Stepping stones or building blocs? Regional and multilateral integration

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1. Introduction

Do regional trade arrangements help or hinder multilateral liberalisation?

The debate surrounding this question can be colourfully illustrated by recounting the famous exchange between two eminent economists, Larry Summers and Jadish Bhagwati at a World Bank conference in 1992. Summers, who was head of the Bank’s research department at the time, was supposed to welcome Bhagwati as the keynote speaker with the customary ‘few kind words.’ Instead, Summers launched into a half hour discourse on what a good thing regional integration was. His most famous line was “I like all the ‘isms’, unilateralism, regionalism and multilateralism.” Feeling quite upstaged, Bhagwati quietly fumed until it was his turn. Taking the floor, Bhagwati launched into an energetic attack on the Panglossian embrace of regionalism. Among his many dire predictions, he argued that regionalism would undermine the GATT-based world trading system, place small nations under the thrall of hegemonic powers, and even foster wars among trade blocs.

This debate – which has raged for more than a decade – brings to mind the Buddhist parable, ‘The Blind men and the Elephant.’

Once upon a time a wise Raja summoned all the men in his realm who were born blind and proceeded to present an elephant to them. To one he showed its ears, to another its tusk, to another its trunk, and so on. He then said, “Tell me blind men, what sort of thing is an elephant?” Each gave his view, and since each had felt the elephant with his own hands, each was stubbornly sure that he knew the true nature of an elephant. They began to quarrel and eventually came to blows over the matter.

The morale of this story applies directly to the regionalism debate.

Liberalising on a regional basis means liberalising on a discriminatory basis. Therein lays the two-sided nature of regionalism. The “liberalisation” part in “discriminatory liberalisation” is generally good since it removes artificial barriers between domestic and

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1 This paper was prepared for the G-20 Workshop on “Regional economic integration in a global framework”, organised by the European Central Bank and the People’s Bank of China in Beijing, 22-23 September 2004.
some foreign producers. The “discrimination” part, by contrast, is generally bad since it creates new barriers between various foreign producers. Plainly then, one cannot know whether regionalism helps or hinders multilateralism based on pure logic. This brings us to the state of the debate.

1.1. State of the debate

The Larry Summers school-of-thought looks at discriminatory liberalisation and sees liberalisation. An outcome it welcomes since it views regionalism as having a largely benign effect on the multilateral system. The Jagdish Bhagwati school looks at discriminatory liberalisation and sees discrimination. An outcome it views as a serious threat to the WTO-centred world trading system.

We address the two schools of thought in turn.

1.1.1. Stumbling blocs: logic and fears

The Bhagwati-school posits two key risks of regionalism (see for example his tract entitled “The dangerous drift to preferential trade agreements”):

■ 1. Regional liberalisation is a substitute for multilateral liberalisation, and this for two reasons:
   it dampens nations’ enthusiasm for further multilateral liberalisation, and
   it diverts policy makers’ attention from WTO rounds
■ 2. Regionalism shifts power in worrying directions, specifically
   it fosters greater dominance of small nations by hegemonic powers, and
   it increases the chances of inter-bloc trade war.

Regionalism’s dark history – regionalism and fascism in Europe and Asia

The Bhagwati fears are based first and foremost on historical analysis. As Doug Irwin wrote “In the interwar period discriminatory trade blocs and protectionist bilateral arrangements contributed to the severe contraction of world trade that accompanied the Great Depression.” The latter wave of regionalism is often associated with the pursuit of beggar-thy-neighbour policies and substantial trade diversion. Worse yet, regionalism was associated with some of the most horrific episodes that humankind has ever witnessed – the WWII fascist regimes.

This may seem like an unnecessary diversion in a paper on regionalism and multilateralism in the 21st century, but it is not. When Jagdish Bhagwati and Anne Kruger write about the “dangerous drift” of regionalism, they have the interwar period in mind.

Fascism, autarky and regionalism

Fascism is organised around the primacy of the nation and when it comes to economic policy this means promoting national industry by, among other things, avoiding ‘destructive competition.’ High tariff barriers were an important part of this in the 1920s and 1930s. Of course, protectionism was embraced by all major states in those times, but with an important difference. Most nations viewed protection as a stop-gap measure to
address the crisis of unemployment and/or as a reaction to foreign protectionism. In Fascist Italy, Germany and Japan, by contrast, international trade per se was viewed with suspicion. Indeed, national self-reliance, i.e. autarky, was an explicit goal of policy. The connections can be made most clearly by tracing out the logic linking fascism, autarky and regionalism in its most destructive expression – Hitler’s territorial ambitions known as Lebensraumpolitik in German.

Hitler, whose formative years were deeply marked by the economic disruptions in the 1920s and 1930s, was thoroughly suspicious of trade. He believed that the Great Depression was caused by an over production of manufactured goods and explicitly rejected the notion that a nation could prosper as an exporter of manufactured goods and an importer of food. Moreover, while the Atlantic Europeans had prospered and industrialised with the help of captured overseas markets (colonialism), Germany’s colonial ventures were economic disasters. The development of Germany’s industry power relied much more on the formation of a regional trade bloc among the hundreds of small states of the German Confederation – Bismarck’s famous customs union (Zollverein). Hitler’s suspicions of relying on foreigners via trade were confirmed when the League of Nations placed trade sanctions on the Italian fascist state in reaction to Italy’s invasion of Northeast Africa.

