

The Proliferation of Regionalism: Motivations and Effects

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Economics 191B
June 4, 2004
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“The ordinary means therefore to increase our wealth and treasure is by foreign trade, wherein we must ever observe this rule; to sell more to strangers yearly than we consume of theirs in value.” Thomas Mun, 1664.

The movement of goods and services across borders has been a concern for as long as nation-states have existed. Now, in today’s modern society of globalization, this concern has never been more prominent and real. The growing integration and compression of the world’s peoples, places, and states, and the blurring of their territorial boundaries has been the subject of many recent debates. As countries open their economies and reduce protectionist barriers, disputes about the costs and benefits of trade have been brought to the surface. The scene of virtually every major meeting of international organizations regarding economic liberalization is now one of raging street battles and demonstrations.¹ The death of a protestor in Genoa in 2001 attests to the seriousness of advocates and protestors. Classical economic theory, dating back two centuries, promise production and welfare gains from trade and liberalization. Has something gone wrong?

Recent years have brought about a proliferation in economic liberalization and free trade agreements around the globe. Even marginalized developing countries are participating in this phenomenon. Economic liberalization can occur in the form of multilateralism – such as negotiations made by the GATT – or regionalism. Not only has there been a trend for countries to reduce trade barriers on a global level, but there has been a surge in regional economic integration agreements. Countries are no longer only relying on international multilateral negotiations, but are initiating regional reductions of trade barriers. By the end of 1994, every country in the Western hemisphere, with the exception of Cuba, Dominican Republic, Haiti, Panama, and Surinam, was a member of a regional pact.² The focus of my paper will be on the emergence of these regional agreements. Why has there been a surge in regionalism?

Furthermore, what are the effects of these regional agreements, as compared to multilateral agreements? Economic integration may have significantly different implications for industrialized nations and less developed nations. Thus, I will examine the Western hemisphere as it contains both developed countries as well as Third World countries. Because early international trade theory is the foundation for present-day theory, I will begin my research by examining classical and neoclassical trade theory. I will then discuss regional trade agreements in detail and distinguish it from multilateralism. Next, I will offer arguments for the motivations behind nations joining regional pacts in recent years. Lastly, and most importantly, I will investigate the effects of these trade agreements. It is important that we explore these issues with the approach of 2005 – the set date for the start of the FTAA, a hemispherical trade agreement.

TRADE THEORY – CLASSICAL AND NEOCLASSICAL

Adam Smith's *Wealth of Nations: An Inquiry into the Nature and Causes* established him as the single most influential figure in the development of economic trade theory. Challenging Mercantilist ideas that national wealth was reflected in a country's holdings of precious metals, Smith convincingly argued that a nation's wealth was actually reflected in its productive capacity. Further, growth in productive capacity was fostered best in an environment where individuals are free to pursue their self interests. Self interest would lead individuals to specialize in and exchange goods and services based on their own special abilities. Thus, gains are acquired through division and specialization of labor. Smith saw little need for government control and advocated laissez faire. In a setting where individuals in a nation can pursue their self interests, countries would specialize in and export goods in which they have an absolute advantage. This positive-sum game theory was a strong argument for free trade and the elimination of government imposed protectionist measures.

David Ricardo expanded upon Smith's theory. Ricardo argued, in *The Principles of Political Economy and Taxation*, that gains from trade are even greater than Smith had advocated. He pointed out that countries not only can gain in an absolute advantage scenario, but also in a comparative advantage case. That is, in a two commodity two nation context, even if one country is relatively more efficient at producing both products, both will still gain from trade if each produce the good in which they have a comparative advantage. Thus, countries gain by expanding production of and exporting the commodity that is relatively more valuable in the foreign market and reducing production of and importing the good that is relatively less valuable in the foreign market.

The neoclassical theory of trade takes the Ricardian model a step further to include differences in supply conditions. The works of Heckscher and Ohlin tell us that when two countries have different input factor endowments (amount of labor and amount of capital available), a country will export the commodity that uses relatively intensively its relatively *abundant* factor of production, and import the good that uses relatively intensively its relatively *scarce* factor of production.³ For example, assume the world is simplified into two countries (the United States and Mexico) that produce and consume two goods, one of which uses capital relatively intensively and one which uses labor intensively. In the absence of government intervention, we should observe that the United States, relatively abundant in capital, will export the capital-intensive good, and Mexico, relatively abundant in labor, will export the labor-intensive good. Theory also states that relative factor prices will be equalized in the trade equilibrium between the two countries.⁴ Furthermore, theory states that with full employment, there will be a price increase in the good that uses the abundant factor relatively intensively and a price decline in the good that uses the scarce factor relatively intensively. Free trade depicted in

this scenario produces winners and losers. Owners of the abundant factor will see an increase in real income and the owners of the scarce factor will see a decrease in their real income.⁵ Given this, it is hardly surprising that owners of the relatively abundant resources are usually pro-free trade, and owners of relatively scarce resources are usually anti-free trade. Generally, however, the number of winners is greater than the number of losers and international trade is considered a positive-sum game, offering greater efficiencies and wealth.

These theories are the foundations upon which international trade agreements and regional trade agreements are built upon. The promoters of the liberal trade regime, first originating after World War II, stipulate that the creation of an efficient market with little state intervention and reliance of the laws of comparative advantage are the preconditions for economic development.⁶ International institutions, such as the GATT (now the WTO), the IMF, and the World Bank, were erected to negotiate, facilitate, and enforce the elimination of restrictions and the promotion of trade.

In the context of today's globalization of the world economy, free trade is even more important. Advancements in communication and transportation technologies have brought the world closer to a single global market. In such an environment, nations and private corporations must compete worldwide for product sales, and they must strive for the most efficient utilization of the factors of production across national borders. They need to combine labor, capital, and technology efficiently without regard to national borders. The elimination of trade barriers would allow firms to combine and draw from heterogeneous characteristics in terms of factor endowments.⁷ This decreases production costs and increases consumer welfare.

Furthermore, the possibilities are endless and the theory of complete free trade seems more and more feasible. Artificial barriers to the flow of goods, services, capital, knowledge,

and people across borders have been broken down.⁸ The expansion of international organizations and the continuous rounds of multilateral trade negotiations have seemingly consolidated the system of economic liberalization. The latest round of negotiations, the Uruguay Round, brought all GATT members “under a single undertaking with a common system of rules.”⁹ There has been a multiplication and strengthening of substantive international norms, demonstrating that countries are more willing to integrate into and benefit from the multilateral trade order.¹⁰ Why is it, then, that more and more countries are turning to regional integration rather than multilateral negotiations? Developed, as well as developing, countries have recently focused more effort on regional trade agreements rather than multilateral trade agreements.

