

Intricate Trade-Off Behind Regionalism*

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In the 1990s, a second wave¹ of regional trade agreements (RTAs), in which member countries aim to reduce or remove tariff and non-tariff barriers on other member countries' exports, has prospered. Between 1989 and 1994, the GATT was informed of as many as 33 RTAs.² Within Asia, the East Asian Economic Caucus (EAEC) was spearheaded by Malaysia in 1990. In 1992, members of the Association of South East Asian Nations (ASEAN)³ signed an agreement to form the ASEAN Free Trade Area (AFTA) by 2003. In May 1995, members of the South Asian Association for Regional Cooperation (SAARC) pledged to make the South Asian Free Trade Area (SAFTA) effective by 2001. In June 1997, BISTEC (Bangladesh-India-Sri Lanka-Thailand Economic Cooperation) was formally established to bolster cross-country trade, investment, and other resource transfers. Outside Asia, the European Union (EU), North American Free Trade Agreement (NAFTA), and MERCOSUR (a customs union among Brazil, Argentina, Paraguay, and Uruguay) are the most notable RTAs. This paper will conceptually trace out basic causes and consequences of RTAs from an impartial standpoint.

Ordinarily, geographic proximity is a natural driving force in international trade regardless of whether there is any official trade arrangement. Distance is statistically verified to be a very important determinant of trade.⁴ Therefore, nobody is surprised to hear of either AFTA or NAFTA. Member countries in each trading bloc tend to have similar cultures and comparable economies. They are tempted to "merge" as a group to function together in international trade negotiations because collective efforts will make their voice louder and safeguard their public interests more effectively. This is particularly true for small developing economies, which singularly lack strong economic influence. These economies also lack high-caliber human resources and negotiating skills. They benefit from collaborating with each other on the World Trade Organization (WTO) issues and dispute settlements, especially when rival countries are not only economically resourceful but also politically influential. For instance, within AFTA, Thailand concentrates on agricultural issues, Indonesia on textiles and garments, Malaysia and the Philippines on tropical products and oils, and Singapore on GATT rules.

Furthermore, several investment incentive plans among ASEAN members have been invented to help private firms achieve economies of scale and avoid duplication of production within the region. Three major projects were put into place, all of which relied on decreasing tariffs as a means to motivate private firms to specialize and magnify production. These projects are the ASEAN Industrial Joint Ventures, the ASEAN Industrial Complementation Scheme, and the Brand to Brand Complementation Scheme. ASEAN aims to launch an open investment area by the end of 1998, allowing free flows of capital among its seven members while easing access to technology and skilled labor. Conceptually, regional collaboration should help attain improved efficiency, however, cumbersome approval processes and bureaucratic friction often impede progress on such efforts.

Coordination across countries is typically difficult, particularly when a trade bloc includes countries of great diversity. For instance, it is unlikely that Asia-Pacific Economic Co-operation⁵ (APEC) will achieve its original objective of establishing a free trade area, given that members differ to an extreme extent in all regards including GDP, human resources, technology, economic development, and bargaining power. Countries with drastically different levels of development have remote chances of effectively formulating a free trade area for several reasons. Rarely do they have genuinely common interests. Worse yet, as they tend to be dominated by a few influential countries, negotiations or resolutions are likely to be prejudiced, not reflecting collective interests. Because of such biases, small countries are prone to dissension. Otherwise, they are tempted to collaborate with each other so as to gain a counterbalance.

Supporters of regional groupings argue that as trade discrimination measures (e.g., anti-dumping and countervailing duties) loom large amid the growing importance of world trade, developing countries will find it beneficial to participate in regionalism for the following reasons: (1) upgrade production techniques and standards; (2) expand import and export markets; (3) develop the capacity to compete; (4) broaden investment prospects; (5) improve consumer welfare; and (6) prevent the adoption of, or cope successfully with, unilateral measures. However, free trade

areas also generate negative impacts as well. For instance, fledgling industries in one member country frequently encounter difficulties in competing with more advanced competitors in another member country. Given the scarcity of some essential inputs, natural resources, and experience, some businesses are left at a disadvantage under liberalization. In short, although regional free trade seems compatible with an increasingly competitive global atmosphere, it leads to painful adjustments and often overlooked repercussions.