Hitler’s mistrust of trade interacted with his dual doctrines of ‘race’ and ‘space’ to produce a radical and particularly destructive trade policy. There was nothing new about his belief that his race was superior; many people believe this of their own race even today. The dangerous innovation was his view of history as a struggle among races, with a winner-take-all outcome being inevitable. Each race, he thought, had to balance its population and its living space. If a people choose to adjust its population to its living space, Hitler thought, decline and eventual enslavement by another race was inevitable. “Hitler had no confidence in the possibility of increasing food production from available land. The struggle for existence in which the races of the world engaged, the basic element of life on earth, was fundamentally a struggle for space. In this struggle the stronger won, took the space, proliferated on that space, and then fought for additional space. Racial vitality and spatial expansion were directly related.” (Weinberg 1996 p. 34)

In short, Hitler, viewed trade with suspicion and autarky as a merit, but he realised that Germany could not prosper in isolation. The solution, he decided, was to rearrange international boundaries so that international trade became domestic trade. Signing trade agreements with fellow fascists and future victim nations were stepping stones to military invasion.

Italian fascism pursued a similar logic towards a similar goal, but in Mussolini’s case the end point was a new Roman Empire. Fortunately, Italian fascists failed to implement the territorial expansion phase as effectively as the Nazis. Japanese fascism followed a similar logic taking steps towards what eventually became the “Greater East Asia Co-Prosperity Sphere.” In the Japanese case, apologists for imperialism sought to justify the regional trade bloc in terms of anti-Western imperialism.
In all cases, fascism aimed to set up more or less autarky trade blocs designed primarily to further the economic and political power of the hegemonic power.

**Non-fascist trade blocs**

The regional arrangements formed between World Wars I and II by non-fascist nations were highly discriminatory, relying on high external tariffs to provide preferential market access. For example, France and Great Britain sought to consolidate their empires. France formed a customs union with members of its empire in 1928 and the Commonwealth system of preferences established by Great Britain in 1932.

Smaller European nations reacted defensively. Hungary, Romania, Yugoslavia, and Bulgaria each negotiated preferential access for their agricultural goods with various European countries. Belgium, Denmark, Finland, Luxembourg, the Netherlands, Norway, and Sweden signed economic agreements throughout the 1930s. Outside of Europe, the United States forged almost two dozen bilateral commercial agreements during the mid-1930s, many of which involved Latin American countries.

1.1.2. Building blocs: logic and hopes

Summers’ argument is basically a reaction to Bhagwati’s fears. Bhagwati recalls that regionalism lead to terrible outcomes in the past and makes the general point that regionalism might be a substitute for multilateralism. Summer’s argument is to implicitly reject this historical analysis, adopting a what-me-worry attitude, instead. According to Summers’ worldview, post-WWII regionalism has resulted in a great deal of tariff removal and there is no clear evidence that regionalism has sidetracked multilateralism in the capitals that matter.

**Prima facie rejection of fears**

The Summers point of view has been strengthened by the world’s experience over the past 15 years. There are three salient points in the prima facie argument that “all the ‘isms’ are good”.

1980s and 1990s regionalism did not thwart the Uruguay Round

Bhagwati’s warnings fell on attentive ears in the early 1990s. The Uruguay Round, which was scheduled to finish in 1991, dragged on and on. In contrast, preferential trade arrangements in European and the Western Hemisphere spread like wildfire. By the mid-1990s, however, this journalistic reading of history seemed passé. The Round finished, the WTO was set up and the nations that were responsible for the final push for the WTO were exactly the ones who lead the wave of regionalism that Bhagwati asserted would undermine the Round. This leads to the second point.

The key multilateralist nations are also regionalists, and have been since WWII.

Multilateral liberalisation since WWII has been wildly successful at cutting developed nations' industrial tariffs. Yet the nations that steered this multilateral liberalisation - the US, the UK, the EEC6, the Nordics and Canada - are the same ones that drove regional

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2 This section draws heavily on Mansfield and Milner (1999).
liberalisation since the 1958 Treaty of Rome, the 1960 Stockholm Convention, and the 1965 Canada-US Auto Pact. Japan is the exception that confirms the rule. Japan was never a leader in the GATT Rounds and it was also never involved in regional trade arrangements until recently.

Moreover where GATT Rounds failed, the regional route also failed. Historically, developed nations resisted agricultural trade liberalisation both multilaterally and regionally, and developing nations resisted tariff-cuts on manufactures both multilaterally and regionally.

**MULTILATERALISM AS A RESPONSE TO REGIONALISM**

Finally, a number of observers believe that regional integration efforts promoted multilateral liberalisation via ‘competitive liberalisation’ (to use Fred Bergsten's recent term). For example, most scholars believe that formation of the EEC induced the US to push for multilateral tariff-cutting via the Kennedy Round. Kenen (1989) provides the textbook treatment, which entails two steps. First, the phase-in of EEC preferences harmed US exporters. Second, redressing the discrimination required multilateral liberalisation (the direct way to offset it, joining the EEC, was unthinkable). In this roundabout way, European regionalism created a burst of free-trade multilateralism among US exporters, and the US government followed suite. Similar arguments have been made that the EU’s Single Market Programme (announced in 1985 and ratified in 1986) fostered the launch of the Uruguay. See Schiff and Winters (2003) for more examples.

1.1.3. **A dynamic view of regionalism and multilateralism**

For ten years, I’ve been pushing a more focused rejection of the Bhagwati fears. Building political economy models of trade liberalisation known as ‘the domino theory of regionalism’, and the ‘Juggernaut theory of reciprocal liberalisation’.

**2. Dominos and Juggernauts**

To think about regionalism’s role as a stumbling or building bloc, it is useful to answer two questions independently and then to hook them up in the next section. The questions are:

"Why are countries eager to open markets regionally?" and;

“Why has GATT/WTO multilateral talks been so successful at liberalising the industrial tariffs of industrialised nations?”

We take these questions in turn.
2.1. Why does regionalism spread in waves?

One oft-heard explanation for why regionalism is so popular rests on two assertions.³

- Regional integration has prospered as an alternative to multilateralism since multilateral trade negotiations have become too cumbersome to deal with today's complex trade issues. (This argument, first introduced when the Uruguay Round proved difficult to conclude, as re-emerged as the Doha Round is proving difficult to conclude.)