REGIONAL ECONOMIC INTEGRATION – DISTINGUISHING BETWEEN REGIONALISM AND MULTILATERALISM

To understand why nations are engaging in regional integration, we must first understand the different implications and effects of multilateralism versus regionalism. Regional economic integration is a partial movement to free trade. The participating countries in the arrangement obtain some of the benefits of a more open economy without sacrificing complete control over the goods and services that cross its borders.¹¹ Regionalism is the preferential reduction of trade barriers among a subset of countries that might be geographically contiguous, a strategy of discrimination in liberalization.¹² Regional pacts take the form of four possible levels of integration:

1. *Free Trade Area*: all members of the group remove tariffs on each other’s products, while at the same time each member retains its independence in establishing trading policies with nonmembers. The trade agreement between the United States, Canada, and Mexico, NAFTA, fits into this category.

2. *Customs Union*: all tariffs are removed between members and the group adopts a common external commercial policy toward nonmembers. The group acts as one body in negotiations with nonmembers. The Latin American trade agreement Mercosur is an example of a customs union.
3. *Common Market*: all tariffs are removed between members, a common external trade policy is adopted by nonmembers, and all barriers to factor movements among the member countries are removed. This is clearly a higher level of economic integration. CARICOM, the agreement between the Caribbean countries, fits into this group.
4. *Economic Union*: contains all of the features of a common market, but also includes the unification of economic institutions and the coordination of economic policy throughout all member countries. This level of integration calls for the establishment of several supranational institutions and national sovereignty is greatly reduced.¹³ The European Union, not examined in this paper, is an example of an economic union.

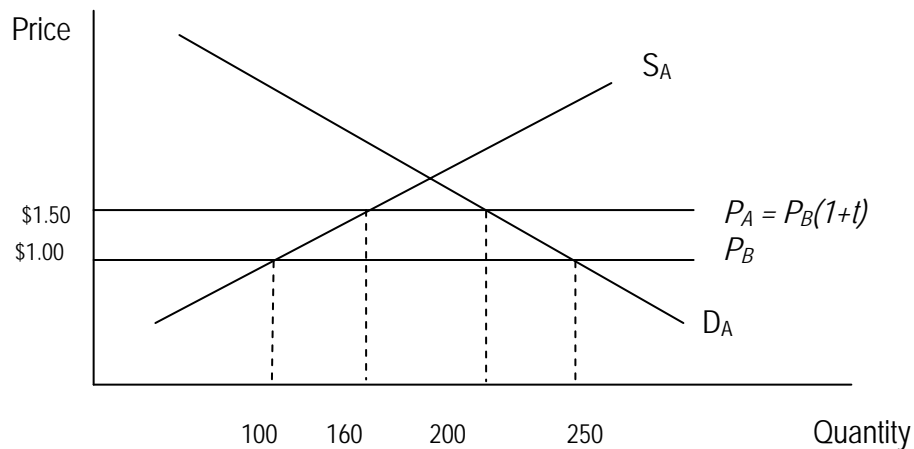
Nearly all of the 134 WTO members have now concluded regional trade agreements with other countries.¹⁴

Because regional trade agreements may include protection measures against nonmembers, the benefits of regional liberalization are contested and not as widely held to be as efficient as multilateralism. The world of regional liberalization is one of second best. Regionalism means a shift in the pattern of trade between members and nonmembers, and thus, the net impact is ambiguous. It is a step towards liberalization, but at the same time, it may lead to inefficient trade barriers for nonmembers. Effects of regional economic integration can be categorized into static and dynamic effects.

Static Effects

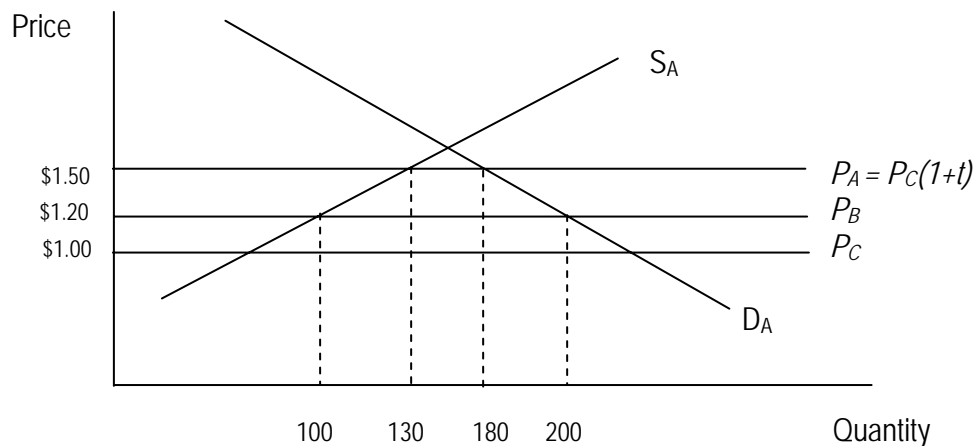
Static effects are the direct results of the formation of regional economic integration.¹⁵

The two static effects of economic integration are trade creation and trade diversion. Economic integration leads to a shift in production origin from a domestic producer whose resource costs are higher to a member producer whose resource costs are lower. This, called trade creation, leads to an increase in welfare. In the diagram below, the price in country A is \$1.50, the same as the price in country B with a 50% tariffs. Before liberalization, country A produced 160 units and imports 40 units from Country B. After liberalization, country A produces only 100 units and imports 150 units. Consumers benefit by greater consumption at a lower price. Consumers now only have to pay \$1, rather than \$1.50. Producers benefit by lowering production and moving resources to a more efficient industry.



