NAFTA and the EU include provisions on labour. The limits to even the reformed Article XXIV are that its rules and provisions for reporting and time limits do not apply to those areas to which the GATT/WTO system does not apply, so that discrimination is possible and that there is no explicit provision for regular review of the activities of regions (once their formation has been assessed). Although the EU is now reviewed under the Trade Policy Review Mechanism as a single country, other regions are not, although comments are possible in the individual reports on the countries which are members of other schemes.

In other ways, the new WTO system could further regionalisation. The admittance of the EU as a member and the explicit recognition in the new Article XXIV Understanding that regional groups are a growing force suggest that they will acquire a more formal position, rather than being treated as anomalies. The new issues offer strong examples of how to move forward to any regional group which chooses to do so, as does the increased information on what other regional groups have done and are doing. This has emerged from the negotiations and from the Trade Policy Reviews on the EU, and may come from examinations under Article XXIV. The agreements on services are still very limited; there are still tariff peaks; and some countries may be willing to move faster on some of the transition periods set out in the Uruguay Round on non-tariff barriers. The improvement of the disputes procedure in the new WTO, and also in some regional organisations, may stimulate other organisations to examine and improve their own procedures.

The question of whether international conditions have made regional groups more or less likely remains open at both economic and institutional level. Lowering barriers generally makes regionalisation easier, but less beneficial. The increased regulation makes them potentially more difficult, but offers a framework for a set of procedures and for how to make progress as interests change. The strengthened WTO may make acquiring bargaining strength through alliances less necessary, by reducing the scope for bilateral pressures, or more necessary by establishing a continuing bargaining process. What is clear is that groups will need to be more formal, in their internal regulation and in the relations with the rest of the world and with the international institutions than might have been possible in the past. This may influence the answers to some of the questions raised about the possibility of overlapping memberships. At a minimum, it may make it difficult to leave the answers ambiguous as some present groups do.

Chapter III

CONDITIONS FOR SUCCESSFUL REGIONALISATION

The organisations which have been formed and the WTO regulations for regional organisations assume that the arrangements are permanent. Therefore, the conditions must be ones that will continue, or on which the regional member countries will evolve together, in the same way and at the same time. The same assumptions are made for the WTO and other international organisations. Legally, it remains the case that countries can withdraw, subject to appropriate notice, but in practice the stronger the degree of integration, both *de facto* and legally the more difficult this will be. It is notable that even the regional organisations which have ceased to have practical importance have normally gone dormant rather than being formally wound up, with usually part of the original cooperation continuing.

As the focus of this paper is principally on the effects of regional organisations and their role in international organisations, this is not the place for a detailed discussion of the criteria which have been developed in the economic, political, and social and other conditions for regional organisations, but it is worth summarising the type of issue raised in order to indicate how likely different groups are to meet them, and to continue to meet them. If there is, as will be argued here, a difference between their likely success in developing and in industrial areas and evidence that they will evolve in particular directions, these conclusions have important implications for their effects on their members and on non-members, on members' relations with other regional organisations, and on the relationship between regional and international organisations.

Economic conditions

Current international policy discussion is often limited to the economic conditions, but it is difficult to think of any organisation which has been formed only for economic purposes or where the conditions derived in other disciplines, notably the political and social conditions, have not had an important role. Even in the 'economic' dimension, it is difficult to discuss their role without considering issues such as negotiating power and the working of political institutions.[1]

One basic difference between developing and industrial countries is that the structure of the economies of developing countries changes more rapidly and more fundamentally. This applies at a sectoral level, at a technological one, and in terms of macroeconomic variables such as trade, the role of government, the fiscal and other balances of the economy. This frequently entails changes on the monetary side as well, in the institutions, in the role of exchange and interest rates, and in inflation rates. All of these are areas in which conventional examination of criteria for regions looks for complementarity, congruence, or convergence.

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[1]'The issue of multilateralism versus regionalism is a difficult one to get one's arms around, on at least two levels. First, even in narrowly economic terms it is a tricky area: after all, it was precisely in the context of preferential trading arrangements that the Byzantine complexities of second best were first discovered. Second, the real issues cannot be viewed as narrowly economic'. ...Any discussion of the international trading system necessarily involves an attempt to discuss not what policy ought to be but what it actually will be under various rules of the game. And the science of politics is, if possible, even less developed than that of economics.' (Krugman in Garnaut, Drysdale 1994, p.167).

An examination of trade structures for complementarity, to find the advantages for the area itself of trade creation, and the possible damage for it and for the rest of the world for trade diversion, normally looks at existing trade structures, with some allowance for how these will change, given present industrial structures, if barriers are removed or altered (e.g. World Bank, 1995). This is potentially risky for any group, but the uncertainties are greater for countries whose trade and industrial structures are changing more rapidly or for which change is actively sought in development policy. In practice, complementarity measures tend to produce higher numbers for trade groups among industrial countries or between industrial and developing (EU and NAFTA) than for developing (MERCOSUR) (World Bank 1995, p. 20). But it will, of course, always give the maximum index of 1 for a trading group defined as the world. Therefore it cannot explain why countries should form regional groups rather than going directly to full international trade.

Using complementaries may be inappropriate as well as uncertain. It is possible to make a distinction between the objectives found in trading groups among industrial or among developing countries. The former look at the traditional efficiency advantages of removing barriers to current economic activities. After years (centuries) of development, their industrial structure is a major characterisation of the economy, and changing it in response to an integration programme can be expected to have a significant effect on the performance of the economy. The entire analysis of the effects of the Single European Market, for example, as done by the Commission itself, was in these comparative static terms. Some external criticism of this went one step beyond, to identifying potential dynamic effects if efficiency led to higher output and potential savings from efficiency stimulated growth. But this type of gain would be unlikely to have as strong an effect in developing country integration, and it has not normally been the objective of developing country groups. Their existing structures of industry are small relative to their economies or to their planned development,. The static gains from rationalising these among member countries through easing flows of trade are correspondingly small.

The objectives of a group like the Andean Pact or ECOWAS were not merely 'dynamic' in contrast to the 'static' gains calculated for an industrial country grouping, but structural. They included development of new industries through the cross-border coordination which economies of scale, a broader home market and better access to inputs, might permit. By avoiding completely the high costs of establishing some industries, they would avoid the inefficiencies which industrial country integration is expected to eliminate *ex post*.

There is no necessary contradiction between these ways of analysing a potential region, but the identification of future possibilities is more uncertain, and the best region for those which are foreseen today may be different from those identified 20 years ago or which might be identified in 10 years time (WTO's transition period). The macroeconomic criteria are even more likely to give different answers at different periods. Even for the EU, defining and reaching 'convergence' on the macro variables which have been agreed as essential at the next stage of union is proving difficult. In Europe, these tend to vary across countries and over time by a few percent. Among developing countries and between them, the variations are much greater. Only months after the 1 January 1995 implementation, the differences in performance of Argentina and Brazil led to pressure on the agreed tariff for MERCOSUR, and quantitative import restrictions by Brazil.. Disagreement over industrial regulation and location of industry contributed to the breakdown of the Andean Pact in the 1970s, while a fundamental change in policy led Chile to withdraw. It is possible that the more the developing countries are successful in growing rapidly and changing their industrial structure, the less likely is any region to survive as the economically most appropriate group.[2]

The obstacles most likely to arise in the two types of integration are also different. The industries facing rationalisation in an industrial country group may see immediate costs, and therefore attempt to reduce these, perhaps by increasing protection against non-members. Such pressure groups will not (yet) exist in developing countries, but the continuing need to allocate new industries among the members, whether it is done by planning or markets, will lead to a continuing risk of major opposition, leading then either to protection or break-up, particularly if any members appear to be consistently gaining or losing. For an organisation linking industrial and developing countries, both sets of difficulties are present. The pressure groups are already present to resist rationalisation in the more advanced, and are likely to emerge in the less. The objectives in joining are also potentially inconsistent.

The changes in industrial and in macroeconomic structure over time could imply changes in both the 'optimum' size and the appropriate partners of a developing country trading group. Technical conditions also change. Different industries require different sizes to achieve appropriate economies, and there seems now to be no regular evolution towards ever greater scale. The conditions for the size or coverage of a trading area may not be the same as for all the present and potential 'new areas' of international agreement. This is reflected at sub-national level, where countries frequently need to make different levels of organisation for different purposes, so it is not surprising that it should be true at international level as well. The possibility of conflict among the appropriate groups or levels for different types of cooperation has already been mentioned; but there is also a potential conflict between economic and other objectives here.[3] There is a third set of potential conflicts. The appropriate size for any individual region may give rise to a number of regions within the WTO or other international group which is not, in theoretical terms, optimum for reaching solutions to common problems. This number in turn will also vary among organisations, with the nature of each organisation.

