

**PREFERENTIAL TRADING ARRANGEMENTS:
A SURVEY OF THE THEORY AND CURRENT ISSUES**

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Abstract

This paper reviews the theory of economic integration pioneered by Jacob Viner and examines the resource allocation and welfare effects of preferential tariff reductions. The dynamic gains from integration are examined in turn, including the achievement of economies of scale and improved technical, allocative and price efficiency resulting from intensified competition. The paper discusses the causes and consequences of the recent trend toward preferential trading arrangements and the reasons why policy makers view them as superior to nonpreferential protection. Conditions for optimal partners in preferential arrangements are derived, and the optimality of three actual or prospective integration arrangements is discussed in light of these conditions: The U.S-Canada free trade agreement, the EC internal market program, and prospective integration initiatives in Africa. The paper concludes with a discussion of the implications of the trend toward preferential trading arrangements for the multilateral trading system and the prospects for liberalization in the Uruguay Round.

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Introduction

The postwar movement toward international economic integration started with the formation of the European Common Market (EC) in 1957 and was followed by numerous other integration initiatives worldwide. To cite only a few, the European Free Trade Association (EFTA), the Latin American Free Trade Association (LAFTA), the Central American Common Market (CACM) and the Asian Economic Association (ASEAN) in the 1960's, the Caribbean Community (CARICOM), the Economic Community of West African States (ECOWAS) and the entry of the UK, Ireland and Denmark in the EC in the 1970's attest to the growing importance of regional trading arrangements. Economic integration involving the formation of common markets, customs unions, and free trade areas has thus received widespread support among both industrial and developing countries. The degree of interdependence of countries participating in existing trading arrangements, listed on Table 1, nevertheless varies widely. Table 2 shows the share of intra-area trade in the total trade of each existing trading group over the period 1960-86. The importance of intra-area trade is far larger in the EC than in any other group, and its increase over this period is particularly pronounced. With the exception of CACM and CEAO, intra-area trade has not increased significantly in other groups.

The trend toward economic integration gained new momentum in the 1980's with the enlargement of the EC to include Greece, Spain and Portugal and the proposed unification of its internal market in goods, services and factors of production by 1992, the formation of the South Pacific Regional Trade and Economic Agreement (SPARTECA) in 1981, the Australia-New Zealand Closer Economic Relations Agreement (ANZCERTA) in 1983 and the protocol signed in 1986 by Argentina and Brazil on the gradual removal of trade barriers on bilateral trade in certain products. In 1988, a free trade agreement between the U.S. and Canada was reached; a

framework agreement (that did not involve trade preferences) between the U.S. and Mexico was signed, and a free trade agreement is now contemplated; the ANZCERTA agreement was expanded to include services, and the deadline for eliminating all barriers on bilateral trade was brought forward; and agreement was reached to eliminate all remaining trade barriers within the Caribbean Community CARICOM.

The trend toward preferential trading arrangements raises two distinct but related issues:

First, what is the impact of preferential trading arrangements on the allocation of world resources and on global welfare, given that they involve both a free trade aspect (the elimination of trade barriers among members) and a protectionist aspect (the maintenance of trade barriers against the rest of the world). A subsidiary issue is what is the impact of such arrangements on each individual member and on all the members taken together.

Second, what is the impact of regionalization on the multilateral trading system and on the prospects for multilateral liberalization. Trade subject to some degree of preference accounted for one third of world trade in 1986, virtually all of which occurred among industrial countries. Further regionalization carries the risk of fragmenting the trading system into trading blocks, although it may also create the impetus for multilateral liberalization as more countries join existing arrangements.

These issues are addressed in this paper. Section 1 examines the underlying reasons for the recent trend toward regional trade. Section 2 discusses the types of preferential arrangements that exist. Sections 3-7 provide a review of the literature on preferential trading arrangements. Section 8 summarizes the conditions for maximum gains from preferential trading arrangements, from the viewpoint of both members and the world as a whole. Section 9 reviews three actual or prospective arrangements (the U.S.-Canada Free Trade Agreement, the EC internal market program, and proposals for regional integration in Africa), and assesses their potential effects.

Finally, section 10 discusses the implications of the trend toward regional integration for the multilateral trading system.

1. Reasons for the trend toward preferential trading arrangements

Five factors have provided the impetus for the recent integration initiatives. Among the industrial countries, these initiatives are part of the trend away from government intervention in the 1980's, as manifested in deregulation, privatization, and tax reform aimed at increasing the efficiency of resource use. Both the U.S.-Canada free trade agreement and the proposed unification of the EC internal market were motivated by the expected supply-gains resulting from the removal of regulatory barriers that impede cross-border trade in goods and services.

Second, impatience with the slow and cumbersome process of multilateral negotiations have contributed to recent initiatives by industrial countries to liberalize trade on a bilateral basis. The United States has led this trend by concluding a free trade agreement with Canada and initiating discussions on a similar agreement with Japan while remaining committed to multilateral negotiations. The bilateral discussions that led to the U.S.-Canada Free Trade Agreement were initiated following the failure of the 1982 GATT Ministerial meeting to launch a new round of multilateral trade negotiations (Stern et al., p.4).

Third, preferential trading arrangements have been viewed as a means of diffusing trade conflicts that have escalated in the 1980's. In part, this reflects dissatisfaction with the multilateral dispute settlement mechanism under GATT and disagreement over what constitutes "unfair" trade practices. It is noteworthy that the desire to shield domestic exporters from

"administered protection"¹ was explicitly mentioned by Canada as one of the reasons for entering into a free trade agreement with the United States (Canada Department of Finance (1988) pp. 21-23). The same consideration prompted the director general of the Board of Foreign Trade in Taiwan's Ministry of Economic Affairs to call for a free trade agreement with the United States (Journal of Commerce, October 4, 1988). Similarly, the need to diffuse trade tensions is one of the factors underlying the U.S.-Mexico framework understanding reached in January 1988.

Fourth, in the aftermath of the 1982 debt crisis, economic integration among developing countries has been seen as a means of promoting growth and industrialization, and of economizing on scarce foreign exchange resources. Tariffs continue to be more important than nontariff barriers in trade among developing countries; their removal is thus viewed as a means of achieving industrialization by "swapping" markets for each other's products, and to reduce their dependence on the industrial countries that are protected by nontariff barriers. These considerations underly recent moves to eliminate of internal trade barriers among CARICOM members, some progress toward establishing a customs union between Argentina and Brazil, and proposals for regional integration in Africa. Regional integration among developing countries has also been viewed as a means of economizing on foreign exchange by setting up clearing accounts for intra-area trade. Such internal clearing accounts exist for most regional trading groups among developing countries, including the Latin American Integration Association, the Central American Common Market, and the Caribbean Community.

¹ "Administered protection" is the use of administrative procedures, such as antidumping and countervailing investigations, or health and safety regulations, in a manner that impedes trade flows. There is some evidence that administered protection is used as a substitute for safeguard measures. See Finger and Hall (1982).

Fifth, the integration process has acquired a momentum of its own as nonparticipating countries have moved to join existing or prospective preferential trading arrangements to avoid being discriminated against and to reap the benefits of an enlarged market. Thus, a number of European countries that are not presently members of the EC are exploring the possibility of membership. Discussions are also underway for a free trade area between the EC and the Gulf Cooperation Council (GCC). Similarly, proposals have been advanced for a Pacific Free Trade Area including the United States, Japan, Australia, and other Pacific Rim countries, following the U.S. proposal to explore the possibility of a free trade area with Japan. Among the developing countries, Uruguay has expressed interest in joining the proposed customs union between Brazil and Argentina.

These developments have stimulated new interest in the subject of preferential trading arrangements, given that it is not a priori clear whether such arrangements represent a move toward free trade or protection. While there may be important economic benefits to be reaped from free trade among the countries participating in these arrangements, the formation of preferential trading groups could have detrimental effects both on participating countries and on the rest of the world.

2. Types of preferential trading arrangements

Preferential trading arrangements can take several forms, depending on the types of markets that are being linked and the degree of policy harmonization among members in a number of areas. For analytical purposes four types of integration arrangements can be distinguished: In ascending order of integration, these are: Free trade areas, customs unions, common markets, and economic unions. Each of these involves the removal of restrictions on intra-area trade and maintenance of various forms and degrees of protection against the rest of the world. Common

markets and economic unions also involve the removal of intra-area restrictions on factor mobility.

