UNU/CRIS e-Working Papers

W-2002/2

New Regionalism and Global Economic Governance

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I do not mean to deliver here today another "Bruges speech", but just to exchange candid views with research fellows whose expertise is so precious for our policy-thinking and our policy-making.

Economists are all very fond of the international trade theory, which they see with reason, as one of the few robust paradigms available in their quest for efficiency. For decades, until the early 90's, trade liberalisation has vindicated their judgement since it has been credited with being the main source of world growth. The very fact that international trade was rising twice as fast as world output provided strong and convincing evidence of this powerful link.

The rapid expansion of Foreign Direct Investment (FDI), especially in the direction of the Developing Countries (DC's) in the 90's and the subsequent generation of intra-firm trade, particularly in manufactured exports from developing countries towards industrialised countries (ICs) markets, confirmed the prima facie evidence that freeing trade and investment was the driving force behind world growth and development in the South. And indeed, the most successful developing countries - the very few truly emerging economies - have been both larger FDI recipients and effective manufactured goods exporters, whereas import liberalisation - although often quite selective - has undoubtedly contributed to their external competitiveness. These brilliant performances have provided support for the belief that trade was the main engine for growth and that Newly Industrialised Countries (NIC's) strategies were the benchmarks for the laggards.

These developments coincided in the 90's with a growing aid fatigue among donor countries confronted both with the need to rebalance their budgets and diminish debt /

GDP ratios and with evidence of only mediocre success of their Overseas Development Aid (ODA) performances, since the most heavily supported countries were often also the least performing ones. So emerged the convenient slogan : "trade, not aid"! Markets and global firms would deliver what foreign aid was unable - or donor countries unwilling - to secure.

Therefore a new avenue was wide open for further liberalisation. The Uruguay Round has been a landmark in extending trade liberalisation to all products - agriculture and textiles - and services, to new participants through the move from the GATT club dominated by the Quad towards a UN type WTO, and to new topics ranging from intellectual property to investment and public procurement. As tariffs and quotas were being reduced or dismantled - mainly on the Industrialised Countries' (IC's) side - the liberalisation focus shifted from border protection towards internal legislation, from tariff lowering to regulatory convergence, from shallow to deep integration. With respect to the latter, the regional route has appeared more promising than the multilateral one, since collective preferences which are reflected in technical barriers to trade and in sanitary and phytosanitary measures, are more likely to converge among neighbours than world-wide.

The EU with its drastic move from a patchy common market towards a genuine single market in the late 80's, early 90's has pioneered this way towards level playing field-driven trade policies based on harmonisation or mutual recognition. NAFTA was another major move since it extended, for the first time, the Free Trade Area (FTA) concept to a North-South arrangement, turning trade towards US and Canada and FDI from the US and Canada, into a formidable lever for Mexican development, with a view to substituting trade for migration. In order not to be evicted from the NAFTA market, the EU immediately started a FTA negotiation with Mexico, which was concluded in 2000. A second North-South FTA was born!

The NAFTA precedent was significant in the frame of reference of the Barcelona Process initiated in 1995 with a view to turning EU autonomous and non reciprocal preferences granted to Mediterranean countries, into a fully fledged Euro-Med FTA by 2010. The immigration reduction argument was indeed also very instrumental in opting for the Euro-Med venture. Another idea behind Barcelona, however, was for the EU to extend to its most immediate Southern neighbours, the same benefits, but to a lesser extent, as those granted to Central and Eastern Europe after the fall of the Berlin Wall, namely market access and financial assistance.

In the wake of the completion of the Single Market (1992), the Uruguay Round's conclusion (1995) and the launching of NAFTA (1994), we have seen an acceleration of trade liberalisation initiatives both on the multilateral front through the very comprehensive agenda of the Doha Round, which encompasses market access and rules-formation, and on the bilateral front. On the latter however, progress has mainly taken the form of regional trade arrangements of varying membership, product coverage and intensity of rules and norms. Figures speak for themselves since there has been a flurry of such deals, the most recent in Asia which to date was pretty much outside the mainstream of regionalism, except for half-baked ASEAN and sleepy SAARC.