These points suggest some caution in welcoming regional organisations even before looking at countries which are excluded. Those involving industrial countries are more likely to continue to have the common conditions which they had or foresaw at their formation, and therefore to survive. This is not inevitable: if a developing country regional organisation does succeed in establishing common organisations and links at an early stage, and if policies and other economic conditions do not diverge, then the region may see the initial conditions reinforced.. This may, however, also happen in industrial countries, as the more dynamic analyses of the SEM argued. Regional organisations among developing countries which redefine their coverage and their membership may be able to meet shifting international and regional conditions more effectively, but they are less likely to become the strong units which would be equal bargaining counterparts to those of industrial countries. It is arguable (and there is some evidence from the past) that whether an initial trading link will strengthen or collapse is in part a matter of chance, of how quickly and divergently conditions change in its early years, and therefore of whether the initial conditions are reinforced or broken. This poses problems for international organisations and for non-member countries dealing with new

[2]It is tempting to see 24 as warning number for regions: Article XXIV of the WTO may limit them. Decision 24 of the Andean Pact on the regulation of foreign investment became one of the strongest points of disagreement for its members.

[3]Cooper (Garnaut, Drysdale,1994) notes that 'there is no such thing' as an optimal region. 'Optimality calls for a much more complex array of jurisdictions, compromising between the desire for greater decentralisation and the technical need for greater centralisation.' (p.18).

regional organisations. They must not only react to, and perhaps adjust to, the new players, but judge their chances of success, and therefore how irrevocably they should adapt, and also judge whether they can themselves reinforce or weaken the new organisation. The same uncertainties face the groups' trading partners.

Political conditions

These can be defined in various ways (see, for example Zormelo 1995, for a brief review of the literature). A summary of the minimum would include similar or at least consistent structures for decision-making, and mutual acceptability of harmonisation where this is necessary. For this, it is necessary to have some sensitivity and responsiveness to the political and economic objectives of the partner countries, and common political assumptions, or at least common views on how much of the international economic contact among the member countries should be regulated. Over time, they will need compatible views of how far the various domestic interventions which affect traded goods and services and other international transactions should be regulated, and on the forms which these regulations should take. Some agreement is needed on what types of economic or other interest group should be responded to at the regional level, and how this should be done. As in the economic conditions, policies cannot vary too greatly, or change at different paces within a region if a group is to continue to meet the conditions. The evolution of those organisations which have survived shows how 'deep' this integration must become, but also indicates how shallow it can be at the outset. Regional organisations need to allow formally only for the 'shallow' at the beginning, but especially now with the example of more mature organisations before them, cannot ignore the probable future evolution. It is possible, therefore, that as with 'latecomers' in industrialisation and trade, progress through the stages will be faster than for the early regionalisers. The existence of provisions for investment, dispute settlement, labour standards, and the environment from the beginning in NAFTA makes a sharp contrast with the early years of the EC or the WTO. The expanded coverage now of the WTO may in turn influence new regions. Countries which have already accepted global intervention on these new subjects may be more ready to accept greater intervention at regional level. If, however, there are some questions on which national differences are so strong that regional groups are unlikely to be allowed to intervene, at least in the foreseeable future, the greater coverage of the WTO may have reduced the range within which progress can be made at the regional level in this area as it has in tariffs and other economic barriers.

One argument for regional organisations is to increase bargaining power at the international level, and therefore to permit fuller participation for small countries in the WTO and other organisations. If this is valid, it is arguable that similar caution implies that countries must feel reasonably strong relative to their potential partners before they are willing to negotiate at the regional level. For developing countries, which are still developing and changing their own political institutions, this may deter them from entering regional organisations, although strengthening the case for doing so to obtain power at the global level. The empirical evidence on this is contradictory, and the existence of countries of widely varying size, economic and political, makes it a complicated one. The European countries' initiative succeeded among countries that had all reached a high level of national political development, and the recent surge of Latin American groups followed the political reforms of the late 1980s. The entry of Mexico into an agreement with the US would have been almost inconceivable in earlier periods. Earlier Latin American initiatives failed. On the other hand, the apparently stable Asian countries have not formed such groups.

Social and other conditions

These have been touched on among the political conditions,. They again require similar or at least consistent views on what issues are important, how much to regulate and what are the appropriate institutions with which to regulate. These arise out of basic assumptions about how national systems should operate. The questions of acceptability of harmonisation are not just practical, but depend on trust that the same formal institutions will operate consistently across the member countries, which may well require in practice some common background. How deep this commonality needs to be, on what subjects, will depend on the nature of the group, and will change with the 'depth' of integration which it reaches, and, like political and economic constituency, it may itself be strengthened by integration. Some of the new issues have shown different attitudes very clearly, for example how to regulate intellectual property, and over what subjects; environmental choices; labour issues.

Differences remain within even the old groups like the EU, but large areas of common assumptions can be found. The Latin American groups may now increasingly share policies, and deliberate efforts are being made in the context of MERCOSUR to increase contacts and cooperation at all levels. There are sub-regions within Asia where similar backgrounds are obvious; and some where there are long periods of cooperation and mutual respect. There are, however, differences between the degree of common backgrounds and assumptions about economic and other policy found in Australia and New Zealand, or among some of the East Asian, or some of the South East, or perhaps some South Asian countries, and the degree to be found over the entire region.

Regions, or global integration

The difficulty for economic conditions, noted above particularly for complementarity measures, but applying to a greater or less extent for any of the others, is that it is very difficult to think of any condition which would not hold most strongly at the global level. The assumption behind applying them to find an appropriate region is that there are some obstacles to going to the global level, and that regions exist which are small enough that integration is possible but big enough such that they attain most of the benefits. The implications may be that while the benefits continue to grow, there is some point at which there is a rapid tailing off of the growth. The political and social conditions can be taken to be these obstacles. In contrast to the economic factors, on most of these the country, or even a smaller area in a large country, would probably score a higher rating than any region. Thus the condition for a region becomes that the point at which the rising economic gains from integration meet the rising political and social costs lies between the country and the global levels[4]. If there are more viable regions now, this suggests that this point has moved up into the regional range from the country-size range for the reasons suggested in chapter II. The view that regions should replace GATT, argued during the Uruguay Round, was that it had moved down from the global range.

Determining the location of this point is a matter of empirical fact, and there is no *a priori* reason to believe that the answer will be the same in all continents, or the same for developing country-industrial country or pure developing country regional groups as for some industrial countries, or that it is fixed over time. It is not possible simply to assume, without specifying, that political factors limit free trade to some absolute level (as is done in much economic analysis of regions).

The issues raised under each of the three headings here are reasons for believing that groups may reach a good level of benefits and acceptable conditions among themselves sooner than at global level, and therefore that there is scope for them to move more rapidly towards integration. On the other hand, if groups lead to greater integration within the group, this suggests that the

[4]Or: the declining marginal economic benefit (the demand curve) meets a rising marginal cost (social and political).

existence of global links will accelerate the process of creating the conditions for further global integration, and therefore for reducing the scope for regionalisation. The problems of finding appropriate sizes of groups in the face of conflicting criteria, for the group and for the system, also suggest a strong influence from international to regional level. Thus the 'new issues' have spread rapidly from the regional groups to the international level (services from the EU, labour and the environment from NAFTA) and from it to other regions and back to the original regions in a harmonised form.

<u>The geographical dimension</u>

Are there some conditions which are so deeply and permanently embedded in societies that they can only be integrated at a sub-global level, and if so, are these normally regional in the strictly geographical sense, so that permanent regional organisations will survive? The 'unthinkable' and 'unnegotiable' national issues, whether economic: of taxation, common definitions of professions, policies on migration; or non-economic: of defence or medical standards, which are now included in some regions and at global level, and the historical fluctuations in what is viewed as a geographical 'region' make it difficult to identify any such issues. It is, however, clear that such issues can be identified now or for any past period, and therefore that there is a role for temporary groups, and perhaps for a quite long view of temporary. How quickly groups move to 'full' integration whether in trade, narrowly defined, as under Article XXIV, or in the broader definitions will depend on how well they meet the 'conditions' initially, and on how quickly the countries are themselves developing. It will also depend on how quickly the global view of what constitutes 'integration' is widening. Countries integrate to meet an ever-moving target.