A free trade area provides for the free movement of goods within the area, while each member retains its own tariffs and other regulations governing trade with the rest of the world. The European Free Trade Association (EFTA) and the U.S.-Canada Free Trade Agreement (FTA) are examples of free trade areas. In a customs union, member countries additionally impose a common external tariff on imports from the rest of the world and often participate in international trade negotiations as a single entity. Thus, the main difference between a free trade area and a customs union is that members of a free trade area retain discretion over their tariff schedules on imports from the rest of the world. This can cause trade deflection, i.e. a redirection of imports through the member country with the lowest tariff for duty-free re-export to other members. Enforcement of the individual members' tariff schedules against imports from the rest of the world in a free trade area is achieved through rules of origin, which are intended to limit trade deflection.

A common market goes further than a customs union, by providing for the free movement of factors of production, and for the adoption of common regulations on the movement of factors with the rest of the world. This objective was included in the 1957 Treaty of Rome establishing the EC and is expected to materialize fully by the 1992 deadline for the completion of the internal market. An economic union goes even further by requiring member to unify their fiscal, monetary, industrial, regional and other policies and introduce a common currency. Economic unions presuppose a high degree of consensus among member countries on policy objectives in several areas. The only economic union formed so far is the Belgium-Luxembourg Economic Union in 1921, while the EC aims to move in this direction by 1992.

3. Overview of customs union theory

Economic integration alters the relative prices of goods in member countries, with consequent changes in trade flows, production, consumption and incomes both within the group and in the rest of the world. An extensive literature has focused on these effects over the past few decades. The theory of economic integration, pioneered by Viner (1950), has been developed with reference to customs unions but the analysis can be easily modified to apply to other types of trading arrangements. The theory has generally been confined to the resource effects of preferential tariff reductions, largely neglecting the macro effects on the level of economic activity, the balance of payments, inflation and unemployment.

The gains from integration for individual members and the group as a whole can arise from a number of sources. Economic integration increases the opportunities for specialization in line with comparative advantage, thus reducing the real resource cost of obtaining a given output. In addition to possible improvements in resource allocation, tariff reductions can entail gains for consumers by reducing the price of imports from partners. Economic integration can also lead to improvements in the terms of trade of member countries vis-a-vis the rest of the world, and attract direct investment flows from third countries wishing to circumvent the external tariffs of member countries. There may be noneconomic gains as well: Membership in a trading group may enable participating countries to achieve common goals more effectively than if acting in isolation. The bargaining power of member countries in trade negotiations can increase insofar as the economic weight of the union is greater than that of any individual member.

Recent advances in trade theory have influenced customs union theory to some extent. The analysis of the effects of preferential trading arrangements has shifted away from static considerations to the dynamic effects of integration under imperfect market structures, product differentiation and economies of scale. A number of empirical studies have shown that the expansion of markets through preferential trading groups may result in significant gains from

economies of scale (Cox and Harris, 1984) and from growth effects (Baldwin, 1989). Additional gains in efficiency may result from greater competition among the partner countries.

However, customs union theory has lagged behind recent developments in the world trading system. Customs union theory was developed using preferential tariff reductions as the starting point of the analysis. But nontariff barriers have become a more important impediment to trade than tariffs --particularly among industrial countries-- following successive rounds of multilateral tariff reductions in the post-war period. Nontariff barriers include voluntary export restraints, different national standards, government procurement policies that favor domestic producers, and trade-distorting subsidies. In addition, there is evidence that antidumping, countervailing and safeguard measures are being used as a tool of administered protection (GATT, 1988). As noted in section 1, recent integration initiatives among industrial countries aim at reducing nontariff barriers to trade. The effects of preferential removal of nontariff barriers have not been analyzed in a systematic way.

4. Trade creation and trade diversion

The theory of economic integration was developed in parallel with integration initiatives in Europe and elsewhere. Viner (1950) suggested that the desirability of preferential trading arrangements should be evaluated with reference to their trade creating and trade diverting effects. By eliminating tariffs on intra-area trade, a member will increase its imports from partner countries. Part of this increase may reflect the substitution of lower-cost partner imports for domestic production. This is trade creation, which entails a welfare gain directly proportional to the degree of protection formerly granted to domestic producers. But because the tariff changes are discriminatory, another part of this increase in partner imports may reflect the substitution of high-cost imports from partners for low-cost imports from nonmembers. This is trade diversion,

which involves a real economic cost insofar as production shifts from a low-cost to a high-cost source of supply. It thus causes a welfare loss to the world, whose size depends on the pre-tariff difference between partner and world prices.

Viner thus demonstrated that there can be no general presumption as to whether preferential trading arrangements represent an improvement in the allocation of world resources. Such arrangements involve by definition a free-trade aspect -- the trade creation resulting from a reduction of trade barriers on partner imports -- and a protectionist aspect -- the diversion of trade resulting from the reduction of trade barriers on a discriminatory basis. The impact of the arrangement on global welfare thus depends on the balance between these two effects. A predominantly trade-creating customs union benefits at least one member and the world as a whole, while a predominantly trade-diverting customs union reduces the welfare of at least one member and the world as a whole.

The partial equilibrium effects of bilateral tariff reductions are illustrated in Figure 1. In Figure 1a, the elimination of tariffs on imports from partners causes total imports to expand by m_0 m_1 . This increase in imports is partly due to a reduction in domestic production and partly to an increase in consumption ². The reduction in the price of imports from $p_p(1+t)$ to p_p , where t is the pre-integration tariff rate and p_p is the partner price, gives rise to a net increase in consumer surplus equal to area 1+2 (the increase in consumer surplus less the decline in producer surplus). But not all of this is a net gain to the country: area 1 formerly represented tariff revenue which is foregone when tariffs are eliminated. Thus, the net gain to the home country from trade creation is area 2, which represents the deadweight loss of the tariff and is

² Welfare effects thus measured are based on Johnson's concepts of trade creation and trade diversion, expanded to include consumption effects (see below).

approximately equal to one half of the increase in imports multiplied by the tariff rate. The partner country also gains insofar its exports expand, and the world as whole gains.

Figure 1a assumes that the good was formerly imported from partner countries, implying $p_p < p^*$, where p^* is the world price. If, instead, the commodity was previously imported from the world market (implying $p^* < p_p$), and if the partner country is not too inefficient (i.e., if $p_p < p^*(1+t)$), the partner will undercut the rest of the world, even though it is less efficient (Figure 1b). As before, the net gain in consumer surplus (areas 1+2) is offset by the loss of tariff revenue (areas (1+3)). In this case, the net effect of trade diversion on the home country's welfare is indeterminate: Netting out the common areas, the net gain equals area 2 minus area 3.³ The partner country gains as its exports expand, while third countries lose if the customs union is large in its trade with the rest of the world. The impact on global welfare is indeterminate.

5. Extensions of the basic model

Viner's analysis is based on a Ricardian model of production in which each commodity is produced at constant costs. In addition, it abstracts from the consumption effects of price changes by assuming fixed proportions in consumption. Both assumptions have subsequently been criticized as unrealistic, thereby reducing the applicability of Viner's conclusion to the real world. Once either assumption is relaxed, it is possible to show that a trade-diverting customs union could increase members' welfare under certain conditions. Viner's analysis also does not take into

³ In the absence of consumption effects, the home country would unambiguously lose from a trade diverting customs union: There would be losses in producer surplus, tariff revenue, and a deadweight loss equal to the difference between the world price and production costs in the partner country. This would be the result obtained by Viner on the basis of production effects alone.

account terms of trade changes resulting from preferential tariff changes. Allowing for terms of trade effects can alter the conclusions of the basic model regarding the distribution of gains among the members as well as between the members and the rest of the world. We turn to these extensions next.

(a) Consumption effects

The consumption effects of discriminatory tariff changes were first analyzed by Meade (1955). When a union member reduces or eliminates tariffs on imports from partners, the price of imports to the consumer falls and the demand for imports correspondingly rises. Meade refers to this increase in demand as trade expansion. This term thus refers to the consumption effects of tariff removals, while trade creation and diversion refer to shifts in the locus of production. Meade showed that changes in trade flows need not reflect exclusively trade creation or diversion: when imports from partner countries replace domestic production as a result of discriminatory tariff reductions, there is trade creation in Viner's sense, but also trade expansion in Meade's sense. Trade expansion can arise in the case of a trade diverting customs union as well: when partner country imports replace imports from the rest of the world, there is trade diversion and trade expansion. Generally, member countries will increase their consumption of the products which they import from partner countries and reduce their consumption of imports from the rest of the world. The welfare gains from net trade expansion reinforce any gains from trade creation and offset any losses from trade diversion. Johnson (1960) consequently proposed that the terms trade creation and diversion be broadly defined to include both production and consumption effects.