- Regionalism is fostered by the United States’ conversion from devoted multilateralist to avid regionalist.

Both of these assertions are just plain wrong, as I have argued (Baldwin 1997). In Baldwin (1993, 1995), I proposed a very different answer – the domino theory of regionalism.

2.1.1. The Domino Theory of Regionalism

This theory is simple. It starts with an idiosyncratic shock, such as deeper integration of an existing regional bloc or formation of a new FTA for political reasons. This triggers membership requests from countries that were previously happy to be non-members. Why? The stance of a country's government concerning membership in a regional bloc is the result of a political equilibrium that balances anti-membership and pro-membership forces. Among the pro-integration forces are firms that export to the regional bloc. Since closer integration within a bloc is detrimental to the profits of non-member firms (trade diversion), closer integration will stimulate the exporters to engage in greater pro-integration political activity. If the government was previously close to indifferent (politically) to membership, the extra activity may tilt the balance and cause the country to join the bloc. If the bloc enlarges, the cost to the non-members increases since they now face a cost disadvantage in an even greater number of markets. This second round effect will bring forth more pro-integration political activity in non-members and thus may lead to further enlargement of the bloc. The new political equilibrium will involve an enlarged regional trading bloc. Meanwhile it would appear that regionalism was spreading like wildfire.

If the trade bloc is open to expansion, virtually all nations who depend heavily on the bloc will end up signing preferential trade agreements (this is what has happened in Europe and most of the Mediterranean Basin). If the bloc’s natural enlargement 'burn-path' is barred, the new political economy flames may find vent in preferential arrangements among excluded nations (this is what happened when Mercosol was formed). Notice that such regionalism could occur despite any progress being made in ongoing multilateral talks, unless these also promised to fully offset the discrimination.

An old idea. The basic idea is not new. With hindsight, one can discern a version of it in Jacob Viner's account of how dozens of German principalities and city-states were

³ A succinct exposition of this explanation can be found in the Bhagwati (1993) and Krugman (1993) papers that appear in the World Bank/CEPR volume on regionalism (De Melo and Panagariya 1993).
cajoled and coerced into joining Prussia's Zollverein between 1819 and 1867 (Viner 1950 Chapter V.3). But the notion is probably much older. Bismarck himself probably understood the political-economy dynamics of trade diversion. Be that as it may, it is important to minutely examine the internal logic of even the oldest ideas and this requires maths. To my knowledge, Baldwin (1993), which deals with EU enlargement, was the first formal framework to explore the dynamic political-economy implications of trade diversion. Several subsequent studies - most notably Yi (1996), Ethier (1996) and Siedmann and Winter (1997) - have elaborated the basic framework.

**Historical examples.** A domino effect has occurred repeatedly in Europe (e.g. in 1961, 1973, 1986, and 1994), and in the Western Hemisphere with NAFTA, the Enterprise for the Americas Initiative, Mercosol, and it is just starting in East Asia. (See Baldwin and Wyplosz 2003 Chapter 1 on the European cases, Baldwin 1997 on the Western Hemisphere, and Baldwin 2003 on East Asia.)

### 2.2. Explaining the GATT/WTO’s success

The standard account of multilateral liberalisation starts from the Prisoner’s dilemma created by so-called optimal tariffs. That is, nations, just like firms, can use their market power to force down the price of the goods they buy. According to the textbook presentation, all nations can improve their terms of trade by imposing a tariff (although the potential improvement is very small for very small nations). Terms-of-trade changes, however, are worse than a zero-sum game. If all nations strive of better terms of trade, the ‘size of the pie’ shrinks and all may end up worse off. Or, to put it differently, every nation may gain by removing its tariff in concert with other nations.

This standard account is a nice story, but it fails to explain most of the big facts of multilateralism. Stylising the facts for rhetoric’s sake, only rich nations liberalised and then only industrial goods. Moreover, the process took 40 years.

The Juggernaut theory proposes a very different approach. The theory was first posited informally by Baldwin (1994) and Baldwin and Baldwin (1996) and formalised by Baldwin and Robert-Nicoud (2004).

#### 2.2.1. The Juggernaut theory of multilateral liberalisation

The Juggernaut theory asserts that liberalisation begets liberalisation, so once the liberalisation ball starts rolling, it is difficult or impossible to stop.⁴ Here is the logic.

Wind back the clock to 1947 when the GATT became active. At that moment, tariffs started at levels that were politically optimal. That is, tariff levels – like prices in a competitive market – balance the supply and demand for protection in the political market. The main demanders of import protection are import-competing firms and

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⁴ The word ‘juggernaut’ – defined as “any massive inexorable force that advances crushing whatever is in the path” – stems from a British mispronunciation of the Hindu deity of the Puri shrine, Jagannath. A festival is held in Puri involving the ‘chariot of Jagannath’, an enormous and unwieldy construction that requires thousands of people to get it rolling. Once started, however, it rolls over anything in its path.
workers they employed. The government was the supplier of protection, but was reluctant to raise tariffs to autarkic levels since this would harm the general economic health of the nation.

**How to get the Juggernaut rolling**

Starting from this situation, announcement of multilateral tariff-cutting talks based on the principle of reciprocity alters the array of political forces inside each and every nation participating in the talks on the basis of reciprocity. And reciprocity is the key. Reciprocity turns each nation’s exporters from bystanders in the tariff debate to fervent opponents of protection within their own nation. Why? The principle of reciprocity means exporters win the prize of better access to foreign markets only if home tariffs are lowered. Thus lobbying against domestic tariffs becomes a way of lowering foreign tariffs.