We should not be misled though by these figures for, at this stage, those intended RTA's are still in a draft form. Moreover, most are cleverly designed so as to achieve modest progress short of full liberalisation but within the - still unclear - remit of WTO compatibility. For example, no one expects significant moves on agriculture or antidumping outside the multilateral framework of the Doha Development Agenda (DDA). Moreover many of those deals bring together advanced and backward economies : be it either North-South deals such as FTAA, or Euro-Med FTA, European Preferential Agreements (EPA's) between the EU and its ACP partners, EU-Mercosur, or EU-Eastern neighbours, or within ASEAN itself which includes such different countries as Singapore and Myanmar, or the three sets of RTA's planned between ASEAN and the three major Asian economies, namely Japan, China and India. Therefore, the actual completion of those RTA deals, now in the pipeline, might take a long time : transition periods envisaged in the Cotonou trade agreements which will enter into force in 2008, extend to 2020 and under some conditions can be further extended.

Yet questions deserve to be asked about where this kind of trade liberalisation is leading the world economy in an age of globalisation.

Here I would mainly pose two sets of questions around two main topics : the very consistency of a two pronged - multilateral and regional - trade liberalisation on the one hand; the impact of North-South RTA's on development and on North-South real convergence on the other hand.

The consistency issues : are regionalism and multilateralism compatible?

The provisions of article XXIV in the GATT Agreement have been designed to ensure that trade creation outweighs trade diversion in Regional Trade Agreement (RTA) formation so as to counterbalance the distortive effects of the derogation to the MFN clause which result from the preferences granted by RTA's partners to each other : no higher protection for the RTA than for its Members, implicit reciprocity and coverage of "substantially all trade". But the compatibility issue has never been tested by the competent body of the WTO since they have hardly completed the full review of any of the 250 RTA's either already in force or in their negotiation phase.

Yet the debate rages among economists, the vast majority of whom - the hardcore - fear that RTA's inhibit progress towards enhancing multilateral free trade. Their case, on theoretical and practical grounds, is strong : the growing cost of exclusions as RTA's multiply; the sheer complexity of "rules of origin" preferential regimes which make them look like a "spaghetti bowl" – according to Baghwati - and, in this respect, at odds with the needs of global firms operating on global markets and still more with those of SME's trying to compete; the diversion of political attention and negotiating skills from the multilateral area towards bilateral and regional deals, also carries a significant opportunity cost.

Political economists, closer to policy makers, are more lenient. First of all, they accept more readily than hard economists that foreign policy factors have their say in the decision to go for a regional deal. Then they dismiss the discrimination risk by pointing to the "domino effect" which results in the widening of the scope of RTA's leaving no country out in the cold. And to some extent, this applies to the EU which has concluded or initiated RTA's of different forms with almost all of its Southern and Eastern neighbours and is committed to the establishment of a Common Economic Space with Russia and its neighbours, combined with Generalised System of Preferences (GSP) benefits. If all these RTA's materialise - which is expected to happen over the coming 20 years - one would end up with one set of RTA's of which the EU would be the - only - common core, extending from Cape North to the Cape of Good Hope and - with Russia - from Iceland to Sakhalin Island on the North-West Pacific rim. Latin America is in the picture with three FTA's (Chile, Mexico and

Mercosur) whereas Central America and the Andean countries enjoy a special anti-drug GSP tantamount to EBA. Only Asia is on the sidelines since it only enjoys GSP benefits.

But pressure is mounting on the EU, triggered by tiny Singapore, to move towards RTA's with Asia. The draft report by MEP Erika MANN on RTA's backs such an idea as she favours an RTA aimed at services and regulatory convergence with Singapore and - by the way - also with Canada. The European Commission, in line with the conclusions of the chairman of the 133 Committee in July 2002, remains very cautious with regard to such moves. So far indeed, the present Trade Commissioner, Pascal Lamy has not taken any initiative to launch another RTA since he took office, insisting that his overriding priority - which is the EU officially proclaimed doctrine - is multilateralism and in particular the timely conclusion of the DDA by the end of 2004.

What conclusions can we draw from this RTA proliferation ?

- The most obvious one seems to be that preferences granted to each and every country are cancelling each other out, leaving nobody and especially the least developed countries, better off. The reality might be more complex.