Lipsey (1957) applied the theory of second best to determine whether favorable consumption effects may outweigh unfavorable production effects. The elimination of tariffs from

partners will entail a welfare gain insofar as it restores the equality between the marginal rate of substitution in consumption and the marginal rate of transformation in production for all domestically produced goods and imports from the partner, assumed to be initially distorted by a tariff. But a new distortion is introduced between imports from partners and imports from the rest of the world. In a second-best framework, removing one distortion while creating another may not improve welfare. In this framework, Lipsey demonstrates that the welfare gain from favorable consumption effects may more than offset the welfare loss attributed to trade diversion, both from the standpoint of an individual member country and the world.

(b) Terms of trade effects

The effects of discriminatory tariff reductions on the union's terms of trade were first analyzed by Mundell (1964). Under the assumption of increasing costs, a reduction in imports from the rest of the world through trade diversion would improve the terms of trade of each member of the union and correspondingly worsen the terms of trade of the rest of the world. This effect would limit the loss that trade diversion imposes on union members and increase the loss inflicted on nonmembers. The greater the economic area of the union and the greater the amount of trade diverted, the greater the improvement on its terms of trade with the rest of the world, assuming that some trade with third countries survives after the union is formed.

Terms of trade gains can accrue to the union irrespective of its exchange rate regime vis-a-vis third countries. Under fixed exchange rates, shifts in demand have a direct impact on prices. Under flexible exchange rates, a reduction in the union's imports from nonmembers improves its trade balance and tends to appreciate its currency, thus improving its terms of trade.

Terms of trade effects can also have an important bearing on the distribution of gains and losses among union members. If a member country is a small price-taker while the other is a

large country, then the small country will gain the entire benefit from any trade diverted from third countries to its own producers, while the large country will lose. This is because the small country takes the terms of trade as given, so that, if the tariff-inclusive world price does not change after the union is formed, the small country can export its product at that price and appropriate the entire difference between this price and its production costs.

This effect is illustrated in Figure 2. The home country's excess demand curve is ED_h , the partner country's excess supply curve is ES_p , and the excess supply curve of the rest of the world is assumed perfectly elastic at the world tariff-inclusive price $p^*(1+t)$. Total pre-union imports of the home country are m , of which mp_0 are supplied by the partner and mp_0 from the rest of the world. The home country's tariff revenue is the entire area $1+2+3$. When the union is formed, imports from the partner enter tariff-free at the tariff-inclusive world price. As the world price does not change, production, consumption and total imports in the home country remain unchanged, but imports from the partner rise to mp_1 , displacing imports from the rest of the world. The welfare cost to the home country equals the forgone tariff revenue on partner imports (areas $1+2$), partly offset by a gain from trade diversion in the partner country equal to the gain in producer surplus (area 1). The net cost to the union is the real resource cost of diverting imports from a low-cost to a high-cost source of supply (area 2). In this case, this is also the cost to the world since the world price does not change.

(c) Product differentiation

Recent trade models based on product differentiation as a basis for trade have also been used to analyze the effects of preferential tariff changes (Brown and Stern, in Stern et al.(1987)). If each country's products are differentiated by place of production, i.e. they are imperfect substitutes in demand, then each country is facing a downward sloping demand for its exports

irrespective of the country's size. It follows that each country's terms of trade will be affected by tariff changes in its trading partners. The relative size of the union partners is thus less important in determining the distribution of gains and losses among the members: With product differentiation, it no longer follows that consumers in the large member country must pay the world price plus the tariff when importing from the union partner. Instead, both countries enjoy lower prices on imports from each other after they eliminate tariffs among them. The gains from trade creation (and diversion) are thus distributed more evenly among members of the union. The more differentiated the products, the greater the extent to which bilateral (or multilateral) liberalization will result in terms of trade effects rather than shifts in the location of production. From the members' perspective, this implies that the member with low initial tariffs is likely to gain from bilateral tariff cuts (because its import prices decline more than export prices), and the member with high initial tariffs is likely to lose. From a global perspective, the bilateral tariff cutting will have only a small effect on world welfare given the absence of shifts in the pattern of trade and specialization.

6. Dynamic Effects

The potential importance of resource allocation effects as the rationale for customs unions was downgraded by the very low welfare estimates derived by practically all empirical studies on the EC. Comparative-static estimates based on the welfare triangle analysis run as low as half a percent of GNP or lower. As Waelbroeck (1976) remarks, the welfare significance of the EC thus appears less than that of the Concorde airplane. These figures are surprisingly low, especially in view of the fact that the creation of the EC was the leading political question in Europe in the late fifties and a major political issue in the United Kingdom when it was invited to join. These results led researchers to seek sources of welfare gains other than those associated

with trade creation and diversion. One such source is a set of effects loosely termed "dynamic effects" of integration. These effects, discussed below, include reductions in unit costs due to economies of scale resulting from longer production runs. It has also been argued that the enlargement of the market intensifies competition, thereby promoting (a) technical efficiency, (b) allocative efficiency, and (c) price efficiency. Additional dynamic gains may result from an increase in aggregate savings resulting from the increase in national income implied by welfare gains. These effects, which have been measured only recently, are additional to the so-called "triangle" calculations which attribute all welfare effects of departure from free trade to consumption and production effects deriving from: (a) the consumer purchasing goods at prices that do not reflect their scarcity values, and (b) home country producers producing at marginal costs that do not reflect opportunity costs.

The impact of economies of scale on the welfare significance of customs unions was first analyzed by Corden (1972). The elimination of partners' tariffs may permit industries in member countries to reduce costs by exploiting economies of scale, provided that the minimum point on their average costs curves lies below the partner countries' price. The resulting gain in consumer surplus in all members that consume the good would not be offset by any losses in producer surplus because unit costs would fall through the achievement of economies of scale. This gain is additional to the static welfare gain arising from economic integration. Empirical studies lend support to the argument that tariff reductions can lead to cost reduction. Baldwin and Gorecki (1986) found an inverse correlation between the level of tariffs in Canadian industries and the length of their production runs. In addition to firms moving toward minimum efficient scale as a result of integration, multi-product firms are likely to specialize in fewer product lines, thereby also exploiting economies of scale internal to the firm by achieving longer production runs. If product variety enters the consumer's utility function, integration may bring additional gains by

increasing product variety. Recent estimates by Harris (1984) and Cox-Harris (1985) for Canadian manufacturing suggest that the benefits of reducing Canadian tariffs unilaterally may amount to 3-4 percent of GNP, while the benefits of bilateral tariff reduction in the context of the U.S.-Canada free trade agreement could be as high as 9 percent of Canadian GNP. Although not formally measured for the EC, the observed increase in intra-industry trade following its establishment is thought to indicate gains from increased scale (Grubel and Lloyd, 1975).

Technical inefficiency resulting from firms not using the best available technology is also thought to be linked to trade and industrial policy. Integration could lead to a welfare gain by reducing the dispersion in technical efficiency among firms (Corbo, de Melo, Tybout, 1988).

Allocative inefficiency occurs when factors of production are not paid the value of their marginal products and constitutes a further source of welfare loss. Economic integration involving the easing of restrictions on factor mobility would remove this welfare loss by reducing factor market distortions. The EC's economic integration goals for 1992 would presumably promote efficiency in factor markets by easing national restrictions and barriers to entry in financial and labor markets.

Finally, price inefficiency results when firms price their products above average costs because national industrial and trade policies can create barriers to entry which provide leeway for firms to practice non-competitive pricing while at the same time preventing entry of new firms. This effect is even harder to quantify than the preceding ones and is likely to be more important for developing than developed countries (Harris, 1984).

Additional dynamic gains could result from the real income effects of economic integration. If integration raises national income because the welfare effects mentioned above are, on the whole, positive, then aggregate savings, investment and the growth rate of the economy will rise. If, in addition, integration leads to an increase in the rate of technical progress or to a reduction

in the price of capital goods, there will be a further dynamic gain additional to the one resulting from a higher volume of savings ⁴ .

There are two difficulties with these arguments. First, as Johnson (1962) has remarked, it is naive to assume that the size of the market for any given product will increase by lumping together countries with different cultures, per capita incomes, and consumption habits. Besides, if the size of the domestic market were a decisive factor, we should observe large countries with large markets having higher living standards than small ones, which is not necessarily the case. Second, granting the validity of the efficiency argument, it does not justify reciprocal discriminatory tariff reductions any more than it justifies unilateral non-preferential tariff reductions. The dynamic effects of customs unions therefore fail to provide a rationale for the existence of customs unions.