Since this rearrangement of political forces goes on inside every nation involved in the talks, a new political equilibrium emerges. Tariffs are cut because now the supply of protection shifts in (exporters increase the marginal political cost to their government of maintaining any given level of tariffs), but the demand for protection is unchanged. Note that tariffs do not go to zero, but they are cut in all participating nations and these tariff cuts are phased in over a 5 to 10 year period.

The phase in of tariff cuts at home and abroad alters the economic landscape and this generates a sort of political economy momentum.

**The economic source of the political economy momentum**

In all participating nations, export sectors expand output and employment as foreign tariffs come down, and import-competing sectors reduce production and employment as home tariffs are lowered. In economic terms, the long-run supply responses in the export and import-competing sector are greater than the short-run responses. Why does this matter?

Although many factors affect a sector’s political influence in tariff-setting, size always matters. That is, other things equal, a sector with lots of workers, lots of capital and lots of profit will have more influence. Since the export sectors in all nations have expanded while all of the import-competing sectors have shrunk, the next GATT/WTO Round leads to a different outcome.

A few years down the road, when another multilateral Round is launched, reciprocity again re-aligns the tariff-setting balance by turning exporters into anti-protectionists. But this time, the pro-tariff camp is systematically weaker in every nation and the pro-liberalisation camp is systematically stronger in every nation. The result is that all participating governments find it politically optimal to cut tariffs, but again not to zero. As these fresh tariff cuts are phased in the cycle is repeated.

This process means that any sector in any nation that is included in the reciprocal trade talks will eventually get liberalised.
Exceptions that prove the rule

Oversimplifying to make a point, tariffs in the world can be summarised in three points: they are zero on industrial goods imported into rich nations, they are high on food imported into rich nations and they are high on industrial goods imported into poor nations. How does the Juggernaut theory account for these ‘facts’?

Until the 1990s, GATT Rounds focused on manufactured goods, so it is no surprise that food was not liberalised. More specifically, the import competitors in the EU, US and Japan were so strong that they managed to take food tariffs off the bargaining table, so no one inside the EU, US and Japan gained from lobbying against food tariffs. In this way, food tariffs were shielded from the relentless crushing force of the Juggernaut effect.

Developing nations have participated in GATT/WTO Rounds, but not on the basis of reciprocity. Until the 1970s, the GATT was a rich-man’s club. Most poor nations were colonies or newly independent states, few of which wanted to join. When the merit of membership did become to be appreciated by some developing nations in the 1970s, the GATT adopted its “Enabling Clause” – which should have been called the ‘disabling clause’ since it disables most of the GATT’s discipline for poor nations. The Enabling Clause meant that developing nations did not have to make tariff concessions in order to gain better market access. Or, more to the point, GATT Rounds did not turn developing country exporters from bystanders to free traders. Under these rules, the multilateral talks had no impact on the array of pro-trade and anti-trade political forces within developing nations. Little wonder, then, that they decided to stay with the initial level of their tariffs, which were after all politically optimal to begin with.

3. How dominos can start juggernauts

In my view of the world, the interaction between the domino theory and juggernaut theory suggests that regional trade blocs are building blocs toward free trade – at least in most cases. Indeed, North-South free trade agreements are probably the only way to liberalise industrial tariffs in developing nations. An important exception may be South-South FTAs. These points are addressed in order.

3.1. Political economy momentum from FTAs

The juggernaut theory stresses how reciprocal tariff cutting alters the political economy environment in ways that fosters further liberalisation. But this point also applies to regional trade liberalisation. Examples from Europe and the North America serve to illustrate the point.

Mexico. Up until it asked the US for a bilateral free trade agreement in 1990, Mexico followed a classic import-substitution policy – a policy explicitly aimed at preventing US industry from crushing nascent Mexican industry. Mexican tariffs were high and Mexico stayed out of the GATT until 1986. The Mexico-US free trade agreement (FTA) – which was turned into NAFTA at Canada’s insistence – changed all this. Since the FTA was announced under the GATT’s Article 24, Mexican tariffs had to go to zero on substantially all trade in about 10 years.
Once NAFTA had been implemented, Mexico had zero tariffs on three-quarters of all of its imports. Moreover, because the US and Canada have very low MFN tariffs on their non-food, non-clothing imports, free trade with NAFTA is not much different than free trade with the world (with a few spectacular, but low-volume exceptions like steel). Or, more to the point, Mexico’s regional liberalisation forced out or downsized all the import competing industries that would have otherwise resisted multilateral liberalisation. Basically, the NAFTA-launched juggernaut crushed in 10 years the sort of protectionist forces that took the GATT 40 years to crush in the US and Canada.

What all this means is that Mexico had little to gain from keeping its MFN tariffs on industrial goods. Why not, then, go all the way for unilateral free trade? Or, better yet, why not get something in exchange by signing FTAs with anyone and everyone?

Notice that all this may have virtually no impact on Mexico’s stance in multilateral talks. From a tariff-cutting perspective, the Enabling Clause allows Mexico to continue to view WTO Rounds as a political economy Christmas; Mexico’s rich trading partners will cut their tariffs by something like 30%, but Mexico is not really obliged to respond. Moreover even if it decided to be a good player in the multilateral tariff cutting game, the size of Mexican market means that its tariff cuts would have essentially zero impact on the tariff cuts offered by its major trading partners. FTAs, by contrast, very directly link Mexican and foreign market access.

The result of this logic has been impressive. While almost 90% of Mexico’s exports go to NAFTA, Mexico sought FTAs with the EU and Japan. Additional, Mexico signed free trade agreements with its poor and economically small neighbours, including Honduras, Costa Rica, Columbia, Venezuela and many more. Mexican exports have quadrupled since 1990 with all of the growth accounted for by its non-oil exports. It has also doubled its inflow of foreign direct investment, and, although it suffered a macro shock in 2001, its foreign debt has come down steadily and is now less than a third of what it was in 1990.