Some economic conditions, for example the extent and costs of trade, may seem clearly related to geography, but how important they are and therefore what is the 'region' changes with technology. If, as is sometimes argued (Amelung in Garnaut, Drysdale, 1994) there is a difference in kind between the costs of trading within a country and those of cross-border trade, it is possible that there are similar differences between intra-region and full global trade (that the curves implied in the discussion above have discontinuities). But the differences cited, of transportation costs, information costs, the financial costs of adapting to different systems, are not in general, absolute differences. They increase with physical distance, but they also vary with experience, with the size of a company and the nature of its product, and with all the differences of cost, demand, etc., which enter into any trading decision. It is only the costs peculiar to national borders, of tariffs, other barriers, and (normally) exchange rates which can be assumed to be different in kind, and by assumption moving either to a region or to full international trade removes or modifies these.

It has frequently been the case that low-cost and easy transport has been available by water, leading to the traditional definition of regions by water contacts, whether the Ionian league (embracing parts of present Greece and Turkey) or the modern Pacific Basin. As sea transport improved and other forms of transport and other types of international contact became more important, the traditional water routes extended and other linkages became possible. Later trade theories and practice looked for complementarities in output (trade of primary goods for manufactures), often suggesting more trade between regions rather than within them. Emphasis on common tastes and types of markets and inter-industry trade leads back to regions; finding new global modes of production using differences in costs and production conditions leads away to inter-regional trade again, while rapid response and common standards may now be leading back towards regions. In terms of the successful developing countries of recent years, the process can be seen in the NICs' shifts to trade largely outside their area in the 1970s (complementary products and production conditions), and more recently back to their region (rapidly growing markets).

Levels of development and modes of production could suggest geographic groups for some traders at present and inter-continental ones for others. For the groups which are now emerging, regions have supplied convenient non-political names, but potentially inconvenient ones when membership expands. The 'regional' institutions offer a warning here: both the EBRD and the Economic Commission for Europe would find it as difficult to justify all their members as European as NAFTA would to include Chile. But it is difficult to say that economic arguments offer convincing reasons for geographical trading regions.

Do political or social conditions imply a geographical condition? Political seem inappropriate, as institutions have spread among countries because of past associations or example more than because of geography, although as in economic there is some correlation. Historical common backgrounds are rather more frequent at regional level, although again it is easy to think of exceptions, and of regional groups which seem to include or exclude countries with little regard for this. The conditions discussed here do not suggest any reason for introducing strictly geographical criteria in analysing the groups which are appearing: the examination of the other conditions seems more fruitful. This conclusion reinforces the view that the groups have no necessary permanent existence or scope.

This section suggests that while some common elements, and therefore conditions for continuing regions may be relatively permanent, others, notably the economic, may be likely to alter. Therefore while a few groups may survive and become increasingly closely integrated (in the past, of course, such linkages eventually ended as countries), others may form temporarily, but may not survive if interests or structures change. Developing countries are likely to be at a disadvantage in forming permanent groups, and therefore in bilateral and international bargaining. Organisations linking developing and industrial could be particularly at risk of divergence, but if they can survive they are likely to become more convergent and stronger over time. This has implications for whether groupings need to be consistent across all types of economic integration. If they are temporary, different groups for different functions may be appropriate, but such a pattern will become increasingly difficult to sustain for those which do prove to be permanent.

Chapter IV

THE EFFECT OF INCLUDING NEW SUBJECTS IN INTEGRATION

The conclusions of the last two chapters suggest that going beyond trade offers more opportunities for regional organisations, but also greater difficulties. The congruent interests, economic, political, and other, which are required extends with each new issue, and particularly with those which lie on the border with non-economic questions. It has taken many years for even tariffs to be fully accepted as appropriate areas on which to give up some sovereignty in negotiation, and only a few of the regional groups have moved to a common external tariff, and fewer (effectively only the EU) to accepting a common negotiating position on this tariff in international negotiations. Non-tariff barriers began their transition in the late 1970s, but remain sensitive within all regional groups and within the WTO. Both of these depend on how governments (or regional or world institutions) weight different economic interests within their countries, and therefore on the economic conditions. But some NTBs, and many of the new areas (investment, labour, intellectual property, environment, common standards) are affected not only by how countries weight economic interests against others, but on choices among non-economic interests. They therefore require an increasingly wide range of the conditions for cooperation to be met. Because this makes them particularly unlikely to be met at the global level, it is here that opportunities may exist for smaller groups to form and move further. For this reason, it is here that some of the regional groups are showing the most progress, but also the most divergent performance relative to each other. As long as these remain outside WTO, it is also here that regions' effects on non-members are least regulated. It is becoming increasingly difficult to think of integration as a unidirectional movement as different groups are able to make progress on different linkages.

It is important not to forget the more traditional non-trade areas of economic cooperation. Among the African groups in particular, payments systems and trading procedures have moved further than in other areas, while, as mentioned earlier, cooperation in the development of natural resources has made some progress there and in MERCOSUR. The existence of these links clearly will act as a force strengthening and making potentially more permanent any grouping. In contrast, the Asian groups and some discussion of Latin American possibilities (for example, in Garnaut and Drysdale 1994 and in ECLAC 1994) have emphasised the possibility of purely trade-based regionalisation. It is probably more appropriate to look at how groups have actually evolved than *a priori* reasoning. The express exclusion of financial cooperation from NAFTA has already been weakened, while it is being questioned in Asia.

Two areas on which the EU has made substantial progress and which were major targets of the SEM exercise are harmonisation of technical and other product standards and company/competition policy and regulation. Once conventional trade barriers, tariff and non-tariff, are lowered, these differences are particularly important in setting the competitive conditions among companies, and therefore having common regulations is a normal objective within countries. While establishing a common system raises initial barriers to existing firms and then to new entrants, and in the case of competition policy may restrict what were existing methods of doing business, over time they become useful elements of certainty and of informed and fair markets. For countries (and their companies) which are excluded from setting them, as those in non-members of regional groups are, the advantages are reduced in at least two ways. Their existing standards or modes of organisation will not be given weight in the initial negotiations of regulations. If export markets have different standards from their home market, and perhaps also among themselves, they obtain proportionately less advantage than do companies from member countries. As in most cases, the standards are not yet subject to international regulation, the standards can be set intentionally to discriminate against some or all external suppliers. Some, particularly developing countries or others which have not yet set their own regulations, may choose to use those of their markets as a model, but the potential disadvantages of inappropriate standards remain. Like reductions of existing barriers (the conventional implication of regionalisation), therefore, such changes have the potential to make regional blocs trade diverting as well as trade creating, without GATT-type sanctions on raising new barriers. Where more than one large trading area (the EU and the US, even without NAFTA) sets its own standards, the blocs can become obstacles to later globalisation.

Chapter V

OPEN REGIONALISM AND OUTWARD ORIENTATION

The discussion of how regionalisation should develop has produced various terms to define what the users consider to be 'good regionalisation', particularly from the point of view of the international system. The background which has been presented in the last two chapters can be used to attempt to define these in terms of what existing regions have done or in terms of more conventional analysis of regions.

Open regionalism

Various definitions of this have evolved, with a strong divergence between the discussion in Latin America and that in Asia, as well as among sub-groups. The emphasis of all the discussion is on finding new forms which are to be less rigid, or less protectionist, or more market-driven than the EU is believed to be (a simplistic definition for many users of the term may be 'the opposite of whatever the EU is doing'), and it frequently seems to ignore both how regions change over time and how to find a consistent position which can operate in the presence of other regions and the international system.

A common suggestion is that it is regionalisation which is 'market-driven' rather than 'institution-driven'. This raises the question of how regions are formed, and then how they develop. Do market forces see the need for greater coordination or regulation or formal changes in market conditions, and press for the appropriate regional institutions, or do governments see the possibility of improving markets or development and establish the institutions? To ask the question is to answer it, as clearly both will always occur, and which is more important will depend on how economic policy is determined in individual countries. A region formed from relatively unplanned economies may differ in its formation and will certainly differ in its nature from one of planned economies. Over time, either markets or governments may identify new opportunities, and exploit them and if necessary alter the regional institutions to accommodate them.

The discussion then, in considering how regions develop over time, raises the question of how to respond to new interests and, a problem which attracts particular attention, how to relate to new members or other regions. One model proposed, in the line of finding less rigid organisations, is the hub and spokes, with a variety of different linkages from different members to a central one. This is intended to allow for different levels of common conditions. The EU relations with a variety of different areas, the Lomé countries, the other Mediterranean, Eastern Europe, Turkey..., and now potentially with an inner and outer hub of members in some areas of policy, notably financial and labour, is itself the most extreme example of this. It also exemplifies the problems it creates, of complicated arrangements and obligations between the 'hub' and 'spokes' when new relationships are formed and the indirect relationships among the 'spokes'. In Asian discussion, the tendency is to think in terms of nesting groups, with subsets, but not overlap among groups. Among Latin American groups, the possibility is raised of spokes joining more than one hub. At this point, the mechanical analogue would crash. It seems likely that the economic form would be equally unworkable. Except in the case of (at least temporarily) unrelated linkages (trade and cooperation on a regional infrastructure development, for example), it is difficult to see how the differing obligations could be guaranteed not to raise conflicts over time, especially as the regions followed the normal progress of moving towards greater linkages. At a minimum, the administration of rules of origin within each region (which might themselves differ) would create new barriers.