7. Integration and protection

The approach adopted by Cooper and Massell (1965a) and Johnson (1965) establishes a rationale for customs unions by treating tariffs as an instrument of industrial protection aimed at achieving domestic production targets, rather than as a distortion of production and consumption decisions that governments impose for unfathomable reasons. This amendment is essential since their major criticism of Viner's work is that, by failing to explain what motivates a tariff, it fails to provide a rationale for customs unions. Specifically, they argued that the existing body of literature on customs unions "fails to show why a customs union may be acceptable when a tariff reduction is not, and it fails to analyze how a customs union may more

⁴ Some of these effects are discussed by Baldwin (1989).

efficiently serve the ends previously served by non-preferential protection.⁵ They refuted the popular view that the motivating force behind the formation of customs unions is a better allocation of resources, by showing that unilateral non-preferential tariff reductions achieve the same objective at lower cost. In their view, the difficulty with the standard customs union analysis is that it is based on classical trade theory which, with its free-trade bias, views the imposition of a tariff as an inefficient means of achieving any objective, be it to raise revenue, improve the trade balance, increase domestic employment, or protect local industry. In each case there is an instrument which achieves the target more efficiently. Starting from this premise, any pre-union tariff must have been ill-advised, so that its discriminatory removal will bring about a gain, provided that the free-trade aspect of such removal -- trade creation -- outweighs the protectionist aspect -- trade diversion. But if trade creation is viewed as being desirable, why does a country not move all the way to free trade, thereby obviating the trade-diversion cost of a customs union? And if a country is willing to give up some of the benefits of free trade for the sake of fostering industrial development, why risk losing its protected industries for the partial free-trade benefits of a customs union?

In an attempt to answer these questions, Cooper-Massell and Johnson use a different analytical framework from that on which traditional customs union theory is based. The welfare criteria are extended to include the consumption of a public good, defined as "a social preference for particular types of economic activity -- which we shall call industry . . ."⁶ They justify this view by interpreting the existence of protection as an indication that free trade is not viewed as desirable by many countries, notably developing countries. Using this framework, and under the

⁵ Cooper and Massel (1965a), p. 747.

⁶ Cooper and Massel (1965b), p. 462.

assumptions of constant costs, competitive pricing, constant terms of trade, and a heterogeneous industrial sector consisting of industries operating at various degrees of efficiency, they contrast individual optimal tariff policies and customs union formation as alternative means of public good provision. It is shown that economic integration may enable the participating countries to protect a given amount of domestic industry at a lower real cost than if they acted separately, where the real cost of industry is defined as the difference between domestic costs and world prices. The logic of this result is that if policy makers act rationally, i.e. if they try to minimize the real cost of any given amount of industry, then, when acting in isolation, they would impose a tariff configuration inducing local production of successively higher-cost industries up to the point where the marginal cost of protecting an extra industry just equals the marginal benefit to be derived from collective consumption of the public good associated with the domestic production of the industry. Policy makers thus satisfy the collective demand for industrial output by protecting only the lowest-cost industries. The alternative of forming a customs union involves an elimination of those previously protected industrial products which are produced at lower cost in the partner country, and an expansion of output of those products which are produced at lower cost in the home country. The benefit of such a move is that, with the pooling of markets it involves, a given level of industrial output can now be achieved by resort to only the lowest-cost of the previously protected industries. The real costs of achieving a given level of industrial output are thus reduced.

A member country would not be able to achieve its industrialization objective if all industrial products could be produced at lower cost in other member countries and if exchange rates are fixed. In this event, there is a case for protection within the customs union. Such protection is indeed encountered in customs unions among developing countries, such as the West

African Economic Community, which is also a monetary union in which exchange rates are permanently fixed among the members.

The popularity of import substitution policies in developing countries, despite the preachings of the classical free-trade doctrine, lends support to the view that industry is a public good. Developing countries seem willing to pay for having a diversified economic structure and for achieving noneconomic goals. This willingness may be partly motivated by a desire to achieve greater self-sufficiency vis-a-vis the industrialized countries and to minimize the uncertainties of international trade in order to avoid short run fluctuations in export earnings and long run adverse terms of trade movements. Noneconomic goals may also play a role, insofar as a customs union may increase the bargaining power of member countries in relation to third countries. The political gains from integration are often thought to be significant. A number of the existing regional arrangements, such as ASEAN, are commonly regarded as unsuccessful economic entities but successful in raising the bargaining power of their members. Integration among developing countries could thus be regarded as a strategy for diversification and development rather than as means of achieving a better allocation of existing resources.

Though not a novel approach to analyzing development strategies⁷, the Cooper-Massell-Johnson framework is of special interest when applied to customs union theory. If it is stipulated that industrial production is desirable per se rather than as a means of satisfying private wants, it no longer follows that trade creation unambiguously improves welfare and that trade diversion reduces it, not even when consumption effects are allowed for, because the welfare effects of a customs union depend on what happens to both income and industrial output. When

⁷ The "public good" argument for integration is similar to the infant industry argument for protection, insofar as both justify the need for government intervention on the basis of learning effects or uncertainty, which create dynamic inefficiencies in new industries.

trade is diverted, each participating country expands its industrial output to supply the partner's market. While this diversion may reduce each partner's income, industrial production expands, thereby raising the possibility that welfare may, on balance, improve if the policy makers' preference for industry is sufficiently strong. Conversely, if the cost of industry in one of the member countries is relatively high, trade creation may reduce that country's welfare. While a given amount of consumption is satisfied at lower cost, this benefit may less than offset the loss in industrial output. This result has two implications: first, the welfare effects of customs unions cannot simply be assumed to be proportional to trade created and diverted, a fact which makes the interpretation of empirical estimates of trade flow effects more complicated than Viner's analysis suggests. Second, discriminatory reciprocal tariff reductions are preferable to nondiscriminatory reciprocal or unilateral reductions because the trade diversion that the former entails provides scope for each member to raise its output and exports at the expense of nonmembers. The theory thus predicts the formation of preferential trading arrangements as a strategy for fostering industrial development.

The validity of the Cooper-Massell-Johnson argument has been questioned by Krauss (1972), on the grounds that although integration is superior to national protectionism, it is not the most efficient way to promote industrialization. Production subsidies are more efficient insofar as they result in higher private good consumption for any given level of public good consumption because they lack the tariff's consumption cost component. This argument remains valid even if the distortions introduced by the taxation needed to finance the subsidies are taken into account. Corden (1974) has shown that such distortions are likely to be smaller than those introduced by tariffs. Even if an economic rationale for customs unions could be established on public good grounds in the event that, for any reason, subsidies were not available to governments as an instrument of protection, it is clear that the Cooper-Massell-Johnson analysis

is applicable mainly to developing countries and that the "general theory" of customs unions has yet to be written. It may consequently be more illuminating to view customs unions and other integration arrangements as essentially noneconomic institutions. In this connection, it is worth noting that the public debate in Greece, Spain, and Portugal on the desirability of joining the EC centered on the expected political, rather than economic, benefits. Entry in the Common Market was envisioned as a step into what is viewed as the eventually "United Europe," rather than as a trade liberalizing device. Similar arguments preceded the United Kingdom's entry into the EC in 1973 and, indeed, underlie the formation of the EC in 1957.

8. Conditions for maximum gains from preferential trading arrangements

The various theoretical models discussed above are consistent with different welfare outcomes. Empirical results based on different models also differ widely. It is thus essentially up to the policy maker to choose among alternative models when faced with the circumstances of particular countries. Nevertheless, a number of a priori conditions for optimal partners in such arrangements can be established, from the viewpoint of both individual members and the world as a whole.

From the perspective of both member countries and the world as a whole, a large volume of trade between countries that contemplate economic integration would increase the probability that trade creation will outweigh trade diversion. A limited volume of trade would limit the advantages of duty-free access to member countries' markets and would increase the scope for trade diversion.⁸ For this reason, GATT's article XXIV governing regional trading arrangements

⁸ In terms of Figure 1b, a large pre-union volume of trade among partners would indicate that partner prices are close to world levels, thus minimizing area 3 and therefore the scope for welfare losses to individual members and the world as a whole.

explicitly includes a large volume of trade among member countries as one of the conditions for granting a waiver from the MFN principle to members of regional trading groups.

Second, the gains from integration are likely to be larger if the product range of the partner countries is similar but the efficiency with which any given product is produced in each of the partner countries differs. The scope for trade creation is then largest: Upon formation of the union each member will contract the relatively inefficient industries and expand the efficient ones. Conversely, dissimilar economic structures in the partner countries increases the scope for trade diversion: If one country produces a good inefficiently under tariff protection while the other country does not produce the good, then adoption of the tariff by the union would secure the entire union market for the union's inefficient producer. The scope for trade diversion would be reduced if the type of arrangement contemplated is a free trade area, which does not involve the adoption of a common external tariff.

A qualification to the preceding proposition is introduced when a preference for industry is stipulated. The Cooper-Massell-Johnson analysis suggests that the union is more likely to be beneficial if the countries are complementary, rather than competitive as Viner's analysis suggests, in the range of commodities produced. Complementarity increases the scope for welfare-increasing trade diversion and reduces the scope for welfare-reducing trade creation due to a contraction in industrial output.