USA. NAFTA had a rather different impact on the US. The tighter integration with Mexico meant that much of the global trend towards off-shoring labour intensive manufacturing tasks resulted in US manufacturing jobs ‘moving’ to Mexico. This shift resulted in bitter political dispute inside the US, but it also downsized the political power of US groups that would oppose and expansion of NAFTA and/or a pursuit of the Free Trade Agreement of the Americas. Again, regionalism started its own juggernaut and this has made it politically easier for US administrations to pursue regional and multilateral liberalisation initiatives.

EU. The early EU, say up 1981, was a classic example of how regionalism can be a stumbling bloc, at least when it came to one small sector – agriculture. Since the EU had extremely high external protection, the customs union created brand new opponents to multilateral liberalisation. For instance, British farmers had been largely weaned from tariff protection by the time Britain joined in 1973. But once Britain was in, British farmers acquired a vested interest in maintaining the CAP. Or, to put it in supply terms, the high levels of external protection, lead to a ceteris paribus expansion of EU farm output that re-enforced opposition to multilateral liberalisation. More recently, however, regionalism has been a stepping stone towards EU farm liberalisation.
The enlargement of the EU has been the main force behind liberalisation of the EU’s most protected sector – agriculture. Up to the 1980s, the EU consisted mainly of northern European nations whose farmers grew quite similar crops. The EU’s Common Agricultural Policy (CAP) protected these farm products – mainly, dairy, beef, wheat and sugar – much more heavily than southern European farm goods such as fruits and vegetables. When Greece, Spain and Portugal joined in the 1980s, the EU’s political equilibrium was unbalanced. The result was that the CAP was capped (its budget share had to fall), with spending on aid to poor nations pushing down the CAP’s share of the EU budget. The necessity getting the CAP’s cost under control – and concern that never really mattered before the 1980s enlargements – was the prime force behind the MacSharry reforms, which ended up as being the key to closing the Uruguay Round.

The most recent enlargement continues to push in this direction. Since new northern and central European members have farm land that is well suited to producing the goods that that CAP favours most heavily, CAP reform was again political viable. For instance, the CAP was reformed in June 2003, and the Commission is proposing even further liberalisation. Regardless of the stated motives for these reforms, it is clear that political economy shifts implied by EU enlargement are the reason these reform proposals have a chance of being implemented. Thus in the EU’s case, we can say that expanding regionalism triggered juggernauts that crushed opposition to multilateral liberalisation of agriculture.

3.2. South-South FTAs as stumbling blocs

At first glance, this seem to support Larry Summers’ argument that all the trade liberalisation 'laterals' (uni-, bi-, pluri- and multi-) are good. This is largely true, however there are exceptions. Just as the EU's Common Agriculture Policy created a powerful anti-liberalisation force, FTA among developing nations may lead to an anti-juggernaut effect. That is, they may strengthen rather than weaken the political power of anti-liberalisation forces. That is, because developing nations often have high tariffs, South-South FTAs may hinder multilateral liberalisation by creating or supporting uncompetitive, import-substituting industries.

This point is especially true of South-South FTAs announced under the Enabling Clause, because, as mentioned above, the Enabling Clause disables all the GATT disciplines that tends to foster domino and juggernaut effects.

3.3. Concluding comments on multilateralism and regionalism in general

Does recent regionalism threaten the future of the world trading system? My best guess is that because trade is already quite free in the major trading nations, few regional liberalisations are capable of creating important anti-liberalisation forces (the exceptions are likely to be South-South FTAs). For this reason, most regional deals will weaken the key opponents of free trade (import competitors) while simultaneously strengthening its key proponents (exporters). Regional integration will, therefore, foster multilateral liberalisation and vice versa, just as it has done for the past 40 years.
If this is right, regional deals are not building blocks or stumbling blocks. Regionalism is half of the trade liberalisation 'wheel' that has been rolling towards global free trade since 1958.

Allow me to apply this reasoning to East Asia.

4. The East Asian ‘spoke trap’

East Asia finds itself on the eve of rampant regionalism. A Japan-Korea free trade agreement is very likely to trigger a domino effect that induces other East Asian nations to aggressively pursue FTAs, especially with Japan, Korea and China. China-Korea, Japan-China, or China-Korea-Japan free trade agreements would have the same effect, as might China-ASEAN FTAs.

The resulting liberalisation is likely to be good for the region, but there is a danger. The political economy force that drives the domino effect tends to produce hub-and-spoke bilateralism. This would be problematic at two levels.

- Economically, hub-and-spoke-ism produces an inferior outcome for the region as a whole. In particular, it may produce a profusion of Free Trade Agreements that can make the whole region less attractive to foreign direct investment – an effect that might be called, in the Asian context, the “noodle bowl problem”.

- Politically, hub-and-spoke-ism could prove divisive. It tends to marginalise the spoke economies both economically and politically while at the same time granting leverage to the hub economy. Since there are two natural hubs in East Asia – Japan and China – there is a strong possibility that uncoordinated political economy forces could produce a two-hub system. This would be a worrying outcome in that it might foster regional divisiveness rather than regional cooperation. This sort of alignment between trade blocs and political/military camps clearly heightened political tensions in intra-war Europe.

I start with the economics.

4.1. Economics of hub and spoke bilateralism.

4.1.1. Noodle bowl effect and restricted competition

As I wrote in 1994, “A web of trade deals can create a nightmarish tangle of administrative procedures that raise costs for enterprises and for governments. Most costly of all, are those dealing with rules of origin.” This clearly is a danger for future East Asian regionalism. (This point has come to be known by Jagdish Bhagwati’s catchy phrase the ‘spaghetti bowl effect’ but in Asia it should be called the Noodle Bowl effect)

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An additional deleterious effect of a hub and spoke agreements is the way in which it restricts competition from spoke-based firms in each other’s markets. For the most part, competition from hub-based firms would provide all the competition that is needed, but in certain industries and certain countries, spoke-based firms will be more competitive.

