

# Economic Regionalism: The Key to Global Stability?

By Eric Berger

Now that we have reached the post Cold War era of the Twentieth Century, an important question that must be asked is how the United States and other nations will continue to deal with the prospects of what many call a multipolar world. To answer that question, it is now becoming more pertinent for theorists to concentrate on domestic concerns and to develop strategies that will enhance global and national economic stability.

In fact, political economists support various different trade policy methods including the more popular strategies of protectionism (that may or may not involve coercive reciprocity) and systems of free trade. Evidence suggests, however, that trading nations are currently taking on a more moderate and pragmatic system of economic regionalism, or "loose regional economic blocs" as Robert Gilpin calls them, that will help minimize international anarchy and the potential for war and more importantly, move nations away from closure in order to engage in a greater system of interdependence and free trade among those nations involved.

This phenomenon is already happening with the formation of the North-American Free Trade Agreement (NAFTA), the European Union (EU) and the Asian-Pacific Economic Cooperation forum (APEC). Different states in their geographical areas have entered into separate discriminatory trading groups that share amongst themselves, common policies that include lowered import/export restrictions in the form of tariff and non-tariff barriers, while third party nations are left out and forced to bargain amongst themselves.

These agreements differ from protectionist systems because protectionist

countries generally employ certain high level nondiscriminatory tariff rates that apply to all other nations. Protectionism can also involve certain bilateral agreements as well. Obviously, free trade is what it implies— free trade among all nations. However, there are cases where there are free trade agreements as with GATT, the General Agreements on Tariff and Trade (now known as the World Trade Organization), where a group of nations come together to discuss certain issues concerning trade policy. However, the key point with these agree-

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ments is near categorical nondiscrimination, wherein any nation can participate in the accords if it chooses to.

An important question that needs to be answered at this point is: Why are these states choosing to enter into regional blocs as opposed to other strategies? A first explanation is provided by Robert Gilpin in his article, "Emergent International Economic Order," (Gilpin, 1987) in which he approaches the possibility of a free trade system and comes to the conclusion that a present global liberal economic international order today would be impossible because of changing domestic interests and national resistance against economic adjustment to other more distant countries (p. 395). The on and off Japanese and American trade war is a case-in-point. So, as a result, nations are turning to systems of loose regional economic blocks that will naturally form in order to create a greater sense of economic stability

amongst the involved nations.

This second impetus (natural trade with neighbors) to form blocs seems to apply especially to those "smaller" states in Europe and Asia that have substantially smaller Gross Domestic Products in comparison to larger countries, and it would be in their best interest to include themselves in a mutually binding agreement with larger powers from whom they could benefit. The process may include establishing zones of free trade, abolishing import/export barriers, and possibly, in a future case in the European Union, creation of common currencies, as well as other aspects that are generally associated with interdependent systems.

Thirdly, some see the formation of NAFTA to be particularly important to the United States because its hegemonic economic power is declining (Kennedy, 1987:XX and others). Hegemonic Stability Theory states that a hegemon is necessary in order for a free trading system to exist and that when a hegemon's economic power declines, it reverts to a system of greater protectionism and the nations supported by it will follow (Milner, 1988:12). A prominent example of this principle is Great Britain as hegemon in the middle to late Nineteenth Century. Open markets were maintained with a laissez-faire philosophy and its economy grew to a dominant level while benefiting other nations as well (Kennedy, 151-153).

Nevertheless, this explanation is not completely convincing for two reasons. One, cooperation does not necessarily require the existence of a dictating hegemonic leader. Robert Keohane (1984) points out that British power may not have played as great a role as the theory predicts because it did not enforce its economic rules that strongly (p. 256, 258). Two, one cannot definitively say that the United States has lost its hegemonic standing. Although, it is true that China and Japan have faster growing GDP's relative to that of the United States, America's still remains the largest.

Furthermore, the United States is not experiencing a decline similar to Great Britain's because it is not as dependent on external trade as Britain was, and Britain never used its power of reciprocity to its advantage (Keohane, p. 259). Therefore, the explanation for United States involving itself in regionalism, is not due to its waning dominance, but because of the simple reason that it is advantageous (for the United States and others) to promote free activity, particu-

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larly with bordering nations. Exportation and importation are both faster and easier, while at the same time neighboring states can share in indigenous natural resources.

Positive effects would be less significant, however, if countries chose to follow protectionist approaches. It has been considered traditionally advantageous to have open markets in order to encourage as much foreign importation as possible. For example, the United States in 1930 because of the record high protectionist Smoot-Hawley tariff, largely became closed to external trade. Duties on imports were raised from 1922's rate of 13.9 to 19.0, and the level of duty on dutiable imports jumped from 38.2 in 1922 to 55.3 in 1930 (Lake, 1988:194). This caused other countries to stop buying American goods, which in turn further hurt the economy as the United States sank lower into the depression amid severe stagflation.