  On the one hand, the rules of origin limit the possibility of attracting FDI from outside the RTA's since the imported inputs from the third country investor would not be eligible to preferences. By the way, this also holds true for the autonomous preferences such as the GSP or the Mediterranean or ACP preferences. On the other hand, the degree of regulatory convergence can make the difference among countries competing for access to the core market and to the core FDI : placed in a level playing field, more advanced developing and transition economies might, thanks to their greater ability to compete on the regulatory side, get more effective access to the EU market.

It might be that at the end of the day, the actual impact of such huge RTA's on least advanced economies might prove both weaker in terms of welfare gains and more distorted in terms of non-discrimination, than we expect. The multilateral route would then remain the safest one over the long term for the poorest because they could at least retain selectively higher protection for their own markets than they would in continent wide FTA's either with the EU or, as in the case of FTAA, with the US.

- But there is another danger, which would mainly result from the combination of RTA's and gravitational integration around a major trade power such as US, EU, Japan or - increasingly - China, which is the drift from regionalism into continentalism, which the Euro-African patchwork of RTA's might prefigure.

  Some see the prevention of such a drift through the building up of "transcontinental" RTA's such as EU-Mexico, EU-Mercosur, EU-Chile, US-Singapore and so on. And it is obvious that when negotiating an RTA with Mercosur and Chile, the EU has not only in mind a pre-emptive move in order not to replicate its eviction from the Mexican market, but also the strategic role of Mercosur as a pillar of the multilateral trading system. In this respect and somewhat paradoxically, a trans-South-Atlantic RTA between the EU and Mercosur could be holding the latter together thanks to the negotiation process with the EU itself at a critical juncture, strengthening it in the long run. Thus the EU-Mercosur deal may hold in check any fragmentation of the Latin

American market which would be stimulated by bilateral trade deals between the US and Latin American countries.

For all the good arguments put forward by economists in favour of a mostly multilateral liberalisation, there are no doubts for the practitioners that bilateral and regional trade deals will remain for a long time on the agenda of Trade Ministers across the world. For all their shortcomings which should not be ignored, nor underestimated, they contribute to maintaining a dynamic of liberalisation which eventually supports and feeds the multilateral agenda : in a way, they maintain the speed of the bicycle – although they may sometimes deviate it slightly.

Are the RTA's good for development ?

a) the "same neighbours" case

The link between trade and development is well established. Yet the direction of causality remains unclear. The decisive role of domestic policies is increasingly recognised, in particular the way they interact with globalisation constraints and opportunities and may magnify these effects. The balance between exogenous and endogenous factors in growth performance varies with the degree of exposure to outside pressure and shocks : the size of the domestic market and the degree of openness are key determinants in this respect.

This is why regional integration may often ease the efforts of individual countries to diversify their production structures and access more efficient technologies especially through FDI, which is very sensitive to the size of the domestic or of the regional market and to larger markets at home.

This is what economic regionalism is about for DC's :

- larger domestic markets;
- competition among peers (in development)
- better bargaining power
- ability to exploit complementarities, where they exist.

Of course, in the real world, economic factors are at play in a local political context : you don't choose your neighbours and you can't ignore them without bearing a cost. In other words, regional integration responds to both economic and political considerations and therefore is rarely optimal with regard to economic complementarity and coincidence in collective preferences. Regional integration when markets are properly framed by the appropriate institutions delivers more than economies of scale and competition; it helps to eliminate distortive public aids such as tax rebates to attract investment; it promotes competition policy, norms, harmonisation and when in the form of a Customs Union, it generates tariff revenues for the redistribution of welfare gains among Members.

b) what about North-South FTA's?

From my personal standpoint, the real issue arises with North South FTA's, because here you must explicitly address the central question of asymmetry, originating in imperfect competition between developed and developing countries.

From a theoretical perspective this might sound hardly relevant : comparative advantages exist particularly for inter-industry exchanges, especially agriculture and labour-intensive goods against capital and technology - intensive goods and, therefore, trade liberalisation entails welfare gains for both parties and allows for capital accumulation in the developing country. The North-South flow of FDI speeds up the process of switching to a more efficient - and hopefully more sustainable - division of labour within the FTA.

Well, in practice, things don't work that smoothly since as far as the EU is concerned, agriculture belongs to the multilateral agenda, allowing only for narrow room for manoeuvre at the region-to-region level, Mercosur being a good case in point.