4.1.2. Accumulation and location effects

The next effect, which Krugman (1993) calls the 'hub effect', concerns the impact on investment in spoke economies. That is, just as an all-roads-lead-to-Paris transportation system favours industrial location in Paris, a hub-and-spoke arrangement favours industry in the hub nation at the expense of industry in the spoke nations. Baldwin, Forslid, Martin, Ottaviano and Robert-Nicoud (2003) provide a formal analysis of this in the context of the new economic geography.

4.1.3. Hysteresis in Location

A key lesson of the "new" economic geography (Fujita, Krugman and Venables 1999) is that the location of economic activity is marked by multiple equilibria. That is to say, there is not a unique constellation of economic concentrations towards which Asia is inevitably heading. There is true uncertainty about what the economic geography of Asia will look like in 50 years. Moreover, once a particular location gets a head start, it may be extremely difficult for other regions to catch up. The import of all this is that the temporary investment deterring effects of the current hub and spoke system may have consequences that last far beyond the termination of that system. In other words, bad policies - even when they are only temporary - may have very long-lived harmful consequences.

The importance of all this should be clear. Since hub-and-spoke bilateralism favours location in the 'hub', five or ten years of hub-and-spoke bilateralism will give Japanese locations a head-start on other Asian locations. Thus, more new industry may end up in Japan than would be the case with a free trade area (i.e. FTAs among spokes as well). Given the logic of economic geography, circular causality will continue to favour regions that get a head start. The effect of a bad policy may be felt long after the policy is reversed.

4.2. Why is hub & spoke bilateralism so common?

The world is full of hub and spoke trade arrangements and such an arrangement may well emerge in Asia. Before considering solutions to hub-and-spoke-ism, we discuss the political economy forces that so systematically yield hub-and-spoke bilateralism.
4.2.1. **The mercantilist view of trade negotiations**

From a political perspective, exports are good and imports are bad. A more subtle expression of this idea is the trade is good because trade creates jobs. No matter how it is expressed, this idea is nonsense from the medium- or long-run economic perspective. Be that as it may, the important fact is that this mistaken reasoning points governments in the right direction. It leads them to conduct trade negotiations based on an exchange of market access. Specifically, since exports are good and imports bad, if country A wants better access to country's B's markets, then country A is expected to 'pay' for this market access by opening its own market to B's exports.

**LAW OF THE JUNGLE, MFN RULES AND FTAs**

Usually, the market opening that result from this mistaken reasoning is good for all nations involved. A drawback of this mechanism, however, is that it may create a sort of law of the jungle. That is, with market access as the currency of exchange, big countries are rich and small countries are poor. The rules of the GATT correct this imbalance with the principle of Most Favoured Nations (MFN) treatment. However, when it comes to negotiating regional trade arrangements, MFN does not apply, so the law of the jungle may prevail.

4.2.2. **Political economy of hub and spoke bilateralism**

Political economy forces created by an application of this law of the jungle support hub-and-spoke bilateralism. Take a country like the Czech Republic. On the pro-liberalization side, Czech exporters have a large interest in the EU market, but only a minor interest in the market of, say, Estonia. On the anti-liberalization side, Czech import-competing industries dislike imports whether they come for the EU, Estonia or elsewhere. Now consider the line-up of political forces inside the Czech Republic. Czech exporters are willing to fight quite hard for market opening with the big EU market. They are willing to fight much less hard for market opening with Estonia. In other words, there are strong political forces backing market opening with the "hub" but very little support for market opening with other "spokes." Since Czech protectionists simply want to reduce import competition from any source, the protectionists are likely to win when it comes to blocking spoke-spoke liberalization, though they lose when it comes to hub-spoke liberalization.

An interesting add-on effect may occur if foreign investment from the hub is important in the spoke economies. To attract foreign investors, the spoke governments may promise protection from imports. Moreover, given a credible trade agreement with the hub, it is much easier for the spoke government to promise long-term protection against import from other spoke economies. If this sort of pandering-for-investment protectionism becomes quite common, the spoke economies may end up 'Balkanized.' That is, foreign multinationals may be enticed into locating inefficiently small production facilities in

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6 This section is taken almost verbatim from Baldwin (1994), which studied the then emerging hub-and-spoke-ism in Europe. The main change has been to substitute “EACs” (East Asian Countries) for “CEECs” (Central and East European Countries).
each spoke economy. Having done this, the multinationals may become a new anti-liberalization force. Companies from the hub that have invested in inefficiently small facilities in several spoke economies may resist efforts to liberalize spoke-spoke trade. This may make the hub governments more reluctant to take any initiative in redressing hub-and-spoke bilateralism.

4.3. Domino effect applied to hub and spoke bilateralism

The domino theory asserts that the signing of one preferential trade arrangement triggers a chain reaction in that it tends to induce other such arrangements, with the force of this effect feeding on itself. The theory was originally conceived to account for NAFTA and the create pro-EU-enlargement pressures that emerged in the 1990s.

Here we extend the domino theory to the specific case of hub-and-spoke bilateralism. Since the reasoning is fairly involved, it is best to organise the reasoning with the help of a simple analytic framework. In this case, import-supply and import-demand diagrams will be sufficient.

The above political economy reasoning suggests that exports to the hub are the key to the domino effect in this case, even though the full problem is radically more complex. To illustrate the basic logic as simply as possible, we make the extreme assumption that exports to the hub are the only thing that matter.

To be concrete, suppose we have three nation that are potentially spoke, spokes 1, 2 and 3, and one potential hub. This situation is depicted in Figure 1. The right panel shows the hub’s market, with MD reflecting its import demand curve. We assume that all of the spokes are symmetric to each other, so we can illustrate all effects with a single XS curve.