These changes are clearly advantageous for countries both A and B. However, regional integration may also lead to trade diversion. This is a shift in product origin from nonmember producers whose resource costs are lower to a member country producer whose resource costs are higher. This could lead to a decrease in welfare. In the diagram below, countries A and B are trading partners, and country C is an outsider. If Country A and B establish a common

external tariff on Country C, then Country A will import the good from country B rather than country C (who actually has the lowest price). This is inefficient because welfare in this scenario could be increased by eliminating tariffs on country C imports. Without any barriers to trade, countries A and B would import the good from country C. consumers of A and B would pay a lower price and firms could move their resources to a more productive industry. Country C would also benefit by increasing production of this good and importing toher goods from countries A and B (goods in which countries A and B have a comparative advantage in producing).



Dynamic Effects

In addition to these static effects, regional integration can also lead to numerous positive dynamic effects. Dynamic effects are indirect effects of liberalization arrangements. First, the economic integration of a country will lead to a more competitive environment and reduce the degree of monopoly power because companies are forced to compete with others in the economic union. Also, by expanding the size of the market, countries can take advantage of economies of scale. Further, liberalization will generate a greater amount of foreign direct investment due to the economy's structural change, the expected increase in income and demand,

and the reduced risk and uncertainty because of a larger market. Integration can also improve a nation's bargaining power in multilateral negotiations.

Less Developed Countries

The story for developing countries is even more complicated than that for industrialized countries. Certain general characteristics of LDCs have prompted many to advocate against free trade and regional liberalization. In addition to the negative trade diversion effects discussed above, Third World countries face other obstacles. Firstly, developing countries' economic systems tend to be unresponsive to changing price incentives. That is, factors of production may not move easily to the expanding low-cost sectors from the contracting higher-cost sectors. This will reduce the country's gain from trade. Secondly, even though trade theory postulates that LDCs will likely export labor intensive goods and thus, international trade will increase wages, this may not be true in LDCs. Because developing countries have high rates of unemployment, demand for labor will not increase wage levels by much because the supply of labor is not constrained. Thirdly, LDC's specialization area of agriculture and primary goods have certain uncertainties and risks that could lead to greater income instability. For example, unpredictable and uncontrollable weather conditions may significantly reduce a nation's agricultural production for a certain year. Because the country is in free trade and specializes in agriculture, a large decrease in agricultural production leads to a large decrease in exports, which, in turn, leads to a large decline in imports (assuming balanced trade).

Despite these negative effects, regionalism does offer positive static as well as positive dynamic effects of trade for Third World countries. Developed countries usually experience high rates of unemployment and so industries are unable to perform efficiently on their production possibility frontier (PPF). While trade will not provide the theoretically promised

benefit of increased wages, it will be an outlet for the “vent of surplus” of labor in Third World countries.¹⁶ The larger markets acquired through economic integration will permit countries to increase its output and employment, thus moving from the inefficient production point within the PPF to the efficient production point on the PPF. Furthermore, some of the positive dynamic effect discussed previously, such as the ability to take advantage of economies of scale, reduction of monopoly power, and increased foreign direct investment, is actually a greater source of gain for developing countries than industrialized countries. Nations such as the United States, who already produce mass quantities, are already taking advantage of economies of scale. Trade will not further increase their production by much. However, LDCs, usually small nations facing small markets, can gain a great deal with the access to larger markets. With the market size available to producers, trade can foster the development of infant industries into internationally competitive industries. In addition, many LDCs have monopolies or state-regulated enterprises. The liberalization process may have positive antitrust effects. Foreign direct investment could also increase much more dramatically in developing countries than in developed countries as an effect of economic integration. Traditionally unstable and small markets will be viewed with new optimism as changes take place in the economic environment.

MOTIVATIONS FOR REGIONAL INTEGRATION

If gains from multilateralism are uncontested but regional economic integration are associated with some negative effects, then why have so many countries sought regionalism? Why have countries not solely depended on multilateral liberalization? The answers to these questions differ for developed and developing countries. Countries, such as the United States, have a different set of reasons for turning to regional integration than developing countries.

U.S. Motivation

The United States has always pushed for multilateralism by initiating new rounds of liberalization negotiations through the GATT. This pattern of exclusive multilateral negotiations changed in 1982 when the Americans encountered European resistance to proposals at a GATT ministerial conference in Geneva. The US, frustrated at the lack of progress in multilateral negotiations, let it be known that they were willing to bargain with interested partners for regional economic integration. As it was well put by President Bill Clinton's deputy secretary of the treasury, the US was now "in favor of all the lateral reductions in trade barriers, whether they be multi, uni, tri, [or] plurilateral."¹⁷ Any progress towards the reduction in trade barriers was, if not the most efficient move, at least a move. In addition to the US's frustration at the lack of progress in the global arena, the US's shift towards regionalism was also motivated by the fact that it would have great agenda-setting control in the regional context. First, with multilateral negotiations, the US has to share the stage with other important actors such as the EU and Japan. Second, regional negotiations allow the US to push for an agenda that goes beyond possibilities of what can be achieved at the multilateral level. For example, the US interest in labor and environmental standards, while ignored at the multilateral level, were included as side agreements in NAFTA.¹⁸ Moreover, this aspect is particularly significant as international trade has shifted from trade in goods to trade in services, foreign investment, and intellectual property not covered or enforced by the WTO (though the recent Uruguay Round did secure some significant protection in these areas). The US, being the most advanced national economy in the world, has the strongest motivation to liberalize trade in services, investment, and intellectual property.¹⁹ Lastly, the US's pursuit of regionalism perhaps was catalyzed by Europe's success with the European Union. The EU's terms of scope, depth, and geographical area are truly

historical achievements and have encouraged emulation in the form of regional agreements in other parts of the world.²⁰

LDC Motivations

The causes of the proliferation of regionalism among developing countries are different than those for the United States. The history of Latin and Central America economic strategy was submerged in Import Substitution Industrialization (ISI) in the 1960s and 1970s.²¹ The model embraced an inward orientation and local production. The central idea of the ISI model was export pessimism, skepticism regarding private markets, and concerns about the presence of and dependence on foreign firms. The goal of the model was to industrialize by substituting imports behind high levels of national protection. These tariffs were as high as 150% to 200%. Furthermore, the model called for state planning and direct public sector intervention in the market. When juxtaposed to the economic trade theory discussed at the beginning of this paper, the ISI model is clearly inefficient. The complex structure supporting ISI wore thin and broke down with the debt crisis of the early 1980s. In addition, due to the inward-oriented economic strategy, countries began to observe stagnant export trade, high inflation, and economic instability.²² Due to these problems, developing countries abandoned ISI and turned to liberalization in the 1990s. The new economic liberalization strategy reinserted these countries into the globalizing world, increased trade, and increased investment and capital flows.²³ Most countries unilaterally liberalized trade, initiated structural changes, and participated in multilateral negotiations.²⁴ These new strategies were in part initiated by sovereign nations, and in part by international institutions. The debt crisis in Latin America forced these countries to seek help from the IMF and the World Bank. The short term and medium term loans for economic stabilization came with strict conditions of neoliberal economic reforms. Participation

in supranational economic integration schemes was part of the overall agenda of crisis management and structural adjustment.²⁵