A central element which the various 'open regionalism' definitions stress is non-discrimination, but the emphasis here differs, between members and non-members or between members and potential members. The implications are very different and can perhaps be discussed in terms of the 'Asian model' and the 'ECLAC' (not the Latin American, because in practice the Latin American regions do not follow this). Both by implication limit their non-discrimination to some, variable, geographical region.

Asian open regionalism

The principle behind this appears to be that a group of countries should negotiate concessions among themselves, but agree to extend these to any country which offers to reciprocate. This is not a traditional, Article XXIV region, because there is no commitment to a target of full free trade and because the element of automatic extension means that the group is not fixed. As any country could obtain the reductions, it is not clear, however, that it would be challengeable under Article XXIV, although the position would be anomalous. It is not clear how a non-Asian applicant would be treated. It is also not clear what obligations would rest on one member to consult another before extending reductions to a new partner. It is possible to look at this as similar to the old GATT bargaining technique of reaching agreement for any commodity among the principal suppliers and principal buyers, and then automatically extending MFN treatment to all, on the grounds that the others did not add significantly to the costs or benefits of those negotiating, and the result could not affect any country outside the principal traders adversely. Where there is substantial regional trade, a similar argument could hold. There would, however, be some difficulty in defining any Asian region where intra-regional trade was as large a proportion of the total as the GATT commodity-based groups usually involved, and therefore where all the countries involved would accept the principle of automatic extension. Where tariffs are low, it becomes easier, but less worthwhile. As new areas of cooperation become important, the problem of whether reciprocal privileges could be extended in part or only for all subjects would arise.

This remains at the proposal stage, and it is not clear that any of the present groups with potential would follow it. It seems to be advocated most frequently in the Australia-New Zealand area. Within APEC, the scope has already been challenged, with finance initially excluded, but now proposed. For other issues like regulation and standards which are likely to arise in regional groups, it is difficult to see how mutual recognition or harmonisation could be defined or achieved without a rather more formal structure than is assumed.

In terms of the discussion in chapter IV, therefore, it probably is not practical to extend the concept to new issues. In terms of chapter III, it implicitly assumes that all the conditions are met within the region, and outsiders will not want to join or complain. The conditions may hold in a few small sub-regions of the region, but these would probably be too small to provide the high intra-regional trade shares which are also assumed.

ECLAC open regionalism

This is a slightly more formal concept: that any group allow any country which is prepared to accept the agreements already reached to join. It also suggests that the regions be on the basis of a negative list of what is excluded, rather than a positive one of what is included on the grounds that this is likely to lead to more integration (ECLAC, 1994 p. 13). It is also more likely to meet Article XXIV's criterion of 'substantially all' trade. MERCOSUR has followed the negative list criterion, as far as goods are concerned, but the questions of other forms of cooperation and the new issues and even services have not yet been dealt with; by implication all are excluded, except where explicitly included. The openness to new members is a more difficult concept. ECLAC (1994) suggests that, 'What differentiates open regionalism from trade liberalization and non-discriminatory export promotion is that it includes a preferential element, which is reflected in integration agreements and reinforced by the geographical closeness and cultural affinity of the countries of the region.' (p. 12) The openness is thus limited by an assumption that all Latin American and only Latin American countries meet the political and social conditions. It is difficult to reconcile Mexico's membership of NAFTA or the potential extension of NAFTA to the whole hemisphere with this, and it raises questions about the Caribbean. The freedom to join with 'flexible membership criteria' raises a variety of questions and makes several assumptions. It is to be eased by adopting international rather than regional standards. This effectively eliminates regional standards as a component of the agreements, which begs the question of why have a region rather than global integration. Regional investment is to receive national treatment. There is no mention of migration, the environment, or other non-WTO issues. If this is to go beyond simply applying WTO rules, it probably requires more preconditions than trade cooperation. ECLAC also suggests macro-economic coordination - a major step, which make the obligations of the members to each other relatively extensive, at the level of some of the most integrated regions. Flexible membership, on the other hand, suggests some members could have a restricted level of obligations. It is not clear that these are compatible concepts.

Flexible membership also raises the question, particularly important in the context of the range of agreements to be found in Latin America of whether cross-membership of more than one organisation should be permitted, and of whether countries should be able to join more than one regional group without approval or joint negotiation of all the groups involved.

In practice, the greater the degree of integration which any group reached, the less likely is it to be flexible (except in a transition period) with new members. If the existing members have found it necessary to extend and deepen their relationship, they will see a need to do this with a new member. The more an organisation becomes established and evolves these new linkages, and the more this in turn makes the economies and countries more congruent in their characteristics, the more difficult it will be for a new member, without this history, to meet the formal and the national conditions for membership. In the terminology of the EU, the 'acquis' must be adopted, and each increase in this raises the *de facto* barriers to new members.

As was indicated, the Latin American regions do not follow this model. MERCOSUR is open to new members, but they cannot be members of other organisations (it is for this reason that Bolivia can cooperate on natural resources, but is barred by its continuing formal adherence to the Andean Pact from full membership) and must accept the full obligations. If Chile joins NAFTA, MERCOSUR would not admit it. In principle, NAFTA might not bar joint membership. There are no formal procedures for negotiating with new members or criteria for these (Bernal 1994 Columbia Journal. 27). Members may form links with other countries or groups (Mexico is negotiating them with the EU and with some members of the Andean Pact). NAFTA itself, however, derives from Canadian unwillingness to be left as a 'spoke', when the US began negotiations with Mexico.

It is too early to know whether this informality can survive as NAFTA evolves. In an interesting contrast, the US has suggested that it would negotiate now with MERCOSUR, not with its members, and the EU already has done so. On the other hand, the EU is willing to negotiate with Mexico, and it is not clear whether the (so far purely speech-level) proposals for TAFTA, Trans-Atlantic, would involve the US, the US and Canada, or NAFTA. The US has also suggested that it would negotiate with CARICOM as a whole, not with individual members, while the members of that, because of their obligations to each other and to the Lomé agreement must secure both joint action and EU acceptance of any agreement with NAFTA. The perceptions and the choices of other trading organisations are driving the new organisations, NAFTA as well as MERCOSUR, to become more integrated, and earlier, than they might have done in the absence of the other groups. This suggests that weak or open regionalisation may not be open to new organisations given the organisations which already exist with their own rules and institutions.

On paper, the obligations of any joint memberships look highly complicated. In practice, there would be problems and certainly the benefits of economies of scale and industrial development which developing countries (on the model suggested at the beginning of this paper) look for in regional groups would be restricted, but experience suggests that if all the participants actually wanted this, it could be arranged. 'Messy regionalism' of this type has already flourished for example in the Caribbean, with the interlocking of the US Caribbean Basin Initiative and ACP privileges, and in southern Africa where South Africa has had a variety of formal and informal relations with countries which were members of the ACP. This type of solution, however, would reinforce the conclusion that the relationships of developing countries, both among themselves and with developed, are likely to be temporary and variable.

Does open regionalism mean anything?

It appears to be based on a distaste for the EU and also a misunderstanding of its history. The nature of the EU's organisation reflects the policies and interests of its members; those of an Asian or Latin American organisation would be different. Perhaps, in the context of the 1990s rather than the 1950s and 1960s, they would be more 'market driven'. But the EU as it stands now reflects a late stage of a process of increasing centralisation and institutionalisation which was itself 'market-driven' in the sense that each stage of integration led to the identification of other 'unfair' differences. The new groups are already seeing the same pressures, and the WTO shows their effect at international level. Open regionalisation does not and cannot exist in the sense in which it has been elaborated in either the Asian or ECLAC models, except as a transitory stage.