Presuming the hub initially imposes an MFN tariff of $T$ on all three of its partners, the signing of the first hub-spoke FTA shifts the import supply curve down from $MS_{MFN}$ to $MS_{1-spoke}$. As usual, this raises the price facing exporters based in the spoke nation that negotiated the FTA, with the size of the rise being from $P'_{-T}$ to $P^1$. Thus on the export side, the first FTA signer gains areas 3, 4 and 5 (before its border price as $P'_{-T}$). The excluded spokes lose an area equal to area 2, because the FTA drives down the domestic price in the hub to $P^1$ and this drags down the excluded nations’ border prices to $P^1_{-T}$.

When the second hub-spoke FTA is signed, three things happen to spoke exports.

- The second FTA signer sees its exports rise as the price it faces rises to $P^2$. This implies a gain to the second signer of areas 2, 3 and 4.
- The first FTA signer sees its export volume to the hub fall as the price it falls in the hub market falls to $P^2$.
- The remaining spoke sees its exports fall as the price it faces for exports to the hub fall to $P^2_{-T}$.
Figure 1: Domino effect in hub and spoke bilateralism

When the third and final hub-spoke FTA is signed, two things happen.

- The first and second FTA signer see their exports fall as the price they face falls to the free trade price, $P^{FT}$ (at this point, the hub has eliminated all import duties). This implies an additional loss of area 4 for both.

- The third FTA signer sees its export volume to the hub expand significantly, as all the discrimination is removed. And the price it earns on exports to the hub rises from $P^2-T$ to $P^{FT}$. The gain to the third hub from this is the sum of areas 1, 2 and 3.

4.3.1. Race to be first

To summarise, when we focus only on spoke exports, the first FTA signer earns areas 3, 4 and 5. The second earns 2, 3 and 4. The third earns 1, 2 and 3. Because area 5 is bigger than area 2, and area 4 is bigger than area 1, we can say that the gain is greatest for the first, next biggest for the second and smallest for the last. This ordering has important implications.

Let us suppose that for some reason or the other, the hub cannot, or at least might be able, to simultaneously negotiate all three FTAs simultaneously. To keep things simple, let us make the artificial but useful assumption that the hub can do one FTA per year. It is obvious from the discussion above that any spoke that believes it will eventually sign an FTA with the hub would like to be the first one to do so. Or, to put it more colloquially, there will be scramble for the head of the queue, once the spokes knows that the hub is open to FTAs. Moreover, the same scramble would occur even if the hub can negotiate many FTAs at once but there is a possibility that some of these might be put off, or that at some point the hub would stop signing FTAs.
This is what happened when the US and Mexico announced their FTA in 1990. Within months, Chile, Brazil, Argentina, Uruguay and Paraguay all formally or informally approached the US with requests for FTAs. The Bush administration, fearing five separate battles with protectionists in Congress, discouraged these efforts and offered the Enterprise for the Americas Initiative (EAI) instead; this was launched in June 1990. According to CEA (1991 p.255), the EAI created a process leading to free trade agreements, the first step of which required nations to sign so-called Framework Agreements. These committed countries to reducing their investment restrictions, inter alia, in exchange for promises of closer US ties in the future. Although the Framework Agreements might be viewed as unilateral 'concessions' by mercantilists, 26 Latin American countries signed them in 1991.

The model discussed above leaves out two very important elements. First, it ignores the impact of FTAs on the spoke’s economies. A full analysis would account for the political economy forces opposing an FTA with the hub. While these are surely important to the whole picture, post-war history shows that very few spoke economies can resist the appeal of an FTA with the hub, once the hub starts signing such agreements. The second aspect has greater relevance to recent regionalism, namely, the attitude of the hub to further FTAs. In Europe, where the EU is clearly the hub, this is not an issue since the EU has committed itself to what might be called open FTA-ism. The EU will sign an FTA with almost any nation that is democratic and is willing to accept the EU’s insistence that agricultural trade be excluded. In the Americas, where the US is the dominant hub, things are quite different. The US has been extremely reluctant to accede to the many FTA offers it has received. Plainly, it would be nice to have a convincing analysis of why the EU and US approaches are so different, but I suspect that the real answer is non-economic.

5. Implications for the likely evolution of East Asian regionalism

At the end of 2003, the first hints of the ‘wildfire of regionalism’ can clearly be seen in East Asia. No one, however, is in charge. There is no overarching plan for managing it. Judging from the history of unplanned regionalism in other areas of the world, the most likely outcome will be hub-and-spoke regionalism. The reason is simple. Bilateral trade flows in Asia form a hub-and-spoke pattern. As Section 4.2 argued, the mercantilist forces that drive nations’ trade policies tend to free up major trade routes, leaving minor trade routes un-liberalised. Because bilateral trade flows in Asia form a hub-and-spoke pattern, the future pattern of FTAs is likely to follow the same pattern.

5.1. East Asian bicycle: two hubs, many spokes

But who will be the hub in East Asia? Given their importance in trade flows, it seems that both Japan and China will naturally emerge as hubs. Given the political economy

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7 At the time, I was working for the Bush administration’s Council of Economic Advisors following trade policy matters.
reasoning above, it seems likely that the pattern of FTAs that will be signed in the next ten years will have two hubs, Japan and China – something like a bicycle (Figure 2).

**Figure 2: A possible FTA pattern: East Asian bicycle**

![Figure 2: A possible FTA pattern: East Asian bicycle](image)

Figure 2 is a schematic drawing of this prediction for East Asian FTAs. While it does not show all the FTAs (e.g. Singapore has signed many bilateral FTAs), it stylised the implications of rampant bilateralism. Since ASEAN is not an effective free trade area, it is shown as a dashed and irregular shaped line.