However, as these developing countries began to open up and engage in multilateral negotiations, they found that their interests were consistently disregarded. The GATT was successful in reducing tariffs at the multilateral level, but the proliferation of non-tariff barriers to trade seemed to annihilate the benefits. Moreover, the GATT seems to have institutionalized measures that are opposite to the founding principles of the liberal order but beneficial to developed countries. For example, developing countries have a comparative advantage in agriculture and textile industries. According to economic free trade theory, then, these countries should export agriculture and textile. However, the GATT, under the mercy of developed countries, has established provisions that reversed the law of comparative advantage by exempting these industries from free trade. In agriculture, subsidies and quantitative restrictions were used by developed countries. In the textile industry, developed countries have also created separate agreements, violating GATT principles of liberalization.²⁶ Furthermore, the GATT has imposed several non-tariff barriers that are unfair for developing countries. An example of this can be illustrated by the Tokyo Round of GATT negotiations. As LDCs participated in the Tokyo Round in 1979, they recognized the need for further liberalization and to address the issue of non-tariff barriers. As a result, the Enabling Clause was introduced. However, the developed countries also managed to conclude side agreements, outside the conventional GATT framework, whose privileges and obligations were mostly restricted to the signatories of the codes. The issues covered included subsidies, dumping and countervailing duties, customs valuation, import licensing, and technical barriers to trade.²⁷ These further excluded developing countries. In such a context of helplessness, LDCs have turned to regional agreements, where

they can control the agenda. LDCs looked towards deeper integration, with the elimination of tariffs and non-tariff barriers. This process becomes exponentially complex as the number of countries increases. The advantage of a regional integration arrangement with a limited number of trading partners offers more potential for each actor's interests to be considered.²⁸ Regional agreements also allow for a more homogenous forum for negotiations.²⁹

THE POSITIVE OUTWEIGHS THE NEGATIVE – REGIONALISM OFFERS PROMISING PATH

I now turn to the effects of regional economic integration. The examination of regional schemes has revealed potential positive as well as negative effects of trade. The discriminatory effects of regionalism can be harmful for global welfare; however, there are significant economic and non-economic consequences of regionalism that may increase welfare. The trade and welfare implications of regional economic arrangements are difficult to determine and require the examination of a broad set of variables, not just that of trade diversion. Do the positive effects outweigh the negative effects? I argue, and will demonstrate in the following case studies, that most regional integration, though short of the utopian world of multilateral liberalization, is still beneficial for those involved. My argument rests on the fact that the positive dynamic effects outweigh the negative static effects of trade diversion in the current international context.

Static Effects

The main pessimism regarding regional economic integration deals with potential trade diversion effects. Theory implies that there could be an inefficient decline in trade with nonmember countries. However, many studies today show that trade diversion is minimal. The United States' tariffs are already at an all time low of less than 3 percent.³⁰ Studies including Latin American countries in a Free Trade Area of the Americas also reveal little trade

diversion.³¹ Tariffs in these countries have also dropped considerably and probably will reduce even further as multilateral negotiations continue in the background.³² Trade diversion would have been substantial around the Great Depression period, when all countries put up extremely high multilateral tariffs to increase domestic production and decrease unemployment. But today's economic environment mitigates this negative static effect.

In addition to low multilateral tariffs, there have been empirical studies done on the effect of regionalism on nonmember states. The conclusion drawn by Jeffrey A. Frankel in *Regional Trading Blocs* states that regionalism, in recent experience, has tended to increase trade with members as well as nonmembers. Regional integration gives rise to liberalization in general.³³ Frankel calculated a statistical model in which he attempted the net effect of regional trade agreements. He examined the dummy variable for "openness"; if tariffs and other barriers against imports from nonmembers remain unchanged when a given regional group is created, then the coefficient on the variable should be negative. If the coefficient is positive, then trade creation is the net effect. Estimates pooled from the years 1970, 1980, 1990, and 1992 depict optimistic stories with net positive results. The coefficient for the Western Hemisphere specifically showed significant positive coefficients in 1985 and 1990, the years when Latin America entered its era of economic integration. There was also evidence that suggests negative effects, but in general, countries that integrate into a regional group also open up to all potential trading partners.³⁴

Dynamic Effects

Dynamic effects also increase the positive net effect of regional integration. First, the attraction of foreign direct investment (FDI) is a significant effect that should not be left out of the consideration of regional trade agreements.³⁵ A country's economy becomes much more

attractive with regional integration, due to the bigger market size and the elimination of protection.³⁶ Econometric studies done on the relationship between FDI and trade revealed a positive correlation. Theoretically, FDI and trade are viewed as substitutes rather than complements. The logic is that if there are high barriers to trade which prevent firms from exporting into the protected market, then there would be an incentive for direct investment to jump the protective barriers. Empirically, however, FDI and trade seem to be complements.³⁷

Second, regional integration should be seen in a positive light because it offers a much faster and easier way for countries to let down their barriers of trade. While GATT negotiations seemed to drag on, regional negotiations were progressing rapidly. The conventional wisdom became “GATT is dead.”³⁸ Regional agreements such as NAFTA and Mercosur developed from the proposal stage to the implementation stage in just a few short years.³⁹ Not surprisingly, regional integration is much easier due to the smaller number of countries involved. Negotiation costs and transaction costs increase considerably with the increase of the number of countries.