Third, the scope for trade diversion is reduced if the union covers many countries, because the probability that an outside country is a more efficient supplier is reduced.

Fourth, the scope for trade diversion is reduced if the common external tariff is low. If the formation of a customs union entails averaging of the members' national tariffs, the scope for trade diversion would be largest in those members where the move to the union's common tariff

schedule involves an increase in tariffs. In a free trade area the scope for trade diversion would be lower, the lower the members' individual tariff rates.

Fifth, low elasticities of supply in both the partner country and in nonmembers tend to reduce the amount of trade diverted. If the partner country supply price rises as trade is diverted while the price of nonmembers falls, the amount diverted falls.

Sixth, geographical proximity of the partner countries would ensure that the gains from trade are not wasted on transport cost.

Finally, the benefits of economic integration are greater in the absence of nontariff impediments to the free movement of goods among partners. Such impediments include technical standards, health and safety regulations, and public procurement practices. The importance of removing such obstacles was recognized by the EC Commission's White Paper on completing the internal market and by the U.S.-Canada agreement, both of which include provisions for harmonization of policies in at least some of the above areas. The benefit would obviously be larger, the greater the simultaneous progress in removing such administrative and regulatory impediments to trade worldwide.

From the perspective of the member countries taken together, the benefits are likely to be greater the larger the preferential trading area relative to the rest of the world. The scope for terms of trade gains vis-a-vis the rest of the world is then largest, with a corresponding loss to nonmembers.

From the perspective of an individual member, the benefits are likely to be greater if the member is a small country relative to its partners. It can then reap substantial terms of trade gains as it exports to its partners at their domestic prices, i.e. at the tariff-inclusive world price. A qualification to this proposition must be made if the small member country produces differentiated products and can thus not be assumed to be a price taker. Another benefit of being

small is the scope for achieving economies of scale through duty-free access to a larger market. The impact of a high initial level of tariffs on an individual member's welfare is indeterminate: Their preferential reduction would increase the scope for both trade creation and trade diversion. The scope for trade diversion would be reduced if tariffs on imports from third countries were simultaneously reduced, as would happen if the country joined a customs union with a lower external tariff than the individual member's. A high initial level of tariffs could also entail terms of trade losses for the individual member: Insofar as tariff reductions deteriorate the member's trade balance, they would tend to depreciate its exchange rate and worsen its terms of trade.

9. Choice of optimal partners in recent integration initiatives

The theory of preferential trading arrangements provides some guidance for the assessment of recent integration initiatives, from the viewpoint of both members and nonmembers. This section assesses the potential trade-creating and diverting effects of three prospective or proposed integration initiatives among both industrial and developing countries. The U.S.-Canada free trade agreement, the integration of the EC market by 1992, and proposals for economic integration in Africa are discussed in turn, in light of the a priori conditions for optimal partners discussed in section 8.

(a) U.S.-Canada Free Trade Agreement

The U.S.-Canada Free Trade Agreement (FTA), signed in January 1988, came into effect on January 1, 1989. The FTA provides for the gradual removal of all tariffs and most quantitative restrictions on trade between the two countries over a 10-year transition period starting in January 1989. Rules of origin define those goods that are eligible for duty-free treatment when exported from one country to the other. Eligible products are defined in most cases as those with

a local content of at least 50 percent. Certain safeguards, including quantitative restrictions, would be maintained on agricultural trade although export subsidies would be prohibited. Less visible barriers to trade, such as technical standards and "administered protection", would be reduced by the FTA's provisions aiming to achieve greater transparency and compatibility of standards and by the establishment of a binding bilateral dispute settlement mechanism. The agreement also excludes the partner country from global safeguard measures taken by the United States of Canada under GATT Article XIX, unless exporters from the partner country are "important contributors to the injury caused by a surge in imports from all countries" (Canadian Department of External Affairs (1988), p. 167).

The FTA broke new ground in trade negotiations by including provisions for the reciprocal opening of trade in services, (including financial services), government procurement, and investment. The agreement calls on each country to extend national treatment to the providers of services in the other country (except transport, basic telecommunications, legal, medical and social services). The agreement on services was facilitated by the absence of any obligation to harmonize regulatory regimes, obviating the need for agreement on the scope and nature of regulation. National treatment as defined in the agreement includes the rights of establishment and nondiscrimination in professional licensing under the different regulatory systems prevailing in each country.

The provisions on government procurement go beyond the obligations that the two countries have undertaken under the relevant GATT code, in three respects: first, the agreement broadens the scope of the public entities covered, to include state and local authorities in addition to the federal governments. Second, the threshold value of government purchases open to cross-border competition is lowered to \$25,000 from \$171,000 under the GATT code, providing

export opportunities for small firms in both countries. Third, the transparency of procurement procedures is improved to ensure equitable treatment of suppliers in both countries.

Three factors limit the potential trade-diverting impact of the agreement or increase its trade-creating potential:

- a. The low level of tariffs in both the United States and Canada.
- b. The large volume of trade between the two countries, and
- c. The similar economic structures of the two countries.

In addition, their geographical proximity ensures that the gains from trade are not wasted on transport costs.

Table 3 shows the post-Tokyo Round average level of tariffs in the United States and Canada. The average tariff on industrial products is low, limiting the competitive advantage that Canada would gain from duty-free access to the U.S. market. Although U.S. exporters would gain a more significant advantage by obtaining duty-free access to the Canadian market that is protected by higher tariffs, the considerably smaller importance of Canada, both in world trade and as a market for U.S. exports, would limit trade diversion as a proportion of total trade. Nevertheless, trade diversion could be significant in relation to the exports of individual exporting countries, particularly in sectors such as textiles and footwear that are protected by tariff rates that are well above average in both the United States and Canada, as well as by quantitative restrictions under the Multifibre Arrangement (MFA) or under temporary safeguard measures. Agreement in the Uruguay Round to phase out the MFA would reduce the trade-diverting potential of the FTA.

More than one third of the two countries' total exports represents intra-area exports, one third of which has already been liberalized under the U.S.-Canada automotive pact, a sectoral free-trade agreement signed in 1965 (Table 1). The large volume of trade already occurring

between the two countries indicates that substantial gains from trade are already being reaped, limiting the scope for trade diversion.

The similarity in two countries' production structure increases the scope for trade creation as each country contracts the relatively inefficient segments of its industries and expands its relatively efficient ones. Additional gains could result from the achievement of previously unexploited economies of scale particularly for Canada, whose market would increase 12-fold compared with a 7 percent increase in the United States.

Empirical estimates of the real income gains from free trade are highly sensitive to the underlying model used. Estimates of the gains for Canada range from 2 1/2 to 9 percent of GDP (Canada Department of Finance, 1988). The estimate at the upper end of this range is based on a general equilibrium model with imperfect competition and increasing returns to scale (Harris and Cox, 1984), whereas lower estimates measure the consumption and production gains without taking economies of scale into account. Based on the optimum conditions reviewed in the previous section, the gains for the U.S. are likely to be lower than for Canada. First, Canada is by far the smaller partner, so that its terms of trade would tend to improve by the bilateral tariff-cutting as it exports to the U.S. at the U.S. domestic price, i.e. the tariff-inclusive world price. Second, the gains from the achievement of economies of scale are likely to be much more important for Canada than for the U.S. On the other hand, the higher initial level of Canada's tariffs compared to the U.S. implies that the scope for both trade creation and trade diversion is greater for Canada than for the U.S.. If trade balance effects are taken into account, bilateral tariff cuts could worsen Canada's trade balance, causing a depreciation in the exchange rate and terms of trade losses for Canada.

Whatever their size, the real income gains in both countries resulting from free trade can be expected to increase the demand for imports from the rest of the world. This income effect

would tend to offset at least part of any losses incurred by third countries on account of trade diversion resulting from relative price changes.

The effects of the FTA's provisions on the reciprocal opening of investment, trade in services and government procurement are more difficult to analyze. The present level of protection in these areas is less easily measurable than tariff and quota protection governing trade in goods, and the extent to which the FTA may give rise to discrimination is difficult to judge in the absence of detailed country-specific data on trade in services. The extent of discrimination inherent in any bilateral arrangement would obviously depend on the extent to which bilateral liberalization is extended to third countries through reciprocal market-opening measures negotiated on a bilateral or multilateral basis. The ongoing negotiations on trade in services in the Uruguay Round provide an opportunity for multilateral liberalization of trade in services, which would reduce the scope for trade diversion in this area.