<u>Outward-oriented regionalism</u>

This is a more practical term, in that it accepts that regions, like countries, have *de facto* if not *de jure* external policies, which can be judged on the same criteria. Policies can emphasise improving the development and competitiveness of the member countries, while taking full advantage of the opportunities in the rest of the world, or concentrating on internal policy and the regulation of agreements with others. This analysis can in principle be applied to non-trade policies as well as trade. The old Andean Pact and the other regional organisations with strong discrimination between national and external flows make the obvious parallel with import-substituting policies, while the new Latin American and most of the Asian appear to be following the external. The criteria which are laid down in the WTO Article XXIV are intended to increase the probability that a group will be externally oriented, with the requirement for 'substantially all' trade to be included intended to avoid the case where a group tries to secure only those goods on which it has an interest in offering special concessions, and effectively, therefore, to increase the economic conditions for a group in the hope that this will produce one which is more likely to be open. It also restricts the potential for adversely affecting the rest of the world through the restriction of a common external tariff to the pre-existing levels. It does not, however, extend to unregulated questions, although in some cases the other international organisations' emphasis on internal as well as external liberalisation might do so.

The more that international levels of trade barriers come down and the more other transactions are governed by WTO regulation, the fewer the opportunities for new or existing groups to be protectionist against non-members. But we must still ask whether there are tendencies for groups to become more restrictive, because they see their fellow members' interests clearly and accept these as valid (one of the political conditions for success suggested in chapter III). Further, the 'acquis', as discussed above, itself acts as a non-tariff barrier by setting an increasing contrast between common practices and standards within a group and those outside. This is only partially offset by the growing internationalisation of standards. There are, therefore, some institutional forces which drive regions in on themselves, and the more they meet the conditions of chapter III and the longer they exist, the more likely is this to happen. But the same forces which drive these institutions to become stronger are also being pressed, by the same traders, although perhaps slightly fewer of them, at the global level, and therefore the same forces are tending to lower barriers among regions. Thus, although there may be a tendency for the protectionist tendency to increase, the absolute level could be falling. This is a translation into policy terms of the same interaction as between trade creation and trade diversion. The answer of whether external countries benefit, in net terms, is, again a question of empirical determination, not a general one.

Chapter VI

HOW TO DETERMINE IF REGIONALISATION IS HAVING AN EFFECT ON ITS MEMBERS

This chapter and chapter VII are intended only to outline *how* to measure the criteria which the discussion so far suggests for answering some of the questions which have been identified as depending on empirical answers rather than analysis, not to do this analysis. It is obvious that *trade* does affect partner countries, but to know whether we should be concerned about the effects of *regionalisation*, it is necessary to know how to identify when it is going beyond other forces affecting trade flows. As indicated above, this could be because of elements which also affect non-members, as well as those trade policies which are in principle under multi-lateral control.

There have been increases in recent years in the share of intra-regional trade in all the continents, and in some regions within them. Some of these increases are in areas which have seen the introduction or planned introduction of trading groups, notably in Latin America. There have been large changes in the MERCOSUR area and between Colombia and Venezuela. The major increases, however, have been in intra-Asian trade. As this is an area in which regionalisation has scarcely passed the proposal and discussion stage and other areas have also increased their trade with the fastest growing region of the world (African exports to Asia, for example, have grown faster than intra-African), this suggests that regionalisation is not the explanation there, and regionalism may also be an inadequate reason. Import growth by the industrial countries was slow until 1994, but so was their growth.

To measure the actual impact of a trading group, it is necessary to determine if trade among its members is higher than conventional reasons can explain, and then if the differences can be correlated in timing, in the composition of the fastest growing sectors, and in the emergence of new trade flows, with the timing and sectoral provisions of the trading group's integration. This two- stage approach is required because full modelling of trade flows and the effect of formation of a region is made difficult by the absence of a sufficient number of regions to be able to model them directly. The solution is thus formulating expectations (whether by modelling or finding apparent patterns by observation of other areas or historical series) of the 'without regionalisation' trade pattern, and then asking if the observed trade is greater than this.

The most common methods involve measuring the 'intensity' of trade within a group before and after integration. As discussed in the conditions for trade (chapter III), this attempts to measure how far trade, commodity-by-commodity, for each country, imports and exports, within the region is greater than the trade flows with the world as a whole. It is assumed that the before-regionalisation ratio reflects all the other forces, both economic and strictly regional, which may affect trade. This initial ratio can be substantially greater than 1, but may (MERCOSUR gives some examples, Zormelo 1995) be substantially less. An *increase* in the level, rather than the *absolute* level, can then be presented as a possible effect from regionalisation. A complete analysis must then look at which inter-country flows or which commodity flows have increased, when, and by how much, and correlate these with the policy changes, and their timing, of the integration programme. On these measures, the EU has been found repeatedly to show effects.

A preliminary study of MERCOSUR (Zormelo, 1995) suggests that there has been an increase in intensity, and to some extent the inter-country pattern of the increase can be correlated with the integration programme. Most of the Asian groups seem to fall at the first stage (no increase is found in intensity, e.g. Anderson, Blackhurst 1993), but for them it may be too early to see effects. It seems likely that some other Latin American groups would meet the increase in intensity criterion. There are severe practical problems in deciding at what point to break between 'before' and ' after' integration because of the importance of anticipation of effects. The measure also does not allow for interaction and possible substitution between investment and trade, but it is superior to the simple comparisons of levels of trade which are frequently used. It is clear that there is substantially more work to be done in this area to determine if regionalisation is actually increasing integration of the member countries before attempts are made to look for effects from any group on other countries.

In principle, a similar exercise can be carried out for investment flows or migration. Both are seriously hampered by poor data. For the latter, the only example would be the EU, where intra-EU movements have increased, but data on EU-non-EU movements are poor, so that it is difficult to determine differential changes and it was only in the most recent year that common external barriers have started to operate. For investment, different periods give different answers, but the consensus is certainly that there has been a relative growth in intra-regional investment.

Chapter VII

HOW TO DETERMINE IF REGIONALISATION IS HAVING AN EFFECT ON NON-MEMBERS

An introduction to the effects

There are two types of effect: those arising from the changes within the region, as indicated in Chapter VI, and those arising from any changes in policy of the region towards the rest of the world, compared to the countries which preceded it, in the formation of the region, or later in response to the economic changes or to a different balance of interests in the group. The trade effects of a region are traditionally analysed in terms of trade creation and diversion. Lowering the barriers within a region reduces the costs of trade within it compared either to trade within each country or to trade with countries excluded. The first effect *creates* trade with other members by replacing domestic production, when one member offers a lower cost or otherwise preferable product. The second *diverts* trade from non-members to members because the former continue to face barriers. Both effects benefit the members, both in their income and in efficiency of allocation of production. The first has no direct effect on non-members; the second damages non-members. Since the analysis of the effects of the Single European Market in the mid-1980s, 'trade creation' has acquired another connotation: if the traditional benefits to members do occur, an area can be expected to expand, at a minimum during the transition to higher efficiency; potentially, at a permanently higher rate if the efficiency effects are large enough. This will in turn lead to higher demand, and expansion of imports, within and from outside the region.

This analysis of creation and diversion can be extended to other factors of production. Investment will be created or diverted into the region to meet the new production demanded by the changes in trade flows. Labour may follow a similar pattern. The effects of the other non-trade elements on non-members should normally appear in trade effects. It is even possible to extend it to policy-making: members may become more interested in improving trade flows within the region as these become a higher share of their total trade. Here, however, it is possible to argue the reverse, that there may be declining rates of return to policy-making as the intra-regional barriers become smaller relative to the external.

The relative importance of creation and diversion effects must be analysed empirically for any region, but there are some *a priori* expectations. Trade diversion is more likely if: the members of the group are complementary, so that a good or service not previously provided within a country is now available within the group, and if a group is large, for the same reason. The complementarity argument suggests that the expansion of the EU from the original largely industrial countries with similar natural resources to more agricultural countries (Denmark and Ireland), and then to more southern areas like Spain, Portugal and Greece might be progressively diverting. The evolution and extension of the CAP can be analysed in this way, until the reforms of the last four years within the EU and as a result of the Uruguay Round. For small countries to join what is now a large group, as Austria, Finland, and Sweden have done, suggests that for them, if not for the existing members for whom the addition is small compared to the existing size, the effect may be diverting. For NAFTA, the addition of a developing country, with a sub-tropical location, to two advanced, industrialised, temperate countries could similarly be more than proportionately diverting.

The effects on non-members are negative (or zero) from the initial static effects (only diversion); potentially negative or positive if growth effects on imports are added in. The diversion effects on developing countries of integration among industrial countries may tend to be relatively low, if fewer products are competitive (if there is a high share of primary exports, for example), but will be higher if the tariff reductions within the region remove advantages which they previously had from preferential trade regimes.