Some would say, not without reason, that narrowing the scope of trade-offs to non-agricultural goods and services raises two objections :

- it makes the deal unfair and a bit one-sided!
- WTO-compatibility might be questioned : does "substantially all trade (art. XXIV)" refer to present or to potential trade?

To this I would answer that this sensitive question of agricultural trade liberalisation is a bit overrated for two reasons :

- On the one hand, multifunctionality is not a tactical game; it's here to stay. Its fair application by the EU - through the Mid Term Review - and by Japan will provide the Doha Development Agenda (DDA) negotiators with a reasonable margin for manoeuvre, but within limits because as Pascal Lamy puts it, agriculture is not coal mining : in Europe, you can't close farms the way you have closed pits. It is a culture and a landscape inhabited by people - not empty spaces where land is just another production factor - which are at stake!

- On the other hand, the real long-term development challenge in the South remains, for most countries, industrialisation; for it is industrialisation that provides jobs, allows for upgrading the added-value of goods and services thereby over time generating more highly skilled jobs, bringing new and more productive technologies and contributing to the emergence of a middle class. This is particularly so for countries, such as those in Latin America unable - or unwilling - to achieve land reforms and thereby ensure better income distribution within the farming sector. The combination of overspecialisation in agriculture, uneven land ownership and capital flight - illustrated by the case of Argentina - is hardly a recipe for long-term endogenous development. Investing the gains made through agricultural exports in manufacturing and services would give development a chance.

So let's concentrate on the industry and services side of North-South bilateral or region-to-region RTA's.

Things are not simpler than with agriculture, by any means, because we are confronted, but in a more intensive way at a regional level, with the asymmetry of competition between North and South encountered at the global level. This explains best - along with poor domestic policies - why there are so few winners and so many losers within developing countries when they are confronted with globalisation, why there has been no real North-South convergence and why absolute poverty persists in the South in spite of decades of world growth coupled with FDI and trade expansion.

I know from experience how economists are uncomfortable

- not only with the intricacies of models of imperfect competition (especially when they extend to the welfare gains distribution) and the possibility of "winners take all" situations;

- but also with the need to take account of the persisting inertia of the legacy of the colonial era in relation to the North-South division of labour, as well as the inner dynamics of the market capitalism system, which most of the time rewards the rich proportionally more than the poor because initial endowment of resources matters more than most economic models are willing to admit.

So let's go back to the crux of the matter : contrary to World Bank scenarios, I fear that North-South RTA's are more risky for the weaker partners than the South-South ones although I do not deny that they can also cause problems for small islands or landlocked countries.

In a North-South deal, such as EU-Med or EU-Mercosur or Nafta, when you put all actors on a par, tariff-wise and rules-wise, first movers inevitably start from a situation of comparative advantage over the late comers. Their initial competitive edges are very different because of firms size, with their economies of scale and market power, more efficient infrastructure and public goods supply, externalities linked to agglomeration and network effects with regard to innovation, highly skilled labour supply, business-to-business services etc.

Opening up respective markets in a "WTO-plus" deal between unequal partners may indeed trigger off better development. But if we don't want the cold shower of competition to translate into a lethal shock for infant industry, the North-South RTA must meet some conditions. For if North-South divide is a real issue at the global level, it will prove even more sensitive in a bilateral deal where partners are standing face-to-face and have to cope in a bilateral framework with extremely sensitive issues such as trade imbalances, low level of FDI, deteriorating terms of trade - including as pointed out by a recent UNCTAD report with regard to intra-industry trade - and, last but not least, increased migratory pressures.

The initial motivation might be about substituting trade for migration; but once a North-South RTA deals is clinched and if it does not deliver its expected benefits, it might be that compensations will be requested in terms of "substituting migration for trade" such that trade deficits can be funded by remittances inflows.

In this respect a North-South RTA deal must do better than multilateral liberalisation and autonomous preferences if it is not to result in a flurry of trade irritants, possibly with the prospect of a ‘divorce’ where economic and political costs might prove higher tomorrow than the expected benefits today.

What are the conditions that would make a North-South RTA deal a successful deal ? I would just name four :

1) preferably it should be a North-South-South deal, namely a region-to-region agreement so as to strengthen the competitiveness of the Southern partners

while increasing their attractiveness for FDI and their bargaining power in negotiations.