In the area of safeguards, the degree of discrimination would depend on sectoral trade developments in the two countries, on the frequency with which safeguard measures are invoked, and on the manner in which the agreement is implemented in practice. Exemption of U.S. or Canadian exports from global safeguard measures adopted by either country could place a disproportionate burden of export restraint on third countries. The effects of this eventuality on third countries could nevertheless be mitigated by the exception included in the agreement in the event that exporters from one country account for an important part of the import surge in the other country.

(b) Single European Market⁹

The Single European Act, which came into effect on July 1, 1987, provides for the removal of remaining impediments to the free movement of goods, services, and factors of production within the EC by 1992. Although all tariffs and quotas on intra-EC trade were eliminated in 1968, the EC internal market continues to be segmented by regulatory barriers that impede trade flows. These include different national standards, barriers to entry and competition, discriminatory government procurement practices, border formalities and national quantitative restrictions against the rest of the world. These regulatory barriers distort the allocation of resources within the Community and raise production costs by creating monopoly rents, preventing the achievement of economies of scale, and imposing administrative costs.

Studies commissioned by the EC estimate the gains from the creation of a truly "single" internal market at 4.5 to 7.5 percent of GDP (EC Commission, 1988). These estimates include the gains from achieving economies of scale, and differ by the extent to which domestic macroeconomic policies make use of the room created by the release of productive resources from inefficient uses. Subsequent estimates based on the premise that higher investment in the EC will lead to a permanently higher growth path range from 9 to 35 percent of GDP (Baldwin, 1989).

The estimates of the real income gains from the formation of a single European market assume that barriers against the rest of the world do not increase. If so, the EC's trading partners would clearly benefit by expanding their exports to a market with greater growth potential. A unified market of 320 million people with common technical standards and without internal borders also provides opportunities for third country exporters to achieve greater economies of scale. However, important aspects of the EC's external regime after 1992 have not yet been

⁹ The Single European Market is discussed in greater detail in Kelly et al. (1988), Annex I.

defined. Access to the EC market could be limited if existing national quantitative restrictions were to be replaced by EC-wide restrictions. Special interests within the EC--particularly in the automobile sector--are pressing for the most restrictive national regime to be adopted on an EC-wide basis after 1992. In this event, barriers against the rest of the world may, on balance, increase in certain sectors, with adverse consequences for third country exporters.

In the areas of services and government procurement, the EC has taken the position that access to the single European market will depend, to a yet unspecified extent, on reciprocal concessions by its trading partners. The only decision reached so far in these areas is the Second Banking Directive, approved by the EC Council in 1989, which seeks reciprocal treatment for EC banks abroad as a condition for permitting non-EC banks to enter the EC market. The reciprocity provisions are based on "national treatment", but includes provisions for the EC to negotiate "equal access" in cases where domestic regulations in third countries restrict market access. As is the case with the U.S.-Canada agreement on financial services, the single European market thus provides a framework by which internal liberalization could be extended to third countries through reciprocal market-opening measures. Its effects on third countries will depend on how the "equal access" provision is used in practice.

Other areas in which the EC's external regime is now being defined include standards and government procurement policies. Differences in standards, testing, and certification requirements have been rated by industrialists as the single most important barrier to intra-EC trade. (EC Commission (1988), p.51). The mutual recognition of national standards within the EC is consequently expected to result in significant savings by avoiding the duplication of certification procedures and the modification of production runs to comply with different technical requirements across the Community. The removal of such technical barriers to trade within the EC could act as a barrier if third countries are given the benefit of single-point access to the EC,

and if the EC standards adopted discriminate in favor of EC producers. Although the EC has not yet reached decisions with respect to the treatment of third countries in the area of standards, legislation is already pending in the U.S. Congress calling for retaliation against the EC in the event that it discriminates against U.S. companies. Similar controversies surround the recent EC draft directive calling for a small price advantage in favor of EC suppliers.

(c) Regional integration in Africa

Proposals have recently been advanced for a regional integration initiative in Africa. The World Bank is exploring ways in which it could assist the integration process through its lending operations and analytical work (see, for instance, Wodajo (1988)). Impetus to these proposals has been provided by three factors. First, the need to enhance growth prospects and debt servicing capacity in Africa; second, the need to diversify exports into higher value-added products in order to reduce the variability of export receipts; and third, the prospective loss of preferences extended to African countries by the EC under the Lomé Convention in the event that world trade in tropical products is liberalized in the Uruguay Round of trade negotiations. A reduction in internal barriers to trade is expected to increase opportunities for industrial expansion and to attract foreign investment by increasing market size.

In assessing the potential trade-creating effects of regional integration in Africa, it is instructive to note that existing preferential trading arrangements in Africa have failed to increase intra-area trade (Table 2). Foreign exchange shortages cannot explain the stagnation of intra-area trade because they apply equally to trade with third countries. The reasons for the stagnation of intra-area trade must therefore be sought elsewhere. Similarly, it is not clear that market size is a major constraint on foreign direct investment flows in Africa. With a market size amounting to about one third of the total in Sub-Saharan Africa, Nigeria has received proportionately lower

direct investment inflows in the first half of the 1980's compared to countries with considerably smaller markets, such as Cote d'Ivoire and Kenya.

A major factor limiting the possibilities of expanding intra-area trade is that Africa's production structure is geared to agricultural and mineral commodities, whose homogeneity limits trading opportunities. Intra-industry trade has provided most of the impetus for the expansion of trade among industrial countries in the post-war period. A convincing case for the trade-creating potential of an African preferential trading arrangement would have to rest, at least in part, on the similarity of the area's industrial production structure and on the different degrees of production efficiency for any given product. The scope for trade creation would then be largest, as each country contracts its comparatively inefficient industries and expands its most efficient. Conversely, the scope for trade diversion would be limited if, and only if, barriers against third countries were low. A risk would otherwise exist that short-term growth would be achieved at the expense of long-term efficiency if regional trade integration led to inefficient import substitution behind trade barriers against third countries. The scope for trade diversion in an African regional trading group is large given the relatively high average level of tariffs of African countries. This scope would increase further if a common external tariff were contemplated, involving an averaging of existing national tariff schedules, rather than a free trade area.

The existence of substantial unrecorded trade in Africa is sometimes interpreted as an indication that profitable trade opportunities do exist. However, cross-country price differentials that give rise to unrecorded trade are often caused by policy-induced distortions rather than differences in comparative advantage. Aside from tariffs, these include currency misalignments. Progress toward dismantling internal trade barriers in the presence of currency overvaluation

could result in severe distortions in the pattern of specialization. It is thus not clear that regional integration should be undertaken in the presence of domestic distortions.

10. Implications for the world trading system

The trend toward preferential trading arrangements has a bearing on the international trading system and on the ongoing Uruguay Round of trade negotiations. This trend can alternatively be viewed as a start toward multilateral liberalization or as a fragmentation of the world trading system into protective trading blocs that would undermine the MFN principle of GATT. The risk of fragmentation includes two elements: first, the discrimination inherent in preferential trading arrangements. Second, the risk that protective barriers erected by trading blocs against third countries could increase compared to existing barriers imposed by individual countries in the bloc. An additional risk is that bilateral liberalization could reduce the stake of participating countries in the success of the ongoing multilateral trade negotiations.

These risks are relatively small with respect to the known elements of the two major recent initiatives--the U.S.-Canada FTA and the single European market. As noted in the previous section, both of these could result in substantial real income gains for the areas concerned. These gains would benefit trading partners and would tend to offset any trade diversion effects, although third-country suppliers of products that enjoy relatively high protection in these areas may be adversely affected.

Regarding barriers against third countries, there is little indication that the U.S.-Canada agreement would involve an increase in such barriers because it does not involve tariff averaging. Some of its effects will nevertheless depend on how the agreement is implemented, particularly in the area of safeguards. Indeed, the agreement may strengthen the multilateral trading system and contribute to multilateral liberalization in a number of ways. First, it demonstrated that trade

liberalization is feasible at a time when protectionism is on the rise. Of particular note are the steps toward liberalizing trade in agriculture, which has long been regarded as an area where liberalization is difficult or impossible. Second, certain aspects of the agreement could serve as a model for multilateral agreement in the Uruguay Round. These include the agreement on services, investment, standards, government procurement, the dispute settlement mechanism, and the use of export subsidies in agriculture. These areas, which are included in the agenda of the Uruguay Round, account for the majority of trade frictions in recent years. Third, as pointed out by Smith (1988), it may provide an incentive to third countries to negotiate tariff reductions on their major export products in the Uruguay Round so as to reduce the advantage gained by competing suppliers in the United States or Canada on each other's market. The same argument applies to services, trade-related investment measures, technical standards, and government procurement that are also on the agenda of the Uruguay Round. Fourth, the agreement does not prevent either country from extending the same treatment to third countries in all areas covered by the agreement. It thus provides a framework that opens up the possibility for other countries to join if prepared to undertake similar commitments, thus extending the size of the free trade area. On the other hand, the accession of new members would dilute the benefits of membership to the existing members, who would thus have an incentive to resist such expansion. This could be the case, for example, vis-a-vis Canada if a free trade agreement between the U.S. and Mexico were to be concluded.