Regional trade agreements, in sum, allow “smaller groupings of economies to achieve speedily more significant levels of cooperation.”⁴⁰ Third, regional integration promotes competition among other regions for further economic liberalization, leading to even more reduction in global trade barriers.⁴¹ For example, if NAFTA liberalizes to a greater degree, the APEC countries would feel the need to further liberalize in order to meet the expected increases in the NAFTA countries’ economic efficiency and to secure market access to NAFTA.⁴² Some scholars have termed this “competitive liberalization.”⁴³ Fourth, regional integration among countries with different development levels, such as the United States and Mexico, can create the transfer of technology to less developed countries.⁴⁴ This effect, along with access to a larger market and more resources, can greatly improve a country’s international competitiveness in the world

market.⁴⁵ Lastly, regional integration improves a nation's bargaining power in the global arena. This is especially true for extremely small countries, such as those in Central America. With GDPs and populations equivalent to those of small cities, Central American countries are threatened to be left out of global developments and ignored in multilateral negotiations.⁴⁶ When nations can enter into negotiations as a group, they will have a louder, unified voice.⁴⁷

NAFTA

Background

The North America Free Trade Agreement (NAFTA), an agreement creating a free-trade area with Canada, Mexico, and the United States, was signed in August 1992, and took effect on January 1, 1994. The regional agreement plans to eliminate all tariffs among the three members over a fifteen year period, as well as to reduce non-tariff barriers. Important sectors include automobiles, textiles and apparel, agriculture, energy and petrochemicals, and the financial services. For example, NAFTA's projection will reduce Mexican tariffs on automobiles from 20% to 10% immediately, then decline to 0% in the next 10 years.⁴⁸ NAFTA was met with great excitement as well as great cynicism and protest, being the first regional trade agreement that links the economies of a developed giant such as the United States, with a developing country such as Mexico. The differences between the United States/Canada and Mexico are enormous and have raised concerns about an integration of this form. The United States 1990 GNP per capita was \$22,000, while that of Mexico in the same year was under \$2,500. Furthermore, in 1992, Mexican wage rates were on average 15% of the average wage in the US.⁴⁹ It is evident that NAFTA has stirred emotions as more than 2,000 Mexican farmers marched in Mexico City to the Congress building in protest on December 3, 2002.⁵⁰ There are optimistic as well as pessimistic predictions of NAFTA's effect on the three countries involved. The US and Canada

already integrated to quite an extent through the earlier CAFTA. Thus, the main feature of NAFTA was the removal of trade barriers between Mexico and the two developed countries.

Mexico's ISI model of inward-looking development strategy began to falter in the early 1960s and hit rock bottom with the 1980s debt crisis. The beginning of the debt crisis brought an end to the ISI paradigm. In 1986, Mexico joined GATT and began to cut tariffs unilaterally.⁵¹ Since then, Mexico has made remarkable progress. It has reduced its public deficit from 17% to 1.5% of GDP in six years. Mexico's inflation has also dropped from 180% to 16%. With the renewed confidence in Mexico came a decrease in interest rates, an increase in capital flow, and enhanced investment opportunities.⁵² Mexico, with a bright future, sought out a trade agreement with the United States. It took the initiative to gain market access to the world's largest economy, to attract foreign business, and to enhance stability.⁵³

Economic theory stipulates that there are greater gains in efficiency and growth if the countries involved in trade have different labor endowments, productivity levels, capital markets, and natural resources. These differences lead to different comparative advantages.⁵⁴ Furthermore, theory tells us that there will be winners and losers in this situation. The US export winners include those in chemicals, plastics, machinery, and metal industries. The US losers include those in the business of citrus fruit, sugar, apparel, and furniture.⁵⁵ Unskilled jobs could shift from the US to Mexico. Jobs would be created. Jobs would be lost.

Ten years later, we have the benefit of hindsight. What have been the effects of NAFTA? Can the costs be justified by the benefits? I will examine the effect on Mexican exports, foreign direct investments, job creation, productivity, and welfare.

Trade

The US tariffs on Mexican products fell from 3.3% to 1.1%. Canadian tariffs on Mexican products fell from 2.4% to 0.9%. Tariffs on imported manufacturing goods entering the US fell from 5.8% to 1%. Mexico's import tariffs fell from 11% to 5%.⁵⁶ In 2001, 87% of imports from Mexico entered the United States duty free.⁵⁷ The Congressional Budget Office undertook a statistical analysis of NAFTA's effects on US and Mexican trade and GDP. Conclusions reveal that NAFTA has had a positive effect on both countries. NAFTA has increased both US exports to and imports from Mexico, and the number is increasing each year. Has there been a change in exports and imports? NAFTA has increased both US exports to and imports from Mexico, and the number is increasing each year. Increases in trade leads to greater economic output because they allow nations to concentrate its labor and capital on the industry at which it is the most productive relative to other countries. US trade with Mexico dramatically. Exports of goods to Mexico rose by almost a factor of six between 1982 and 1993 (pre-NAFTA), and tripled again by the third quarter of 2000. Mexico's share of US trade with the world also rose significantly. In 1982, exports going to Mexico from the US accounted for 3.7% of all US exports of goods. In 2001, that figure reached 14.2%. The figure below indicates the upward trend of trade between the US and Mexico.

U.S. Trade in Goods with Mexico

(As a percentage of U.S. GDP)



Source: Congressional Budget Office using data on trade from the Bureau of the Census and data on gross domestic product from the Bureau of Economic Analysis.

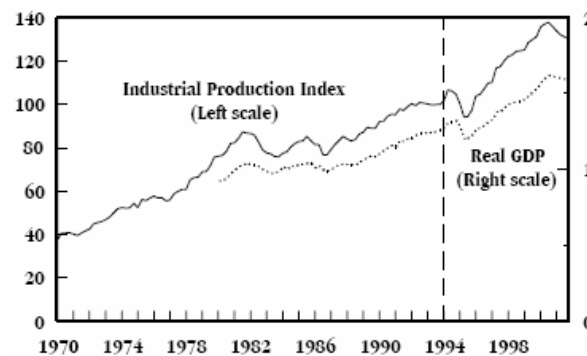
Note: The dashed vertical line marks the beginning of the North American Free Trade Agreement on January 1, 1994.

Furthermore, NAFTA has raised the US GDP by a small percentage, and raised Mexico's GDP by a larger percentage (due to the much smaller size of the Mexican economy). The following graph shows the Mexican industrial production and real gross domestic product.

Mexican Industrial Production and Real Gross Domestic Product

(Index, 1993 = 100)

(Trillions of 1993 Pesos)



Source: International Monetary Fund, *International Financial Statistics*.

Note: The dashed vertical line marks the beginning of the North American Free Trade Agreement on January 1, 1994.