Small developing countries typically build up trade barriers for the sake of domestic employment, economic growth and development, and sustainable external trade balances. These objectives lead them to forgo some efficiency in resource utilization. In this regard, RTAs serve as a means for reducing market distortions or encourage efficiency in resource use. However, as debated since the 1950s, regionalism generates not only trade creation but also trade diversion.⁶ Trade creation refers to the situation where, in the absence of tariffs or trade barriers, an efficient member country produces the output in which it has a comparative advantage in an amount exceeding domestic demand in order to export to a less efficient member country. Trade diversion, on the other hand, occurs when a member country switches imports from an efficient non-member country to those from an inefficient member country because of the RTA's biased tariff structure. From a global perspective, trade creation is a clear-cut contribution of the RTA to efficiency in resource use, while trade diversion is the opposite. Nevertheless, from each member country's viewpoint, the RTA typically brings about a higher volume of international trade. It is difficult to conclude how much is due to trade creation and how much is attributed to perilous trade diversion.

Evidence of trade diversion is plentiful. One lucid example is the impact of NAFTA upon Thailand and other ASEAN nations. Throughout 1992-94, Thailand commanded trade surpluses against all NAFTA members. However, after NAFTA went into effect (January 1994), the trade edge dwindled into a deficit in 1996. Machinery and parts, electronics, textiles, and shoes were hardest hit. Canadian and American importers are enticed not only by cheap Mexican products but also non-ASEAN Asian producers who are engaged in intense price-cutting warfare spurred by their efforts to penetrate the North American market in the midst of NAFTA privileges.

Similarly, the broadening of the EU could easily result in a decline in ASEAN exports once new members with abundant labor and production opportunities start to play more active roles in the EU. This already occurred when Spain, Portugal, and Greece joined the EU and will worsen if the Czech Republic, Slovakia, Poland, and Hungary participate more fully in the EU economy. Examples of goods liable to trade diversion are textiles, garments, and motorvehicles because they are produced by both EU and ASEAN countries. Compared to NAFTA, the negative effects of EU expansion on ASEAN's exports are potentially greater, as the post-regional tariff rates in EU are higher than those imposed by the U.S., Canada, and Mexico.

Worse yet, as a land enriched with cheap labor, Mexico has increasingly diverted investment from ASEAN and other developing countries to itself. Japanese and U.S. investors are captured by Mexico because of advantages in production costs, transportation, and access to NAFTA status. Examples of ASEAN industries suffering from investment diversion are food, chemicals, textiles, metals, and electronics. In fact, some economists argue that investment diversion has a stronger adverse impact than trade diversion.⁷

Tariff revenue is another channel through which RTAs affect welfare of member countries. Once tariff revenue decreases as a consequence of the RTA, the government has to either raise taxes elsewhere or cut expenditures. Otherwise, it will encounter growing fiscal deficits. For many countries, tariff revenue constitutes a significant portion of total government revenue. Thailand, for example, received 15.9 percent of its government revenue from import tariffs in 1996. Therefore, how the government handles income reduction and its consequences should not be overlooked as an important outcome of the RTA.

Viewed from another angle, tariff reduction due to the RTA gives rise to a redistribution effect across member countries. Suppose countries A and B decide to organize an RTA and country C is an outsider. From a welfare standpoint, tariff revenue that country A previously collected on imports from country C is redistributed at least partially to country B's exporters. Thus, the RTA is often termed "discriminatory liberalization" because it hurts the country undertaking liberalization and benefits the partner. What follows immediately is that the member country which has low tariffs initially is likely to gain more from the RTA. Examples of such countries are the U.S. and Canada in NAFTA, and Singapore and Malaysia in AFTA.

The various issues discussed above indicate why regionalism remains controversial, especially among academics. Some⁸ view RTAs as a stepping stone or complement to global free trade, while others⁹ claim that the proliferation of RTAs is a threat to the liberal trading system. At one end of the spectrum are some economists who believe that regionalism is a useful supplement to multilateralism. At the other end is the view that regional groupings and

discriminatory preferential trade arrangements are counter-productive to the central pillar of WTO or unconditional trade practice. In some cases, collaboration across countries bodes well for trade enhancement. In others, fragmentation as a result of the RTA generates pressure of retaliation, either from another RTA or from a powerful country. By and large, once RTA member countries are aware that they gain more from the RTA if they undertake non-discriminatory liberalization before-hand, the RTA speeds up progress toward multilateral free trade.

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