In both cases, the effects are not confined to trade diversion. The range of investment opportunities, and the range of possible cyclical changes in demand for investment are also increased with size and diversity of country. In the EU, where labour mobility is allowed, the range of skill levels and wages of labour is increased. Investment has perhaps a greater probability of negative effects because growth in the region is normally expected to be greater than it otherwise would be. Even if there is some increase in growth outside, this will be smaller. The incentive to invest in the region will always be raised relative to investing outside. For labour, the effects are yet more likely to be negative because there is less likely to be an opportunity for outsiders to move into the region to capture some of the benefits.

There may also be effects on the other, non-trade policies. The more goods and services are provided within the region, the more may be regulated by regional standards. The operation of policies like public procurement favouring of local producers becomes more potentially restrictive if the region includes more producers than each country. The exclusion of 'sensitive' products from import liberalisation or preference schemes with respect to non-members, in particular developing countries, may increase if more countries means that there are more 'sensitivities' to consider. On policy, the effects are likely to be made more negative by introducing a new player into international negotiations with fewer interests in lowing international barriers.

A potential second set of effects from policy arises from the greater difficulty institutionally of taking protective action within the region in response to any interests which consider themselves damaged. This gives an incentive to do so externally. It also follows from the greater sympathy assumed (as discussed under the political conditions in chapter III) for interests of fellow members relative to those outside. These policy effects are likely to be negative unless constrained internationally. Much of the regulation under Article XXIV of the WTO is intended to prevent trade diversion, by limiting the opportunities to increase protection against the rest of the world and supervising the implementation of integration programmes, but where policies are not regulated, Article XXIV will not apply. For some of these arguments, however, there are potential offsetting effects other than regulation. The larger is a region, the more likely is it to include competitive industries as well as complementary. Protection against non-members may seem less important or even irrelevant because there is also competition from within, from other members, and therefore the pressure from individual countries may be reduced, while in so far as commercial policy is administered centrally, the pressures may be further attenuated. These offsets may be less important for policy-driven diversion than trade diversion because international regulatory constraints are absent. Another force which could go the other way is that in the long run any increase in trade with non-members from higher growth may lead to increased pressure to reduce barriers for the same reasons which led to the pressure to reduce them within it.

In determining how important effects are on particular non-member countries, again the question of complementarity or competitivity is central: a group of industrial countries may be more potentially diverting from other industrial countries; a mixed or developing country group will be more likely to divert from developing countries. Location, however, is also likely to be important. For labour movements and some types of services trade, those countries nearest to a group (the Caribbean to NAFTA; the Mediterranean countries to the EU) may be more vulnerable than the more distant, for which the traditional trade and investment effects are more likely to be important.

As new issues are included in trade negotiations and thus in regional analysis, their incorporation into the analysis of regional effects on the rest of the world has been rather *ad hoc.* An important one is the setting of common or harmonised standards. Even if the objective is greater efficiency or setting minimum acceptable health or other provisions, it is inherently likely that countries outside will find it difficult to meet them more often than do countries in the region. As outsiders they have not themselves been involved in setting them. Their procedures and legislation will not have been taken into account. Traders may need to adapt more or to meet different standards in their home markets and in the regional group. If they are trading with all members of the group, they may make the same efficiency gains as those within the region. If they are not, there will be no offset, and if the region meets the criterion of relatively high intra-member trade, the corollary is that outsiders will have a smaller share with the members, and thus gain less from harmonisation. The standards at issue can cover trading procedures, quality or other standards for goods or services, procedures for doing business of various type, environmental or energy protection, labour, and, as groups become more integrated, all the elements of legislation of a modern state.

These are the elements which have been used in analyses of the effects of the EU on non-members, and as it is the only regional organisation which has been important enough and long-lasting enough for effects to be observed, it will be discussed in slightly more detail below. Such analysis could be applied to NAFTA as well, but this has been surprisingly limited. All this analysis, however, depends entirely on the model of the objectives for integration defined above as appropriate for industrial country integration. If a developing country group is formed with more structural motives for integration, and if it is successful in implementing these, the effects would need to be analysed much more in the traditional terms of the effects of development on trading partners, with regionalisation regarded as accelerating, and perhaps modifying, the composition of these, rather than concentrating on traditional trade (or other) diversion effects. In broad terms, the effects would be greater in terms of leading to faster growth and probably in terms of changing the composition of trade rather than 'diversion' in the traditional sense. Some of the macro effects of investment diversion in response to faster growth might hold, as might both types of diversion resulting from policy: reduced interest in the rest of the world and efforts to divert protection to the rest of the world. The scale of developing countries' intra-regional trade, however, tends to be smaller so that the policy effects might be correspondingly smaller.

Measuring the effects of the EU

The long existence of the EU, although in principle permitting us to assume that its effects on the rest of the world will be larger and more measurable than those of other areas, also means that the trading patterns of its trading partners and of the world have changed too much to permit analysis of the type discussed in chapter VI to have any meaning, and thus to allow us to estimate the size of the regionalisation effects which may be having an impact on non-members. The most recent studies have been simply of the increase in the degree of integration stemming from the Single European Market of 1992. These can be used to indicate what the direction of effects of a full analysis might be (Page, 1991, summarises some attempts).

The results are highly dependent on what elasticities are assumed for primary and for manufactured goods because there are clear diversion effects for competitive manufactures and increased trade because of growth in imports of primary products and some manufactures. As expected, the more like the EU countries a non-member is, the more it is likely to lose; the more differentiated, the more likely it is to gain. The NICs lose; primary producers, both OPEC and the least developed, gain. If this is reinterpreted in terms of timing, the more developing countries industrialise, the more likely they are to be damaged by industrialised groups which exclude them. The same is even more true of investment effects. It is the investment motivated by growth and demand, notably investment in advanced production, which is the type of investment most likely to be diverted. This affects advanced developing countries more. Investment in primary production is likely to be less sensitive to relative growth in different areas. One change which can already be observed in Mexico, and is at least consistent with expectations of the effect of NAFTA, is a large increase in investment from non-NAFTA countries, notably the EU and Japan, in 1994, much greater than the normal rise or than the rise from the US.

The potential effects on labour are a particular risk for developing countries. As noted above, barriers to migration always mean that labour cannot benefit from the potential gains in terms of return which capital has from investment diversion. As common standards are now being extended to EU immigration controls, and as these, unlike goods or investment, are not subject to any WTO or other international restrictions on either type of regulation or (as under MFN rules) discrimination by country, there is nothing to prevent controls being tightened overall, to ’protect’ labour within the EU or such tightening being discriminatory. The increased regulation at international level of the rules governing all other forms of protection clearly increase the risk of protection in the areas still unregulated. Carson, Puymoyen (1995) have found increased regionalism of migration, but not tested for whether this is the result of discriminatory rules. It is notable that NAFTA, a developing-industrial country region, unlike the EU, which is a purely industrial group, does not include free movement of labour. This makes its benefits even to its developing country members (actual and potential) potentially smaller than those of the EU to its members.

On harmonisation ECLAC 1995 has identified increased requirements on fruits and vegetables as potentially damaging for Latin American producers (p. 27). The variation with distance is confirmed by Korean concerns about the SEM which emphasise trade rather than factors of production (Young and Langhammer 1994). The effects of a possible monetary unification are too uncertain and too recent for their effects to have been analysed.

On the policy diversion side, it is difficult to reach conclusions about the net effect of the EU as a region, particularly if we attempt to judge its history, rather than looking at single episodes like the SEM. There is strong evidence in its failure to participate fully or effectively in the Uruguay Round early stages of an immediate negative effect. Its characteristic trade policy outside the GATT/WTO has been to form alliances with subgroups of countries: the Lomé countries most obviously; the other preference agreements with groups of developing countries; cooperation agreements with a range of regional groups, from the earliest days of the Andean Pact to MERCOSUR. In each case, the immediate effects may have been trade or policy-diverting for other countries, and the cumulative structure offers clear signs of inefficiency, in discouraging joint production for the EU market between members of different schemes and in complicating production for the EU and other markets by exporters attempting to meet two sets of standards, rules of origin, etc. But its preference for dealing with groups may have strengthened the groups, and its internal experience of integration has provided precedents for some of the new issues now appearing in the WTO and in other regions. The countervailing force of the pressures which led to integration within it leading over time also to international liberalisation may be strong. There is also the force of example. This is even more difficult to measure, but may have led to the formation of other groups not only in self-protection or retaliation, but because of the perceived advantages obtained by the EU members. Again, this has operated at the global as well as the regional level.