So, one can see that a policy which allows for a greater system of free trade is more beneficial, or at least deleterious, than a protectionist regime to a nation's economies.

But what are other reasons as to why nations enter into such commitments that involve regional discrimination? One obvious motive could be to create a sense of collective security. These economic communities may not necessarily be political or military entities, but a certain sense of protection would surely be felt. This is most certainly true of Europe during the Cold War. A large incentive to create an European Economic Community (along with NATO), which initially involved preferential trading agreements that lowered trade barriers among the parties and created "security externalities" (Mansfield, 1994:123), was due to the fears of rising Soviet military and economic strength and the country's expansion into Central Europe.

Additionally, another purpose for creating these blocs, might be due to a new, more amicable ideology that has nothing to do with collective security. Nations may simply believe that economic interdependence is the best solution but complete world interdependence might never be possible, especially since GATT seems unlikely to include everyone. Regional trading blocs are certainly feasible and natural means of maintaining at least some sort of free trade and world unity.

There is also an issue of pride.

Regional trading blocs are inherently discriminatory and therefore exclude third parties. This exclusion along with the legitimate fear of losing markets, gives these nations the incentive to bargain and form their own blocs. As a result, what happens is a developing situation where there is a system of group exclusivity that is more closed than the ideal multilateral trading system, but is certainly more open than protectionist systems.

Although there exist many historical models of free trade and protectionist systems, regionalism seems to be a comparatively recent phenomenon, at least in the form it is taking place today. Granted, there were early

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periods in history where there was regional trade, but these systems did not have formal agreements and were more likely due to the fact that these situations arose during a time that predated the importance of the concept of a global economy.

This view applies to Eighteenth Century Great Britain. Great Britain was a hegemon that promoted a system of free trade, but this system, however "Eurocentric," did not completely exclude non-regional states. The country was the financial center of the world, controlling raw materials, acting as the world's trading leader, and opening up its markets to foreign trade (Kennedy, 1987:151). Furthermore, as a predictor, it suggests that the system will not last forever, since British hegemony did decline due to some sort of overexpansion. However, British decline and the hegemonic stability theory might not necessarily apply to today's blocs if one subscribes to Keohane's aforementioned theory; as a result, the United States is justified in entering into NAFTA despite the fact that it is not necessarily declining (as Britain did), because it is not required to promote global free trade.

This period in history can be considered as a form of regionalism, but there is one other historical precedent that is likely the prototype for today's developing global economy: regional European trade during the 1930's. Economic discrimination in the 1930's seems to have indeed led to regional trading arrangements, actually moving trading nations away from protective closure.

This spiral effect seems to have its origins in the Great Depression. During this time, United States domestic policy was such that Congress passed the Smoot-Hawley Tariff in 1930, as mentioned previously. This tariff was a nondiscriminatory tariff that raised the rates of all American imports. It included a 50% surcharge on all normal duties and little flexibility; there were no preferences for those countries that granted preferences to American goods (Oye, 1992:80). This protection and loss of American markets created a huge gap in trade for European countries. As a result, European nations entered into bilateral and regional bargaining agreements in order to regain lost markets. Major players were Great Britain, France, who practiced quota policy, Germany, and the Scandinavian nations (pps. 81-85). These countries scrambled for whatever markets they could get by implementing discriminatory trade policies in exclusive agreements, and what resulted was regional liberalization and the opening of trade.

Eventually, American policy changed because the country saw that the European nations had moved well ahead in exports. America began to look for trading partners in Europe as well but found little. The US then realized that it should fight for the Latin-American markets, a natural move towards regional trade (Oye, 1992:98). The Reciprocal Trade Agreements Act (RTAA) was finally passed in 1934 (Lake, 1988:207), which further liberalized trade by lowering tariffs from 53% in 1933 to eventually 37% in 1941 (Oye, 1992:101). As a result, what occurred was a move towards economic openness that had been triggered by an initial loss of markets. Nations of Europe actually turned to regional trading blocs to obtain trading partners out of pressures from other forming blocs and out of the fear of lost competitiveness.

This framework seems to have continued into the late 1930's, except that its reasons were amplified due to the security dilemma (i.e. the growing fear of Nazi expansion). Similarly, the Cold War

sparked the original European Economic Community. This system, funded by the United States, created policy that helped bolster the countries of Europe that were hurt economically from the war, while leaving out many other nations that were not victors. The original General Agreement on Tariffs and Trade was further designed to maintain European unity mostly out of the fear of the Domino effect, for Eastern Europe had already been absorbed by the Soviet Union. This organization, in a way was actually an economic parallel to the North Atlantic Treaty Organization (NATO), which soon gave motivation for the Warsaw Pact (Gowa, 1994:3). They were economic and political /military alliances designed to maintain security and to minimize the threat of the Soviets.