### 5.1.1. Problems with the bicycle

Some readers may interpret Figure 2 very differently. Indeed, I could have drawn it in a way that makes Japan and China the spokes with every other nation as a hub. This misses an important point. Hub status is all about market access. For most industries, domestic market access is quite important, so it is worth noting the so-called ‘border effect’ (McCallum 1995). As it turns out, domestic firms have much, much better access to the domestic market than foreign firms do, even when those foreign firms have duty-free access. Consequently, the market access provided to a firm in Korea may be much less than one in Japan or China, even if there are Korean FTAs with both China and Japan, but no Japan–China FTA.

Another problem arises when considering the ‘law of the jungle’ bilateral FTAs between big and small nations naturally tend to reflect the concerns of the big nation much more than those of small nations – after all, market access is the currency in an FTA negotiation, so negotiators from big-market nations can ‘buy’ more than those from small-market nations. Given this hard fact of bilateralism, a spoke’s FTA with China and
its separate FTA with Japan is likely to impose conditions that diminish the attractiveness of the spoke market.

While there are many, many other possibilities, it seems to me that the two-hub scenario is the most likely for East Asia – unless something is done to prevent it.

That is the topic for the next section.

6. A proposal for East Asian regionalism

A Japan-Korea FTA (JKFTA) is likely to spark a wildfire of regionalism in East Asia (Baldwin 2002). This is likely to create a web of hub-and-spoke bilateralism that will not be favourable for the region. The best way to avoid this would be for the JKFTA to be a customs union with Japan and Korea agreeing in advance to allow any East Asian nation to join. While economically optimal, such a scheme is politically infeasible. This brings me to the first best plan that has any hope of being politically acceptable.

6.1. Plan A: An East Asian Free Trade Association

The next best option would be for Japan and Korea to form a sort of ‘Asian EFTA’, an association, or union of nations that provide duty-free treatment to each others’ industrial exports. As pointed out above, this combination of two of the three largest economies in the region would create powerful forces for inclusion. Under this proposal, part of the JKFTA would be to establish procedures and an institutional framework that would allow other East Asian nations to join the Union, with China being at the head of the queue – indeed, Japan and Korea should probably consult with China to ensure that the new union was non-threatening to their northeast Asian neighbour. Under this scheme, each new member would automatically provide duty-free treatment to the industrial exports of all incumbent members in exchange for gaining duty-free access to all Union markets. Special rules to allow unilateral tariff concessions to least developed nations should also be considered (i.e. a Union-wide GSP policy that would operate like the US’s Caribbean Basin Initiative).

The advantages of this Union of East Asian Free Trade are many. This plan would:

- prevent, or at least greatly reduce, the likelihood that hub-and-spoke bilateralism would emerge in Asian; this would be especially beneficial to small East Asian nations that might otherwise fall into the spoke trap.

- avoid the ‘noodle bowl’ problem (the Asian version of the spaghetti bowl) of a tangle of FTAs, thus making the region as a whole more FDI friendly.

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8 EFTA stands for European Free Trade Association which was set up in 1960 in reaction to the formation of the EEC. It multilateralised free trade in industrial among members, but was not a customs union and had no supra-national decision making. In short, it was a post-war club for nations that wanted closer economic integration without closer political integration.
- Bring coherence to rules of origin (ROOs) in the region, since the Union would establish principles for the ROOs (e.g., limit them to involving either value added rules, or change of tariff lines).

- Create “conditionally open regionalism” in East Asia, which would result in many of the efficiency aspects of Open Regionalism (Bergsten 1996) while still harnessing the critical political forces that are generated by reciprocal trade liberalisation.

- Since Japan and Korea are developed nation WTO members, the Union would obey Article 24 disciplines, this would make the Union’s market more attractive as a platform for production and as a market for third nation exporters and foreign direct investment (since there would be one set of trade rules, not n(n-1) bilateral FTAs for third nation exporters to deal with). This discipline would also make the Union less threatening to third nations.

- Since Japanese MFN tariffs are very low, and Korean MFN tariffs are relatively low, membership in the Union would expose Union members to something close to world market prices. This has two merits:
  - It greatly reduces the scope for inefficient switches from low-cost non-member suppliers to high-cost member suppliers (trade diversion)
  - It means that joining the Union would almost surely foster further liberalisation, as in the case of Mexico.

6.2. Plan B: An FTA union

Japan and Korea may not be ready for the degree of institutionalisation of regional trade implied by Plan A, so here is a less ambitious scheme that also avoids hub-and-spoke bilateralism.

As part of the JKFTA, the two nations would agree to tightly coordinate their FTA policies with other East Asian nations. There as several aspects of this:

1) All future FTAs between Japan and Korea on the one hand and other Asia nations on the other hand would be required to include cumulation in rules of origin. This would go a long way to reducing the noodle bowl problem.

2) Japan and Korea would agree in advance that they would proceed on future FTAs in tandem,

3) A stronger form of this would require that all future FTAs between Japan and Korea on the one hand and other Asia nations on the other hand would be ‘multilateralised’, i.e. if China and Indonesia want FTAs with Japan and Korea, then China and Indonesia should also sign an FTA between them.

While this might slow the pace of EA regionalism in the short term, it would result in a better long-run outcome.
7. Concluding remarks

While East Asian ‘wildfire’ of regionalism has not yet started, smoke is in the air and flames are likely to burst out very soon. The world should be concerned that there is no plan for managing regionalism in this critically important region. This paper presents an analysis that suggests that a two-hub arrangement of hub-and-spoke bilateralism is a likely outcome, unless regional leaders take explicit action to prevent this divisive situation from arising. It also puts forth two proposals for redress the problem, proposals that would allow East Asia to avoid the spoke trap.
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