The question of how far the existence of other regional groups will modify the international economic scene and change the nature of these effects is more difficult. Each group with its own 'acquis' in terms of internal economic structure and standards makes it more difficult for new entrants to join or find other outsiders with which to link. It may make it more difficult for groups to trade with each other, while increasing the incentive to trade within the group. But the arguments for greater benefits from new global negotiations than from regional also increase as the advantages of regional-level integration are achieved, and the potential marginal advantages from integration are reduced. The rather less sophisticated, but compelling argument that regions are 'easier' because negotiators can only deal with a limited number of countries at a time also could lead to a shift to the international level as the number of players there is reduced by a grouping into regions.

Chapter VIII

THE IMPACT OF REGIONALISATION ON DEVELOPMENT

There are three elements to this. The growth of integration has an effect on the total trade opportunities and on the composition of those opportunities for those who are not members. The growth of integration among developing countries has an impact on the members' development. A more regionalised type of international system can have effects on the nature of trade and trade policy, and therefore on development policy.

The effect of integration on development in excluded countries

The last section suggested that integration among industrial countries may improve world growth prospects, through its dynamic effects on the growth of its members, and it has potential advantages in increasing the possibilities of trading with a large region through eliminating barriers within it and establishing common standards there, even if the advantages given to outsiders are less than those to those inside. But it also suggested that it could help producers of the most primary and least competitive products more than the more advanced (depending on the actual elasticities of substitution and income effects). It could, therefore, reduce the incentive to industrialise, if not actively discourage it. The obvious parallel would be with increasing tariff escalation even when absolute tariffs are reduced. The problems of meeting new standards, especially if these are set in accordance with the region's characteristics rather than on a global level, could increase the cost of initial entry into a market, and thus further hurt the early stages of industrialisation and export. The greater the number of sectors or subjects covered and of types of regulation in place (the more mature the region), the greater the potential obstacles. As many of these obstacles are effectively quantum, rather than proportional barriers, they will be proportionately more of a deterrent for small or new exporters, and thus for developing countries, especially at early stages of diversification of markets or products. The history of the successful exporters of the last 15-20 years has been one of diversification of products, then markets: raising the costs of this could either delay or change the pattern of export development, with more concentration on a limited range of industrial country trading partners and perhaps a greater or earlier interest in regional trading partners among other developing countries. If these inherent effects of integration are intensified by deliberate policy shifts to more protection, especially protection against competitive products, rather than for macro-economic reasons against all products, the bias against industrialising countries will be increased.

Although not universal, a relative surplus of labour is characteristic of some developing countries, and has led to patterns either of outward-processing or labour migration. Restrictive or complex provisions on rules of origin deter the first. Even unchanged barriers to the outside with greater freedom of movement within the group deter the second. Increased controls on migration increase this effect.

If the long-term policy effects are in the end towards greater liberalisation at the global level, the short-term effects in the opposite direction may be offset, but global liberalisation achieved directly would clearly impose lower short-term costs. The question of whether regionalisation is a necessary intermediate step towards global liberalisation is, as argued in chapter III, a question of the non-economic limits on expanding the scope of liberalisation.

The effect of integration on development in member countries

The industrial-country, static efficiency-type arguments for the favourable effects of regionalisation are less powerful for developing countries, but the potential structural advantages are great. But some tend to derive from individual projects or opportunities. This argues more for one-off agreements on a joint project than a trade area set up as a permanent link. The problems of finding continuing advantages in joint development without reaching irreconcilable differences over the direction or rate of development, or the allocation of benefits among countries with potentially different objectives, have not been solved by any existing group of developing countries. They appear to require a higher standard of common interests than the conditions for successful integration of industrial countries because the degree of structural change is greater. But there is an additional consideration. The implicit assumption behind the structural arguments for early regional integration is that there are no costs to early specialisation to offset the saving from the costs of shifting out of an inappropriate choice of industry or inefficient diversification. There is also an assumption that the choices made within the regional context will be efficient. These assumptions could be violated by mistaken decisions, either by the market or the governments, or if the region subsequently breaks up, altering the appropriate scale and composition of production. There may also be benefits from moving through a variety of industries and stages of production in offering experience in responding to changing demand and opportunities. The conclusions about whether regions among developing countries benefit development, even more than among industrial, are highly sensitive to the probability of permanence.

The effect of a regionalised system on development policy

Introducing a new layer of policy formation will increase the importance of policy negotiation relative to markets, for both the members and the trading partners of regions. If the regionalisation of industrial countries sparks regionalisation among developing countries in response, two new layers appear, requiring economic agents in a developing country to take production and trade decisions in the context of the policies of their own government, their region, the partner country, the partner country’s region, and WTO or global policy. There are costs for each level, of information, of compliance, and of the risk of change. There may be benefits if the regional policies are more favourable than the corresponding national or international one would be. There may be additional costs from uncertainty if the continued existence of some of the regions is itself in doubt. In the context of objectives of simplifying and removing restrictions, regions are certainly less favourable than international liberalisation. This follows directly from the similar conclusion on the economic conditions for regions (chapter III) that any economic arguments for a region would apply more strongly at global level, but it reinforces that reasoning: there is the additional cost that an incentive is created to look for policy-created advantages rather than market or efficiency ones. These may have beneficial effects on the immediate income of a developing country and its producers, but are less likely to have long-term development advantages.

Chapter IX

REGIONS IN THE CONTEXT OF MULTILATERAL BARGAINING

The conclusions that emerge from the analysis in this paper confirm the theoretical difficulties of finding any answer to the bargaining issues noted by Krugman, but borrowing his title of 'analytical notes', it is possible to suggest the directions of some of the effects found, and thus the potential risks and benefits to the system from the type of regions which exist and are emerging.

One of the difficulties identified by some observers in the Uruguay Round was the large (and growing) number of participants. Bargaining theory and the arguments discussed in previous chapters, and the experience of earlier and shorter Rounds suggest that a smaller number would produce a more manageable negotiating process, although economic arguments against oligopolies suggest that while the process might be more 'manageable', it might also produce a poorer outcome on welfare. If there is a choice here, it is important to keep both points of view in mind as the objective of the international system is not to produce an 'orderly' procedure but an outcome which maximises welfare.

From the point of view of the international organisations and system, regional complexity is a delay or an obstacle. But from the point of view of the group members (perhaps particularly of the smaller members) who may have formed the group to increase their bargaining power, the obstruction may be desirable. To be most efficient from both points of view, the scope of the negotiating capacity of the regional representative needs to be carefully specified, as do the negotiating procedures. But this requires the institutional maturity which some discussions of limited or open regionalism consider undesirable. The more amorphous a trading region, the more open it may be to trade, but the more difficult it is to negotiate with.

In practice, however, the type of regionalisation observed so far has not reduced the number of participants (the participation of the EU has in fact increased it by one). Regions have offered some saving on non-controversial issues in bargaining difficulty and time. They can reach agreement within themselves and then operate together. On some issues the EU did this, and there is anecdotal evidence of some priority setting within NAFTA in the late stages of the Uruguay Round. Outside the WTO, the preference of the EU and the US for negotiating with groups seems to confirm that regions give some economies of negotiation. In practice, however, regions (and federal countries, the potential next step from a region) continue to need to take account of differing interests, and the introduction of an additional layer increases the number of special interests which need reconciliation and of formal legislative commitments which need to be made consistent with any external commitment at global level. Several additional layers, in the case of regions with partial regions below them: the complicated structure of APEC and the Asian sub-regions, potentially a Western Hemispheric zone, the subregions like MERCOSUR, and perhaps linkages among these or inner groups within them, increase the complication. A clear example is offered by the offers on services in the WTO, where both the US and the EU texts include lists of the state or member-country special rules. Only in areas (like tariffs for these areas) where full harmonisation has been achieved is there a reduction in complexity.

If there are a variety of 'regions' each with different divisions of negotiating power between the centre and the members, the complexity of international negotiations is further increased. For each region, there is a conflict here between choosing the system which seems most appropriate for the region internally, and choosing one which is consistent with other regions and therefore which may do least damage to the international system. Alternatively, the complexity may have the effect for both governments and economic agents of increasing the attractiveness of a simple one-layer international system.

One argument for regionalisation in the late 1980s was as a substitute for the risk of a weakened international system. In the context, the risk of regionalisation itself weakening the system through introducing complications and obstacles was not seen as a problem. With the Uruguay Round settled, and the WTO established, however, risks to the WTO become an important concern, particularly for the countries which benefit most from order and rules, which are especially the small, economically or politically weak. In practice, the existence of regions among industrial countries is likely to produce the damaging effects identified here of regionalisation, regardless of whether developing move towards their own integration, so that the marginal cost to internationalism of regionalisation among developing countries may be small.

