

REGIONAL TRADING BLOCKS AND LIBERALIZATION

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The establishment of the European Common Market in 1992 and the North American Free Trade Agreement and MERCOSUR in the early 1990s marks the beginning of this new system of regional trading organizations and raises questions about the future of the world economy. While economic mercantilists argue that regional blocs represent the first steps in the world's inevitable movement towards protectionism, economic liberals counter that regional initiatives are rather the building blocks of a global free-trade economy.

In reality, today's regional blocs reflect a fundamental liberal motivation within the blocs, and will eventually fuel even greater liberalism both inside and outside of these organizations. However, the larger trend towards a free-trade economy is contingent upon several factors, most importantly domestic politics within regions. Overall, the *à long term* tending towards free trade that was instituted by the General Agreement of Tariffs and Trade will not be compromised by the trend towards regionalization triggered by the ending of the Cold War, but rather strengthened by regional blocs. However, domestic political issues and international trade policies will play a major role in determining the speed and effectiveness of liberalization.

The development of regional trading blocs in Europe and the Americas represents a step beyond mere intra-regional association—the development of what some predict will become aggregate states. Yet the motivation behind the creation of such blocs is not mercantilist or protectionist, and thus regions will never become *de jure* states. Rather, regional initiatives are propelled by the fundamental desire to relax and eventually eliminate external trade barriers. The basic Ricardian model of gains from trade through the pursuit of comparative advantage dictates that free trade is the optimal policy for all countries. Post-Ricardian economics has identified three more compelling sources of gains from free trade: reduced per unit production costs resulting from increased efficiency, reduced consumer costs resulting from de-monopolization and increased competition, and consumer gains from product variety.

The gains from free trade, coupled with the costs of protectionism, which comprise reduced consumption and therefore unemployment, are the underlying incentives of regional trading organizations. Since regional arrangements foster free trade within an area of the world economy, they will stimulate growth and therefore a greater demand for the removal of extra-regional trade barriers. The increased income resulting from gains from trade leads to increased investment, first within the region and

gradually extending to extra-regional ventures. In Europe, this phenomenon is manifesting itself in the "investing and merging" behavior of European firms in striking contrast to their sluggish investment in the late 1970s and early 1980s.

Another clear indication that regional trading blocs will not become increasingly protectionist with respect to extra-regional trade lies in the fact that current trade patterns suggest that extra-bloc trade is vital for each of the current or prospective regional arrangements. North America and Europe or in particular, have traditionally high ratios of total extra-regional trade to GNP, and will not abandon these in favor of complete intra-regional trade.

Even in situations of economic hardship, then, regional blocs are not necessarily likely to turn inwards and construct external trade barriers, for protection rarely succeeds in stopping declining employment. The evidence for the ineffectiveness of protection is well documented in the European Community and the U.S. and it is evident that in the long term, employment in one sector can only be saved through protectionism at the expense of other sectors of the economy. Thus members of regional blocs, acting as unified, future-looking, rational actors, will find it in their best interest to move towards extra-bloc liberalization.

In addition, the growth of regional blocs will contribute to the liberalization of nations excluded from such trading organizations. The most obvious example of this phenomenon can be seen in the growth of MERCOSUR, the Latin American trading organization composed of Brazil, Argentina, Paraguay, and Uruguay. The formation of this South American trading bloc was most clearly a reaction to the formation and growth of NAFTA, the North American Free Trade Agreement among Mexico, Canada, and the United States. The members of MERCOSUR realized that collective negotiation with countries such as the United States would be facilitated by common external rates, and since liberalism has been proven to be the most effective trade policy, these external rates will eventually tend to be lower than they were in the individual states.

Thus, it seems to follow that the current growth of regional trading initiatives represents merely the first step in the necessarily gradual process of integrated world economic liberalization. As Robert Lawrence explains, regional organizations "represent the building blocks of an integrated world economy" which will gradually come together to form a structure of free trade on a global level. Yet, such an outcome is contingent on and complicated by issues which have the potential to greatly hinder and even halt progress towards global liberalization. Those who argue that economic factors are subordinate to political motives in the incentive for regionalization fail in ignoring the benefits from external trade to both bloc members and non-members, but succeed in raising pertinent questions regarding domestic politics. The reasons or explanations for political regionalization include interstate bargaining or coercion, linkage politics or

trade-offs of benefits, and finally, domestic distributional issues or the role of interest groups.

Of the three political factors, the latter sector of public choice economics seems to pose the biggest threat to the liberalization of external trade barriers. While, for example, a 1985 study by the Organization for Economic Cooperation and Development "stresses the fact that a reduction in imports via trade restrictions does not cause greater employment" and other evidence points to long-term negative effects of protectionism, many states continue to construct external trade barriers. The reason for this lies in the nature of the economics behind the evidence. While protectionism increases employment in certain industries, it results in a decrease in exports and therefore reduces employment in other industries. The net effect tends to be zero or negative, but "this economic reality may not be obvious to businessmen, labor union leaders, politicians and others." Therefore, bargaining by interest groups, namely specific corporations and unions, within regional trading blocs, may lead to the implementation of protectionist measures.

The problem with the strictly liberal approach to regional trading blocs, therefore, is that it views these blocs as rational, unified actors. According to the rational actor model, regional blocs would act that liberalization was obviously in their best economic interests as a whole, and accordingly remove existing trade barriers. However, it is evident that internal pulling and hauling and bargaining between interest groups precludes the rational, unified actor approach and results in trading conditions which may contradict basic economics. A clear manifestation of this phenomenon exists in the example of European non-tariff barriers on hormone-infused American beef and European agricultural subsidies. Farmers and those employed in the agricultural sector of the European economy see only their own immediate short term interests, and their political power allows them to see the protectionist policies which they desire implemented, at the cost of the larger European economy.

Martin Feldstein argues, along these lines, that domestic conditions will effectively prevent growth within the European Monetary Union. He contends that "once the disciplining example of the [German] Bundesbank is eliminated and monetary policy is made by an ECB in which all member countries vote equally, there is a strong risk that the prevailing sentiment will be for higher inflation" and to prevent higher unemployment. Thus, region-wide labor laws and transfer payments, in preventing members of the EU from competing with each other, will collectively make them less able to compete with the rest of the world. As a result, pressure for increased extra-European barriers would increase, resulting in the implementation of protectionist measures. In other words, he views an economically but not fully politically unified Europe as being more susceptible to domestic distributional issues, in particular the protectionist demands of workers and employers in sectors such as agriculture. Adherence to traditional European

welfare state policies will ultimately place the EU in danger of acting against its best long term economic interests. This factor must be considered as a potential obstacle on the course to world free trade, for domestic political issues obscure the benefits of extra-regional liberalism to regions as whole, unified actors.

Therefore, regionalism is indeed a force for the liberalization of the world economy, but is potentially impaired in this capacity by the state of domestic politics. If domestic politics and interest groups evolve with the state of the world economy and manage to look beyond short term, industry-specific gains from protectionism, liberalization will indeed occur. The gains from free trade and costs of protectionism fundamentally motivate states inside and outside of regional blocs to move towards liberal policies, but progress towards these policies may be hindered by internal interest groups. Thus, regionalization must be coupled with the stricter enforcement of anti-protectionist international trade law through the World Trade Organization if free trade is ultimately to occur. International regulations limiting not just tariffs and quotas, but also regulatory trade barriers and internal subsidies, must be enforced in order for regions to see the benefits of acting as unified blocs in a free world economy. If regionalism succeeds in overcoming its potential barriers, trading blocs may eventually come together to build an integrated, open world economy in which states can reap the full benefits of free trade. ®