Along similar lines, the Single European Act carries the potential to contribute to multilateral liberalization by eliciting reciprocal market-opening measures in third countries. The Uruguay Round provides a forum in which such concessions can be negotiated, given that its agenda overlaps with the EC internal market program. Alternatively, the EC may pursue bilateral negotiations with individual trading partners. While this approach could lead to greater openness

of the world trading system, it also carries the risk of discrimination against third countries and fragmentation of the trading system. These risks will be lessened if the Uruguay Round results in a reciprocal opening of trade and in agreement on permissible safeguard measures. The EC representative in GATT has made it clear that the EC will set its own rules in the event that the Uruguay Round fails to produce multilateral rules (Financial Times, October 20, 1988).

The single European market initiative has prompted European countries that are not members of the EC to seek closer economic relations with the EC. Countries with which the EC maintains association agreements (Cyprus, Malta, and Turkey) have tried to expedite their accession to the EC mainly out of concern that they may otherwise not reap the benefits of the unified EC market. The same consideration has prompted the members of the European Free Trade Association (EFTA)¹⁰ to pursue bilateral discussions with the EC or explore the possibility of joining the EC. Similar discussions on a possible trade agreement are underway with Eastern European countries. Exports of industrial products from both the EFTA countries and the associate EC member countries already benefit from duty-free treatment in the EC market under trade agreements signed in the 1960s and 1970s. However, the EC internal market could have an adverse impact on their exports of services and agricultural products that are generally not covered by the agreements. Moreover, they could be left out of important decisions regarding the harmonization of EC standards, with adverse consequences for their exports. Failure to reach multilateral agreement in these areas in the Uruguay Round could therefore result in an inward-looking European trading bloc.

Similar trends are apparent in the Pacific area. The suggestion that the United States may conclude a free trade agreement with Japan could force Australia to promote a Pacific trading

¹⁰ Austria, Finland, Iceland, Sweden, Switzerland, and Norway.

bloc. With 27 percent of its exports going to Japan, Australia would have a clear incentive to join the free-trade area as a means of overcoming the competitive advantage that the United States would gain on Japan's market. The idea of a Pacific free-trade zone is an old idea that has been rekindled as a result of "frustration with the lack of real and substantial progress to reform the international trading framework" according to the deputy managing director of the Australian Trade Commission (Journal of Commerce, October 4, 1988). While representing a step toward liberalization within the area, a Pacific free-trade area could divert trade from efficient suppliers in third countries, including heavily indebted developing countries. Examples include agricultural and --to a lesser extent-- mineral exports from a number of Latin American countries.

In the event that an African trade bloc is formed, the resulting trade diversion may be less significant as a proportion of world trade because the size of Africa's market is considerably smaller than that of the EC and the Pacific zone. The loss in exports could nevertheless be important for individual exporters. The amount of trade diverted would be larger the higher the tariff and nontariff barriers Africa raises against the rest of the world. A common external tariff, even if no higher than the present African average, could imply significant trade diversion--and a consequent real income loss--for African countries with below-average tariff rates. If integration is attempted before domestic prices are adjusted to reflect world prices in African countries with overvalued exchange rates, distortions in the pattern of specialization would be compounded.

A fragmentation of the world trading system into protective trading blocs would be inconsequential if the present volume of trade between these blocs were small. But this is not the case, particularly for the United States. Exports to the EC amount to more than one fourth of U.S. exports and 7 percent of Japan's exports; EC exports to the combined markets of the United States and Japan amount to more than 10 percent of its total exports. This implies that the formation of trading blocs in Europe and the Pacific area carry the potential for substantial

trade diversion toward members of the bloc. This potential would be proportional to the barriers erected against the rest of the world.

The prospect of fragmenting the world trading system into trading blocs raises the stakes in the success of the Uruguay Round. A bilateral approach to liberalization may reduce the commitment to multilateral liberalization. But it may also force the pace of multilateral negotiations by providing an incentive to nonparticipating countries to liberalize trade on an MFN basis in order to reduce the competitive edge gained by participating countries.

Table 1: Regional Trading Groups

EC	(January 1, 1959; Treaty of Rome 1957) European Economic Community (France, Germany, Italy, Benelux) January 1966: internal tariffs abolished 1973: U.K., Ireland and Denmark join EC 1981: Greece joins EC 1986: Spain and Portugal join EC
EFTA	(1960; Stockholm Treaty, November 1959) European Free Trade Association (Austria, Finland, Iceland, Norway, Sweden, Switzerland)
CACM	(1960) Central American Common Market (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua) 1966: internal trade freed.
LAFTA	(June 1961; established 1960) Latin American Free Trade Association (Mexico and all South American countries except Guyana, French Guiana, Surinam)
UDEAC	(1964) Customs and Economic Union of Central Africa (Congo, Gabon, Cameroon, Central African Republic)
ASEAN	(1967) Association of Southeast Asian Nations (Thailand, Singapore, Indonesia, Philippines, Malaysia)
CARICOM	(1973) Caribbean Community (All english-speaking Caribbean countries)
MRU	(1973) Mano River Union (Liberia and Sierra Leone)
CEAO	(1974) West African Economic Community (formerly West African Customs Union, 1959) (Cote d'Ivoire, Mali, Mauritania, Niger, Senegal, Burkina Faso; Benin since 1985)
ECOWAS	(1975) Economic Community of West African States (16 countries)
CEPGL	(1976) Economic Community of the Great Lake Countries (Burundi, Rwanda, Zaire)

- LAIA (1980, Treaty of Montevideo) Latin American Integration Association
(formerly LAFTA, 1960)
(Mexico and all South American countries except Guyana, French Guiana,
and Surinam)
- SPARTECA (January 1, 1981) South Pacific Regional Trade and Economic Agreement
(Australia, New Zealand, Fiji, Papua, other small countries)
- GCC (1981) Cooperation Council of the Arab States of the Gulf
(Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates)

Table 2
Share of Intra-Area Exports to Total Exports
in Regional Trading Groups, 1960-86

(in percent)

	1960	1970	1976	1981	1985	1986
EC (10) 1/	38.9	55.3	50.4	52.7	54.3	56.4
EFTA 2/	11.7	18.1	16.9	14.1	13.6	14.6
ASEAN	21.7	14.7	13.9	18.9	17.9	-
UDEAC	1.6	3.4	3.9	3.0	2.0	-
CACM	7.5	26.8	21.6	20.7	15.9	-
CARICOM	9.0	7.3	6.7	7.4	5.5	-
LAIA	7.7	10.2	12.8	12.6	9.6	-
CEAO	2.0	2.3	6.7	10.1	7.1	-
ECOWAS	1.2	2.1	3.1	4.6	2.5	-
CEPGL	0.0	0.2	0.1	0.2	0.8	-
MRU	0.0	0.1	0.2	0.1	0.4	-
Memo items:						
U.S.-Canada	25.8	38.6	37.0	28.1	38.0	36.7
U.S.-Mexico	19.5	22.1	22.0	19.8	25.8	24.2

Sources: UNCTAD and IMF, Direction of Trade.

1/ Excludes Spain and Portugal, which joined in 1986.

2/ Includes only the present six members; the United Kingdom, which left the EFTA to join the EC in 1973, is excluded.

Table 3. Post-Tokyo Round Tariffs on Industrial Products by Sector¹

Percent

<u>Sector</u>	<u>Canada</u>	<u>United States</u>	<u>All industrial countries (average)</u>
Textiles	16.7	9.2	8.5
Wearing apparel	24.2	22.7	17.5
Leather products	6.3	4.2	3.0
Footwear	21.9	8.8	12.1
Wood products	3.2	1.7	1.9
Paper and paper products	6.7	0.2	4.2
Printing and publishing	1.0	0.7	1.5
Chemicals	7.5	2.4	6.7
Rubber products	6.7	2.5	4.1
Nonmetal mineral products	6.4	5.3	4.0
Glass and glass products	7.2	6.2	7.9
Iron and steel	5.4	3.6	4.4
Nonferrous metals	2.0	0.7	1.6
Metal products	8.5	4.8	6.3
Nonelectrical machinery	4.5	3.3	4.7
Electrical machinery	5.8	4.4	7.1
Transportation equipment	1.6	2.5	6.0
Miscellaneous manufactures	5.4	4.2	4.7
All industries	5.2	4.3	5.8

Source Alan V. Deardorff and Robert M. Stern, "Economic Effects of Complete Elimination of Post-Tokyo Round Tariffs," in William R. Cline, ed., Trade Policy in the 1980s (Washington, D.C.: Institute for International Economics, 1983), pp. 674-75.