A spread of regionalisation would probably mean that at any time some countries would be changing their regional systems and therefore potentially wanting to change their external obligations, or alternatively temporarily 'diverted' from such interest (as the EC was during the early stages of the Uruguay Round and NAFTA at the end). Unless this process could be coordinated (an international analogue of setting a wage-negotiating season?), it is likely to make the Round system increasingly difficult as there would always be some regions 'diverted' at any time.

There is one possible outcome of greater regionalisation which has not been discussed, but which already appears to be emerging. In the face of the complexity of different regional obligations, there are pressures to reduce other sources of complexity and special trading arrangements, in particular those with developing countries. An alternative way of viewing this is that, on the simplistic model that policy-makers can only deal with a small number of divisions, regionalisation is a substitute for the pre-1989 division of the world into North, South and East,. With the East gone, the 'South' does not fit into the new continental model. A reduction in developing country preferences happens automatically, as indicated earlier, from the reduction in intra-region tariffs. A growth in geographical regionalisation could lead to a review of non-geographical preference schemes (the ACP scheme of the EU is an obvious candidate) to 'rationalise' the treatment of the countries by rearranging their treatment also into regions. The requirements of reciprocity or permission to negotiate with other schemes also suggest that there will be difficulties in maintaining special preference regimes alongside regional groups. New regional groups with developing and industrial country members pose new difficulties for preference regimes between their industrial country members and non-member developing countries or between developing members and other industrial countries. The Caribbean countries' concern about NAFTA is a notable example, but the expansion of EU membership to the southern members and its agreements with the eastern European countries have affected the ACP and the Mediterranean. It should be emphasised that this needs to be treated as a bargaining question rather than one for calculating the apparent loss or compression of preferences as there are precedents for 'messy preferences' and 'messy regions' where preference donors and recipients have had a joint interest in them. But it does provide an additional reason for expecting the effects of regionalisation to be, on balance, negative for developing countries, as well as an example of the impulse of regionalisation towards a more policy-led bargaining, rather than market-based, trading regime.

These arguments have looked at the economic and bargaining implications of regions for the international organisations. There are also strictly legal ones. The WTO and EBRD have admitted the EU as a member, but have not otherwise altered their procedures to take account of the fact that it is not a country in the same sense as their other members. Formally the position is that the EU takes on international obligations on the matters on which its members give it competence, and they are responsible for obligations in the other issues, and that it is for them to declare which is which. In contrast, other countries are responsible directly for all their obligations even when within the country the central or federal government may not have legal responsibility. Other groups are semi-recognised for some purposes in some organisations, for example the

International Textile and Clothing Bureau and 'developing countries' as self-defined units in the WTO. An increased number of groups with different divisions of responsibilities would put a strain on these *ad hoc* arrangements and reduce the benefits of transparency of rules which are the major objective of the international system. But where there are groups with changing divisions and changing members, the problems of adapting formally to include them become insuperable. Other organisations which have tried to group countries (the joint executive director system in the international financial institutions for example) have needed to change the groups to take account of changed interests, but normally at fairly long intervals: the emergence of OPEC as a group in 1974, the acceptability of South Africa as part of Africa in 1994. If regions take on new responsibilities or if the WTO moved to a similar system, there would be clear problems in defining usable permanent groups.

The MFN rules and the permitted derogation from them which is provided for in Article XXIV depend on clear definitions of nation and region. The preference derogation for developing countries produced some problems here (the controversy over whether Lomé should be treated as a preference area or a region, for example), but the attempt in the new Understanding on Article XXIV to set uniform rules for regions and their integration could run into conflicts, over the length of transition, the definitions of 'substantially all trade' as the definition of 'trade' and 'trade related' expands. Concepts like the Asian 'open regionalism' and partial reciprocity are difficult to reconcile with any rules. These questions have been postponed for services by permitting initial derogations from MFN there, but this only permits existing discrimination, not future groups. All these difficulties are most likely to affect developing countries, if the arguments presented here for their regions to be more likely to be changing and 'messy' and their economies more likely to have structural changes, leading to changes in trade, prove correct.

Chapter X

CONCLUSIONS

The regionalisation which is observed is complex, and there are strong reasons to believe that it will remain so, with the risks of both complexity and change greatest for developing countries. Both the arguments for how regions are formed, and evolve, and experience suggest that regional trading groups either move towards more integration (culminating, at least in the past, in what are now federal countries) or prove to be unstable temporary alliances of countries whose common interests weaken as they diverge economically or in policy approach (the experience of past developing country groups). The experience at international level confirms this. There is a strong case for saying that the most successful group of the last decade is the new WTO. It has expanded its membership, the coverage of its rules, and its powers. The extension of its responsibilities means that in practice it embraces many of the areas that the EU's adoption of the SEM-1992 programme and the formation of NAFTA were intended to integrate: services and national treatment for foreign investment in that sector, intellectual property, dispute resolution; potentially environment, labour and business regulation. Its rules on services have neglected migration up to now, but the framework is there. This suggests that the argument that regions are needed to make faster progress on issues than the international system can manage has a very limited validity (two years for the EU between January 1993 and January 1995; one year for NAFTA). It also suggests that risks that regions may move to non-regulated issues may also prove temporary.

If we look at what actually exists, the evidence casts considerable doubt on the view that the world is being divided or will divide into regions based conveniently on the continents. There is one industrial country region which is becoming increasingly integrated, and has already reached a stage which is nearer to the competencies usually found in a country than in a trading area. There are one or two other regions (MERCOSUR and NAFTA) which are at present formal regions with clear integration programmes being followed, and the potential to develop into new areas. There are some areas (in northern South America, the Caribbean, South East Asia) where there are some moves, some results, and many of the apparent conditions for regions. There are other areas where there is discussion, but where it is difficult to see the political and social conditions as easier to meet than those for global integration, and therefore difficult to see any argument (except perhaps that of limited bargaining ability) for regions as a necessary step before global integration. There are also a variety of groups for special purposes, including some of those in Africa, where there are joint interests and there will be practical benefits from joint efforts, but not the continuing identity and progress over a range of issues which regionalisation implies.

If this is a correct description, it is not clear whether 'regions' are now so prevalent that non-members need to form regions of their own to fit into a new economic regime. The omitted countries include some of the largest countries in the world and most of the largest continent, and substantial numbers in other areas. The arguments and evidence suggest that developing countries are likely to produce unstable regions. With one of the suggested advantages of a region being a stable trading environment, the advantage of greater regional integration over the greater certainty of the present WTO structure is limited. The large number and the importance of the non-joiners also suggests that any regions which do form will face the likelihood of challenge under the new WTO Article XXIV and dispute procedures if they seem likely to have any adverse effect on the rest of the world. Thus there are more serious obstacles to any special arrangements than earlier groups faced. This may make the early stages of a region more costly. The lowering of trade barriers and the inclusion of many new areas in the WTO make it harder to find special roles for regions. Existing ones may continue to advance slightly faster, as their greater integration leads to identification of new needs for regulation earlier than in other countries; new regional organisations, however, unless formed in response to a special problem, are likely to struggle to keep up, unless there is serious 'policy diversion' on the part of the existing regions. The placing of environment, labour standards, and business regulation on the WTO agenda, and the continuing negotiations on areas like financial services, support this lack of an obvious role for regions.

But the regions which exist and those which may form offer a challenge for the international organisations. Both they and the regions will need to accept that there is a conflict between fully flexible systems and global transparency. The advantages for economic agents of transparency and certainty may be greater relative to policy flexibility than they seem to policy-makers (and some academic writers). The nature of the potential conflicts and complementarities between negotiations among regional members and by regions in a global institution is likely to provide an impulse for continuing, rather than Round-style, international negotiations.

For developing countries, the shift to looking at the international system in terms of regions and non-members and the different levels of integration among countries, rather than defining it as industrial countries and developing countries, confirms the ending of a special position for them as a group. But they are a group, and they include various sub-groups, with common interests, over wide or narrow bands of economic issues. An international system which is more adapted to deal with such groups, some of which may be based in geographic regions, others defined by income, type of economic structure, or other characteristic, may offer equal advantages. Developing country *ad hoc* groups will have the disadvantage of being fluctuating alliances, without the negotiating power given by a mature regional group, but the corresponding advantage of not needing to seek group agreement over all issues on a permanent basis. It is unrealistic to require a simple structure or even a tidy or logical one for an international institution which needs to deal with such units. To do so would be to put 'managing' ahead of development or welfare as an objective and would also be different from the 'messy' solutions invariably found at national level (and in the longest surviving region). But it is not wrong to seek to make any solution as simple as possible, for the sake of those not involved in any negotiation: for countries excluded from a region, in the case of the regions which do exist; for participants which are excluded because they are economic agents, not countries, in the case of all institutions.

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