As can be observed from the graphs, there has been a general positive trend of Mexican GDP as well as the trade between US and Mexico long before NAFTA. This raises the question of how much of the increase can be actually attributed to NAFTA. The CBO report constructed a statistical model to disentangle the effects of NAFTA from other causal factors. Results estimate that about 85% of the increase in US exports to Mexico between 1993 and 2001 would have taken place without the creation of NAFTA. Further, 91% of the increase in US imports from Mexico would have taken place without NAFTA. That is, 15% the increase in US exports and 9% of the increase in US imports were direct effects of NAFTA.

FDI

NAFTA has also attracted foreign direct investment into Mexico through several mechanisms. Because producers who set up plants in Mexico, where there is an abundance of cheap labor, have the luxury of exporting goods to the US and Canada duty free, there is a big incentive for foreigners to build production sites in Mexico. This is one form of FDI. From 1993 to 1994, Mexico's FDI doubled. Not surprisingly, post-NAFTA FDI has mostly been concentrated in regions with cheap labor and high population.⁵⁸

Jobs

The number of companies in the maquilador industry rose from 2,000 to 4,300 between 1993 and 1998. These industries hired between one and three million workers. Unemployment rate dropped to 2.3 in 1999. Some states, such as Aguascalientes, Chihuahua, Jalisco, Queretaro, and Guanajuato, now have full employment due to NAFTA.⁵⁹

Welfare

NAFTA has led to an increase in domestic industrial productivity under the more competitive, international environment. Consumers also benefit from higher quality goods at lower prices and a wider scope of choices.⁶⁰

As can be seen, NAFTA has brought tremendous change for Mexico and the US. NAFTA has made Mexico one of the major traders in the world. It is now the 8th leading exporter.

MERCOSUR (SOUTHERN CONE COMMON MARKET)

Mercosur was established by the Asunción Treaty, signed in March 26, 1991. The treaty forms a customs union between the countries Brazil, Argentina, Paraguay, and Uruguay. Mercosur took effect in 1995 and is the fourth largest economic bloc in the world in terms of GNP.⁶¹ Tariff and non-tariff barriers between the member countries were completely eliminated, except for some industries such as sugar and automobile. Because it is a customs union, Mercosur created a common external tariff for all the four countries against nonmembers. The common tariffs to imports from the rest of the world have 11 levels and range from 0% to 20%.⁶²

The effects of Mercosur have been controversial, with many advocating its benefits and others pointing to its negative consequences. I will examine Mercosur in light of trade diversion, FDI inflows into the region, and the average household welfare. Then I will look at a specific case study of a city in Brazil.

Trade Diversion

Because Mercosur is a customs union with a common external tariff, theory dictates that trade diversion may be a significant problem. The concern with a customs union is that it will raise trade barriers against nonmembers, thus undermining GATT achievements of reducing

international trade barriers since 1947. This is especially disconcerting because of the fact that Mercosur's tariffs to nonmembers are substantially above the post-Uruguay Round average in developed countries.⁶³ In a study done by Alexander Yeats, the results of Mercosur are pessimistic. Yeats researched the effects of regional trade agreements on trade creation and trade diversion. He examined the changes in the regional "orientation" of exports. That is, he looked at the nature of exporting goods and what input factors are used relatively intensively. By examining the trade patterns, Yeats found major changes in trade patterns since the formation of Mercosur. There is an increased relative importance in intra-regional trade. He identified inefficiencies in trade pattern, showing that trade was not evolving along the countries' comparative advantages. Testing the model of Mercosur, Yeats concluded that Mercosur countries are exporting capital intensive goods, while their comparative advantage is in labor intensive goods. 63% of Mercosur's intra-region trade is manufactured goods with Brazil, and over 81% of Brazil's exports to Mercosur countries are also manufactured goods.⁶⁴ The reason for this inconsistency is Mercosur's high trade barriers to nonmembers. The treaty has effectively encouraged high cost imports from member countries at the expense of lower cost goods from nonmembers. These manufactured (capital-intensive goods) are protected by higher than average trade barriers against nonmembers. Due to this protection, local producers have a strong incentive to produce capital intensive goods. This diverts exports from more competitive foreign markets to less competitive regional markets.

Clearly, Mercosur does have negative trade diversion effects. However, as I stated earlier, and as Yeats even points out himself, the static trade diversion effects do not fully account for the net effect of regional economic integration. Yeats states that there are many other benefits, such as enhanced negotiation power, better credibility in multilateral negotiations,

advantages of economies of scale, and other dynamic gains from trade, that contribute to the total net welfare effect of Mercosur.

Foreign Direct Investment

One key positive dynamic effect that is not taken into account in the static analysis is the increased inflow of FDI into the region. Because economic liberalization began with the signing of the Asunción Treaty in 1991, much of the FDI inflow began to accelerate from this period on, rather than from the establishment of Mercosur in 1995. Further research needs to be done to identify the direct cause of the increase in FDI into this region, but it seems that the combination of Mercosur countries' liberalization in general (the abandonment of the ISI model), their rise out of the debt crisis, and other stabilizing factors contributed to the acceleration in FDI. As can be seen in the table below, the inflow of FDI into the region more than tripled between 1989 and 1993.

<i>Foreign Direct Investment Flows into MERCOSUR Members (USD Million)</i>						
Year	1989	1990	1991	1992	1993	1994
Argentina	1,028	1,836	2,439	4,179	6,305	N/A
Brazil	1,131	989	1,103	2,061	1,292	3,072
Paraguay	13	76	83	42	50	N/A
Uruguay	38	39	30	N/A	102	170 ⁶⁵

Furthermore, the United States investment into the Mercosur nations significantly increased in 1995. US stock in the region increased by more than 25%, while the US growth rate of investment in the rest of the world is significantly lower than 25%.