¹Weighted by own-country imports, excluding petroleum.

Figure 1a. Welfare Effects of Trade Creation

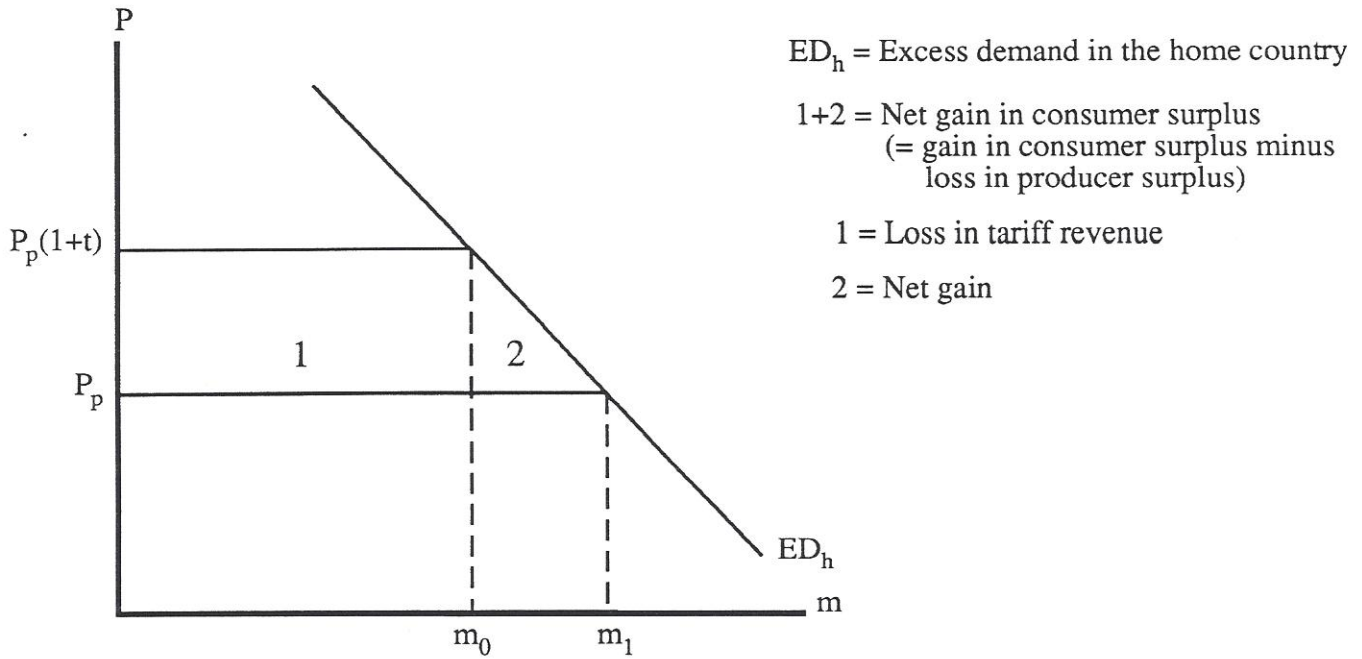


Figure 1b. Welfare Effects of Trade Diversion

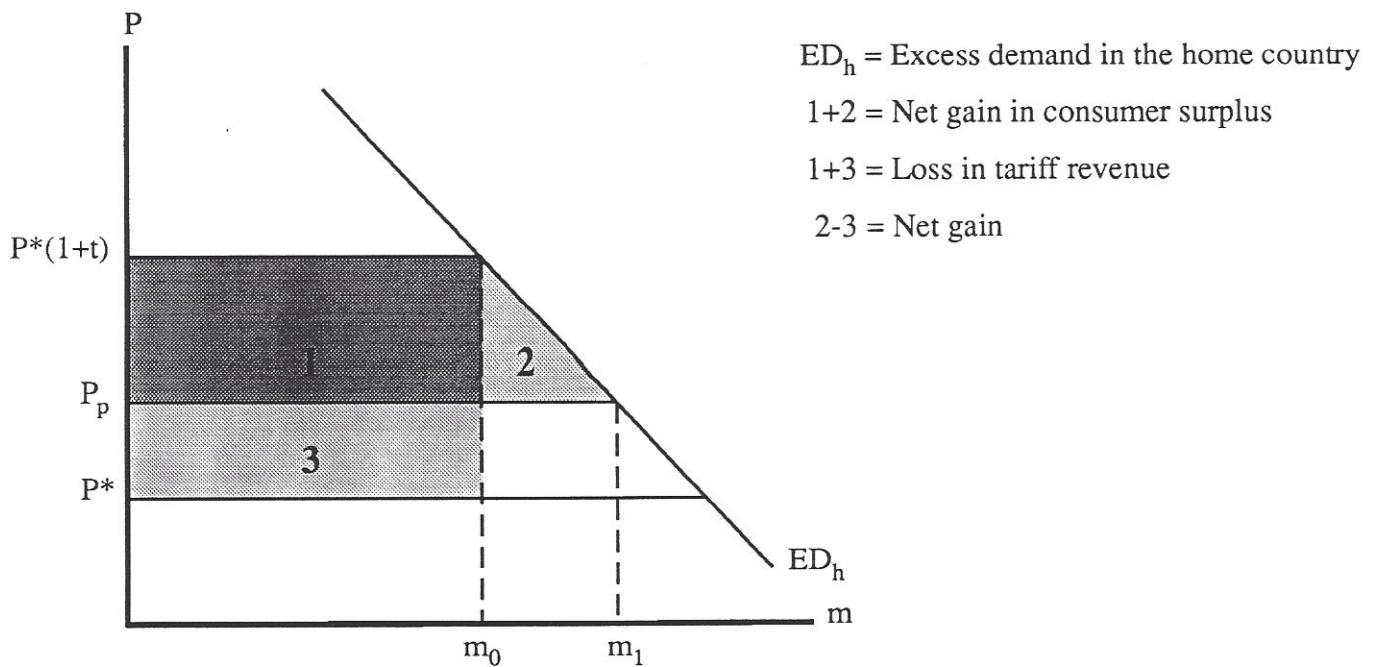
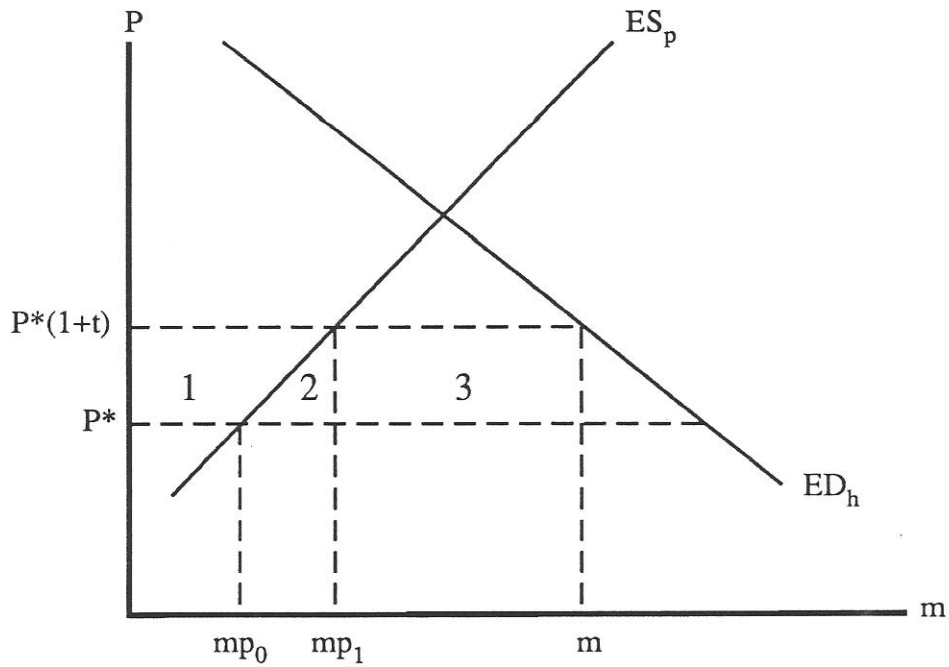


Figure 2. Welfare Effects of Trade Diverting Customs Union



ED_h = Home excess demand curve

ES_p = Partner excess supply

1+2 = Loss of tariff revenue for the home country

1 = Gain in producer surplus for partner

2 = Net cost of union (borne by home country)

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