So, it is clear that the period before the Second World War and the Cold War both saw iterations of trade regionalism, each for different reasons. Furthermore, these examples provide the precedence for much of the current political-economic conditions. As mentioned earlier, NAFTA, EU, and APEC all seem to be regional trading blocs in the spirit of the pre and post World War II eras. In fact, much of the current regionalism began in the 1980's.

Again, it seems that United States protectionist bent caused this wave of occurrences. In 1987, nations of Europe formed the European Community (EC) which agreed to become a single integrated market by 1992. This would involve the free flow of goods, services, labor, capital within and discriminate to third parties. The reason, for this discriminatory liberalization seems to be due to the United States' passages of bilateral agreements with Canada and Japan, and growing Japan and "East Asian Dragons" (Oye, 1992:165). European nations desired to increase their markets as a result of discriminatory practices of the United States and others. This then sparked United States movement towards agreement with Mexico (in addition to Canada) to sign NAFTA in August 1992.

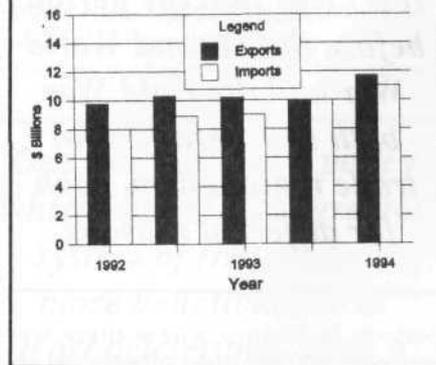
As a result, what we have now is a number of regional trading blocs that are discriminatory, yet because of bargaining agreements, are liberalized trade sectors that came about as a result of opportunistic discriminatory agreements (and other causes such as the tendency to trade with neighbors). Moreover, it further seems to be the one system, as opposed to nondiscriminatory protection

or unlikely global free trade, that can pragmatically lead towards a greater liberal political international order. The proof is in the fact that these blocs have been rather beneficial in opening up the economies of the involved countries and creating the need for third parties to do the same.

For example, the United States' signing of a free trade pact with Mexico and

## The Trade Balance

United States exports to and imports from Mexico, semi-annual and seasonally adjusted, 1992-1994



Canada has so far been beneficial. As of the United States' first quarter measurements of 1994, the United States and Mexico had both, because of lowered tariff barriers to trade of goods/services and investment (Mexico's went from 15% to 12%), experienced increases in exports and imports. United States' exports to Mexico rose 15.7% to a record \$11.85 billion, while Mexico's exports to the US rose 22.5% to a record \$11.29 billion (seasonally adjusted, Myerson, NY Times, June 6, 1994:A1:6). The chart to the right shows export/import rates by quarter since 1992.

Decreases in the unemployment rate (having reached a natural rate at its lowest level in years) have also been noted, which partly indicate that the United States and Mexico now have accelerated GDP growth with a larger rate of domestic consumption. Canada has also been benefiting from lowered trade barriers as seen through a rise in its trade surplus with the United States to \$1.7 billion (American) as of its first quarter data (NY Times, June 22, 1994, D19:2).

In Europe, trade rates are stabilizing and there have been plans to bring a common currency. This too would bring the states closer, improve economic stability, and create self-sufficiency within the blocks. Furthermore, the passage of APEC agreements should prove to reduce barriers to trade and provide for more openness. The long term trend will be difficult to determine; nevertheless, the economic situation is optimistic when comparing this year's numbers with last year's (Myerson, A1:6).

**N**ow it is important to consider certain competing strategies and/or explanations which will lead into a discussion of the consequences and predictions of the current system.

A first question frequently considered when dealing with this economic model is the question as to whether protectionism and/or free trade are better economic systems. The problem with answering this question is that it really is a matter of policy-makers' opinions. At any rate, regionalism is actually a compromise between the two policies that combines protective discriminatory sectors with free trade within those sectors.

Another question involves Third World Countries and/or countries excluded from trade blocs. What will happen to them? Will they try to form their own alliances or will they continue to be peripheral nations experiencing little or no economic growth? APEC has been created, and although its unity is based on a looser agreement between states, it does seem that it will include small Newly Industrialized Countries that can hopefully use this bloc to build their economies. Nonetheless the question over third world countries still remains.

This concept leads to a fourth inquiry that may be raised concerning the possibility of regional blocs which concerns the issue of validity. Can and will this economic strategy actually be a positive force that can bring nations together or will it just cause regional tensions accompanied by sanctions, mercantilist bickering and vindictive trade barriers leading to further problems relating to the security dilemma, like the occurrence of a trade war or worse? A major armed conflict does not seem very likely (even though one cannot preclude their plausibility; however, trade wars are possible).