US Direct Investment Position in MERCOSUR on a Historical-Cost Basis at Yearend, 1992 - 1995 ⁶⁶

<i>(Million USD; shares of total US FDI position in parentheses)</i>				
	1992	1993	1994	1995
Argentina	3,327 (0.66)	4,331 (0.77)	5,945 (0.96)	7,962 (1.12)
Brazil	16,313 (3.25)	16,822 (3.01)	18,798 (3.03)	23,590 (3.31)
Mercosur*	16,940 (3.91)	21,153 (3.78)	24,743 (3.99)	31,552 (4.43)

Welfare

An exploration into the average household welfare of those living in the region will shed light upon the impacts of Mercosur. A study by Guido G. Porto examines the distributional effects of Mercosur on Argentine families. Porto develops a methodology to empirically explore the effects of trade policies on the distribution of income and poverty in less developed countries. Using survey data, he econometrically assesses the general equilibrium effects of trade reforms. His methodology links trade policies to prices, and links prices to household welfare. Porto's main finding is that Mercosur benefits the average Argentine household across the entire income distribution. Furthermore, there is a "pro-poor" bias. That is, on average, the poor households gain more from the liberalization than middle-income households. These are extremely optimistic results that not only lead us to conclude Mercosur is beneficial, but that it also leads to a more equal income distribution.

Case Study of Rio Grande do Sul

Rio Grande do Sul, a city in Brazil, was traditionally one of the most important regions in the nation. Its economy rested on production and export of agricultural commodities such as rice, wheat, and soybean. It is one of the most prosperous cities in Latin America. Like the rest of the continent, it also has a long history of ISI. Rio Grande do Sul was unable to escape the impact of the recession and economic instability that hit Brazil in the 1980s. Unilateral economic liberalization prior to Mercosur affected the region's manufacturing sector negatively in the 1990s. Amidst the uncertain economic environment, Mercosur was welcomed as an option that could offer new possibilities to Rio Grande's economy.

Integration into Mercosur led to substantial positive changes as well as some negative impacts. The regional agreement generated an "avalanche" of foreign direct investment.⁶⁷ For instance, General Motors and Ford built car assembly plants in the region. Rather than being

viewed as a “take over,” as it would have been perceived during the era of ISI, these investments have been welcomed. Furthermore, exports from Rio Grande to other Mercosur countries grew in the 1990s.

Despite these positive effects, Mercosur has also had negative impacts on the region. It has led to the economic exclusion of a large part of the population. Although the region’s average per capita income has always been above the national average, and although the state takes pride in showing the highest Human Development Index of all Brazilian states, the economic development appears to be uneven. Over the past few years, many jobs have disappeared from the labor market, especially in industry and the public sector. There has also been rising unemployment.⁶⁸

I argue, however, that these negative impacts are inevitable if a state is to be lifted out of the inefficient, state-regulated, highly protected economies of the past. These negative social impacts reflect a short-term adjustment to new conditions of an efficient economy.⁶⁹

CARICOM

CARICOM, the Caribbean Common Market and Community, was originally established in 1973 and, much like other Latin American countries at the time, was based upon the economic development strategy of ISI.⁷⁰ This agreement calls for a common market with a common external tariff for fourteen Caribbean states. The economic integration to enlarge individual states’ markets was a necessity for the Caribbean countries due to their small size. The GDPs and populations of the Caribbean states are equivalent to those of small cities. As a whole, the Caribbean has a population of slightly over 30 million, less than either that of Argentina or Colombia. The gross regional product of \$78.3 billion is roughly one tenth that of Mexico.⁷¹

The CARICOM objectives in 1973 of economic integration never took effect until after the 1990s. The collapse of the ISI paradigm brought about structural reforms and liberalization trade policies in the region. The CARICOM governments met at a Summit in 1989 and decided on deeper economic integration. They sought free intra-regional trade and greater harmonization of laws and regulations governing trade and various other issues. More importantly, they decided to lower barriers against third, nonmember countries.⁷² There is evidence that the CARICOM treaty generated positive effects: both static and dynamic.

Static Effects

Trade diversion has not been a major problem with CARICOM nations. Because they jointly decided to lower barriers of trade against third member states, there has not been a decrease of imports and exports from and to nonmembers. CARICOM's static effects have been small due to the nature of the economies. They are highly dependent on external economies; intra-regional trade alone is not enough to sustain the states.⁷³ Thus, the countries cannot erect high tariffs against other nations and create significant trade diversion. Intra-regional exports increased dramatically from 1992 to 1995, at the rate of around 24% per year. At the same time, there was a reduction in the region's common external tariff.⁷⁴ Due to this reduction in protection barriers against nonmembers, the bulk of CARICOM trade consists of exports to the rest of the world.⁷⁵ Most of CARICOM exports are destined for the US and the EU. Furthermore, imports from nonmembers have also grown substantially during the liberalization reform period of the 1990s. This data shows that trade diversion has been an insignificant concern for CARICOM.

In addition to trade data, an examination of CARICOM member's exports and comparative advantages will reveal that the region's CET is not distorting free trade. Based

upon economic theory, countries should export the good in which it has a comparative advantage. In the case of Mercosur, as discussed above, there have been arguments that the export of manufactured goods shows that its CET is distorting the comparative advantages of countries involved. That is, though Mercosur states have a comparative advantage in labor intensive goods, they are exporting capital-intensive manufactured goods. CARICOM data shows that this has not been the case for the Caribbean states. Most CARICOM nations have comparative advantage in foods, while others have comparative advantage in chemical products and wood products.⁷⁶ These countries have a general overall weak competitiveness in manufactured goods.⁷⁷ Data shows that CARICOM's share of manufactured goods in intra-regional exports declined steadily after 1990.⁷⁸ This shows that there has been an "export diversion to the rest of the world" of manufactured goods that had been previously directed towards domestic and regional markets – an efficient move based upon the theory of comparative advantage.⁷⁹

Dynamic Effects

In addition to the static effects of trade, positive dynamic effects of trade can also be observed in the CARICOM case. A study by the World Bank focuses on "microstates" and their negotiation costs and bargaining powers as individuals and as a group.⁸⁰ A "microstate," in its formal definition by the United Nations, is a state with a population of less than 1 million. All of the CARICOM states, with the exception of two, fit into this category. Small states have extremely high fixed negotiation costs and low bargaining power. Multilateral negotiations with the GATT require substantial financial resources, time, and expert knowledge. Microstates, low in human and physical capacity, lack these requirements, and thus, their negotiation costs are extremely high. Without integration into a larger bloc, each state would have to negotiate with a

number of international institutions on multiple issues. If they join forces and become one economic bloc, they can create a regional authority to defend the countries' common economic interests, thereby sharing the fixed negotiation costs and significantly reducing each state's individual costs. The model created by Andriamananjara and Schiff concludes that decisions to join regional groups are based on negotiation costs and bargaining powers, and the equilibrium size of the group is positively correlated with a.) the number of issues to be addressed, b.) the degree of similarities between the countries, and c.) the negotiation costs per issue to be addressed.⁸¹ By joining a regional bloc, nations involved can take advantage of increased bargaining powers. For example, individual microstates can never "logroll." That is, they can never trade votes (I vote for your issue if you vote for mine) with other big nations because their vote or support is usually insignificant. When in a larger group, however, these microstates will have the ability to logroll, and thus, obtain more policies in their preference.