This has been the EU policy with the Mediterranean countries - although we have had little success to date - the ACP and Mercosur, whereas the USA favour State-to-State RTA's in which the power balance is tilted to the maximum towards the stronger partner.

2) It should - according to the level of development of partners and the intensity and coverage of the agreement - be backed by ODA explicitly aimed and strictly conditioned to capacity building and reforms in key sectors with the view to supporting sustainable development. Normally, this bilateral financial assistance should be coordinated with the Bretton Woods International Financial Institutions (IFI's) so as to strengthen its effectiveness. But the indispensable coordination between EU ODA and IFIs raises the issue of the consistency of the World Bank's and the IMF's strategy with EU goals. This can only be achieved through EU presence on the board of both Institutions in order to rebalance the IFI's strategy towards supporting the right development strategies by the right governments, beyond strictly financial conditionality or special interests influence, the source of moral hazard. The very fact that contrary to the EU, the USA can use their leverage within those institutions - exempting themselves from granting bilateral financial assistance instead - was illustrated last August during the Brazilian Real crisis : the IMF, at the USA initiative, was able to mobilise 30 billion $ to ease the pressure on the Real, whereas the EU which had just completed a round of trade negotiation at

Ministerial and Commissioner level in Rio, a fortnight before, was standing silent on the side-lines;

3) it should of course involve generous and effective TRTA (trade related technical assistance) provisions and resources;

4) last but perhaps eventually more important, the trade deal should be "asymmetrical" in terms of market access.

Asymmetry in market access is a difficult and somewhat elusive concept, which calls for serious thinking and some tinkering. Basically it aims to offset, for a certain period, the initial competitiveness differential not across the board but in some limited and carefully selected sectors, but allowing for tariffs on imports from the Northern partners.

The management of such asymmetry is delicate if one wants to avoid the two pitfalls which have marred most industrialisation attempts based on import substitution in the past, especially in Latin America, namely the small size of the domestic market and the consequent absence of competition. In this respect, a region-to-region FTA such as EU-Mercosur, with investment and competition policy provisions, provides a better chance of success, particularly as large markets are more attractive for critical FDI. Yet the key question remains the consistency of turning tariff protection into incentives for infant industry. Our own economic history and most 'Asian Tigers' success-stories starting with Meiji's Japan, point to the combination of industrial policy and market forces as the ingredients of success. So the quality of domestic and regional policies looks to be, once more, decisive in ensuring the gradual establishment of external competitiveness by nascent industry and prevention of the usual drift towards cosy rent-seeking protection.

CONCLUSION

Regionalism would become dangerous for cohesion and balance in the world economy only if multilateralism were to come to a standstill or recede. This is why the Doha Development Agenda is so important now as RTA's multiply.

As long as regionalism is mainly about promoting the mercantilist interests of the leading party to the RTA, its impact on development will remain uncertain. In particular, bilateral individual RTA's between a rich and a poor country can lead to a situation where the initial income imbalances and division of labour will be permanently "crystallised" along a North-South divide. Neo-liberals might satisfy themselves with the idea that "a rising tide lifts all boats". Those who care about real North-South convergence and combating excessive inequalities will be more critical.

North-South FTA's can be powerful tools for development provided they are part of a comprehensive package of - asymmetrical - trade liberalisation, financial transfers and regulatory convergence, particularly in the area of services. However they will deliver their benefits only to the extent that the Southern partner is ready and determined to accept the social change that accompanies development and that the Northern partner is eager to measure the success of the partnership by the industrialisation performances of the other party.

Such development-oriented North-South FTA's call for more than trade arrangements but also a meeting of minds on what constitutes the tenets of sustainable development : stable growth, social progress including core labour standards and environmental protection. In a way it is odd that although the EU is championing these issues in the DDA and in specialised international fora, it has not been more explicit on these specific points, in the negotiating mandates for the RTA's already into force, or in negotiation.

Development-geared FTA's may look close to idealism in the hard world of trade negotiations where mercantilism still lingers. Yet, it is the type of partnership which the Marshall Plan initiated in the late 40's and early 50's between the EU and the USA: on the European side a genuine will to rebuild and unite; on the American side short term financial costs in the interests of long term economic and political gains.