For example, Japan and the United States have been at loggerheads over the US's trade deficit because of Japan's high-

ly protectionist tariff rates. But it is proven that United States' reciprocal policy did force Japan into bilateral agreements in the mid-1980's (Oye 1992:164). Therefore, there is a possibility that regionalism will prove to be an impetus for others to form their own blocs and consequently, become more liberal. So far, data suggests that trade within the blocs is positive, (although one can never be sure because economic analysis is always murky as to where credit is attributed. Improved economic growth, for instance, could be due to post-recession upswings in the natural economic cycle—one can never tell. In fact, the recent crisis in Mexico can be attributed to its tremendous trade inflows and inflation since the implementation of NAFTA, but this too is difficult to prove directly because there are always natural economic declines and there is no reason to believe that this devaluation and disincentive to trade and investment in Mexico will last forever.

A final question that comes up rather often when dealing with the topic of regionalism is the economic effect these blocs will have on the GATT. This issue is difficult knowing that results are not completely conclusive to begin with and are made even more ambiguous with all of the different tariff levels put forth through the different rounds of agreements. Clearly, the purpose of GATT is to create an interdependent free trading system for all nations involved, with no discriminatory or preferential pacts to diminish its effect. If this is true, then would not preferential agreements like NAFTA and APEC undermine the very spirit and effects of GATT ?

Article XXIV, written during the Second World War permits the formation of free trade areas and customs unions that have common external tariffs (Bhagwati, 1992:58). It could not predict that forty years later the European Community and NAFTA would apply to this article. Moreover, Article XXIV's logic does seem to be pragmatic in the sense that, one: these preferential agreements provide an alternate route to free trade which involved nations might not have sought unless GATT permitted them, and two: these agreements do extend GATT style policy to GATT neglected areas such as services (78).

So, these sectoral agreements within the confines of GATT do seem to serve a purpose without completely undermining the international accord. Furthermore, these blocs, especially

NAFTA and most certainly APEC, have not been around long enough to have had a strong negative impact on GATT trade. They may be stealing the thunder that GATT has created, but as Bhagwati points out, "not all action need be at the GATT" (Bhagwati, 1992:78). In addition, they are systems that are moving towards greater free trade because they have reduced barriers among them. This is certainly better than protectionism and seems to be moving towards more of

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a global system.

In considering the conditions under which the blocs are taking place, therefore, it does seem as if they will be successful for those involved. The nations that are part of them are seemingly willing to agree to their terms (to a reasonable extent; Germany recently helped block the first attempt at achieving a common currency in EU). Nevertheless, one can never tell what the future holds. What we do know is that there are many reasons why regionalism is the preferred strategy and the prior iterations of regionalism do provide a good model for today's system. Yet it is impossible to see what long range effects will be. There may be peace; there may also be inter-block relations that could degenerate into a trade war or worse. Right now, however, from a first glance, this economic system of regional trading blocs does seem to be successful. Blocs are forming and trade among them has improved. This system may not preclude the possibility of a future security dilemma, but it does seem to be providing a greater openness, and a more pragmatic and economically secure alternative to global strategies such as protection and deterrence. BI

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#### HELVIDIUS

Real macroeconomic output can be decomposed into a trend and a cyclical part, where the variance of the cyclical series derived from the filtering technique (e.g., the band-pass filter, or the most commonly used Hodrick–Prescott filter) serves as the primary measure of departure from economic stability. A simple method of decomposition involves regressing real output on the variable  $t$ , or on a polynomial in the time variable, and labeling the predicted levels of output as the trend and the Key papers Regional economic integration in a global framework by Tommaso Padoa-Schioppa . . . 27. Market-driven regional integration in East Asia by Eisuke Sakakibara and Sharon Yamakawa . . .  $\hat{\Delta}$  integration? and do regional initiatives assist or undermine global integration? Such issues were debated by the representatives of the group of 20 advanced and emerging market economies that comprise the G-20. The key points are collected in the first chapter of this volume. Key words: Eurasian Economic Union (EEU); economic effectiveness; integration; intra-regional trade; investment cooperation; common industrial policy; common agricultural policy. Introduction.  $\hat{\Delta}$  The EEU is a global leader: it is the world’s largest producer of crude oil; second largest in natural gas production, fertilizer manufacturing and iron making; third largest in potato, wheat and milk production; fourth largest in electricity generation and meat production; fifth largest in grain and pulse crops and steelmaking; and sixth largest in coal mining.  $\hat{\Delta}$  International experience suggests that the stability of an integration grouping is directly related to its ability to create economic benefits for its members.