In the case of CARICOM, there is ample evidence of their increased bargaining power. CARICOM states have been (and still are) involved in negotiations with the ACP-EU, GATT/WTO, UNCTAD, UNCLOS. Moreover, they have joined forces with other countries or groups, such as Cuba, Canada, Japan, Mexico, United States, the FTAA, the OAS, the G3, and much more. Without a common voice to defend their common interests, the CARICOM states could never have been able to unilaterally conduct these negotiations. In addition, a subset of the CARICOM states have formed the Organization of Eastern Caribbean States (OECS) to facilitate with administrative capacities and bargaining weight. CARICOM nations were able to get their nationals elected to key international positions in the ACP Group in the negotiation of Lome Conventions. They were able to succeed in doing this by trading support with others, and obtained positions such as Commonwealth Secretary-General and ACP Secretary-General. This

ensures that the region's interests will not be left out. Lastly, CARICOM states have also been successfully at negotiating a wide range of preferential market access agreements with Cuba, the US, and the EU.⁸²

CONCLUSION

NAFTA, Mercosur, and CARICOM are different in many respects. NAFTA is distinguishable from the others in that it is an economic arrangement between highly developed nations and a developing country. Mercosur consist of a large dominating country (Brazil) and other less developed countries. CARICOM is made up of extremely small states, almost individually insignificant in the world arena. Yet these three economic agreements are similar in that they are *regional* arrangements, established to deal with issues and concerns that multilateral negotiations cannot assuage. The effects of these trade agreements vary across the spectrum, from negative trade diversion consequences, to significantly positive foreign direct investment increases.

These regional agreements are far less beneficial than multilateral free trade, with the elimination of all tariffs and non-tariff barriers on global imports and exports. Economic theory has presented compelling evidence to fight for global free trade rather than regional free trade. However, the world is made up of not only economists, but *politicians* as well. The politics of free trade has hindered the path to the free movement of goods, services, and factors of production across nations. Politically mobilized labor groups have fought successfully in many countries to protect their industry from foreign competition. Though the theory of free trade is very much feasible in today's world of technological advances and globalization, political factors currently impede this from becoming a reality. In this context, countries who can make a partial move through regional economic openness are essentially establishing stepping stones to further

global liberalization. Perhaps the dream of international free trade will be realized one day, but for today, the era of regionalism prevails.

NOTES:

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- ¹ Stiglitz 3.
 - ² Whiting 4.
 - ³ Appleyard & Field 124.
 - ⁴ Ibid. 126.
 - ⁵ Ibid. 129.
 - ⁶ Bourely 35.
 - ⁷ Whiting 30.
 - ⁸ Stiglitz 9.
 - ⁹ Bourely 35.
 - ¹⁰ Ibid. 36.
 - ¹¹ Appleyard & Field 351.
 - ¹² Bourely 45.
 - ¹³ Appleyard & Field 352, Bourely 45.
 - ¹⁴ Bourely 46.
 - ¹⁵ Appleyard & Field 354.
 - ¹⁶ Ibid. 385.
 - ¹⁷ Frankel 5-6.
 - ¹⁸ Victor Bulmer-Thomas 5.
 - ¹⁹ Whiting 33.
 - ²⁰ Frankel 5.
 - ²¹ Ibid. 10.
 - ²² Vellinga 152.
 - ²³ Ibid. 152.
 - ²⁴ Bourely 75.
 - ²⁵ Vellinga 177.
 - ²⁶ Bourely 28.
 - ²⁷ Ibid. 30.
 - ²⁸ Bourely 52.
 - ²⁹ Ibid 70.
 - ³⁰ Frankel 110, 111.
 - ³¹ Ibid. 111.
 - ³² Ibid. 111.
 - ³³ Ibid. 209, 210.
 - ³⁴ Ibid. 227.
 - ³⁵ Bourely 55.
 - ³⁶ Bourely 77.
 - ³⁷ Frankel 129.
 - ³⁸ Ibid. 217.
 - ³⁹ Ibid. 217.
 - ⁴⁰ Bourely 70.
 - ⁴¹ Van Whiting 35.
 - ⁴² Ibid. 35.
 - ⁴³ Frankel 220.
 - ⁴⁴ Van Whiting 31.
 - ⁴⁵ Bourely 71.

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- ⁴⁶ Vellinga 205.
⁴⁷ Frankel 218.
⁴⁸ Appleyard & Field 368.
⁴⁹ Belous & Lemco 2.
⁵⁰ Cevallos
⁵¹ Kim 10.
⁵² Belous & Lemco 163.
⁵³ Kim 10.
⁵⁴ Belous & Lemco 4.
⁵⁵ Appleyard & Field 373.
⁵⁶ Kim 15.
⁵⁷ CBO (Congressional Budget Office) 9.
⁵⁸ Kim 21.
⁵⁹ Kim 26.
⁶⁰ Kim 27.
⁶¹ Radtke 178.
⁶² Appleyard & Field 249, and Blomstrom & Kokko 32.
⁶³ Yeats 1.
⁶⁴ Yeats 5.
⁶⁵ Blomstrom & Kokko 35, Source: IMF: International Financial Statistics.
⁶⁶ Blomstrom & Kokko, 36.
⁶⁷ Vellinga 192.
⁶⁸ Ibid. 194.
⁶⁹ Ibid. 159.
⁷⁰ Bulmer-Thomas 275.
⁷¹ Vellinga 202
⁷² Bulmer-Thomas 275.
⁷³ Andriamananjara & Schiff 26.
⁷⁴ Bulmer-Thomas 280.
⁷⁵ Ibid. 284.
⁷⁶ Ibid. 288.
⁷⁷ Ibid. 291.
⁷⁸ Ibid. 283.
⁷⁹ Ibid. 283.
⁸⁰ Andriamananjara & Schiff
⁸¹ Ibid.
⁸² Ibid.

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