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RETURNS TO REGIONALISM: AN  
EVALUATION OF NON-TRADITIONAL  
GAINS FROM RTAS

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### **ABSTRACT**

The last decade has witnessed an explosion in the number of regional trade agreements (RTAs). There seems to be a general if ill-defined belief on the part of many policy-makers, and among a number of academics as well, that there is more to a RTA than the traditional gains from trade. This paper examines several possible benefits that RTAs may confer to their partners, including credibility, signaling, bargaining power, insurance, and coordination. It assesses the necessary conditions for each of these candidates to work; gives stylized examples of specific types of policy where it might be applicable; examines real cases where the explanation might be relevant; and discusses their overall plausibility. It concludes by examining NAFTA and the Europe Agreements viewed in this light.

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## I. Introduction

The last decade has witnessed an explosion in the number of regional trade agreements (RTAs), whose only precedent, though on a less dramatic scale, was in the proliferation of agreements of the 1970s (see Chart 1). Table 1 lists the agreements notified to GATT from 1947 to end of 1994. By the time the World Trade Organization (WTO) was established on 1 January 1995, almost all GATT members (notable exceptions include Japan and Hong Kong) were signatories to at least one such agreement.<sup>1</sup> These agreements, however, are quite diverse: they range from custom unions to free trade areas to non-reciprocal preferential agreements. Furthermore, they differ substantially in their treatment (or lack of) of issues such as labor and capital mobility, investment, and production sharing agreements, and in whether their scope is wider than that of GATT at the time (such as services in the Canada-US Free Trade Agreement (CUSTA) and environment and labor standards in the North American Free Trade Agreement (NAFTA)). Nonetheless, it is possible to characterize the growth that has occurred over the last decade as taking place in at least three separate, albeit related, dimensions:

- the "deepening" of existing RTAs, as RTAs that originally focused on "hard" trade restrictions like tariffs and quotas on manufactures and agriculture are extended to "soft" restrictions such as health and environmental standards, to other product areas like services and intellectual property where trade policy is typically far more complex to describe or implement (let alone negotiate or conclude a binding agreement), or to issues such as investment and capital mobility that are not strictly within trade policy at all. Here the pre-eminent example is the European Union (EU), whose successive name changes (from the "Common Market" to the European Community to the European Union) describe its progressive evolution from a customs union to a single market (with free movement of labor, capital and services, and substantial regulatory harmonization) and prospectively an economic union with a single currency.
  
- the "widening" of existing RTAs, as countries not previously a member of any RTA sought to join one (or more). Here examples include NAFTA, which essentially involved Mexico's accession to CUSTA, and the accession of some of the former EFTA countries to the EU;

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<sup>1</sup> WTO (1995).

- the creation of new RTAs, or the relaunching of RTAs that had effectively been dormant. The most publicized of these new RTAs has been Mercosur, but other examples include the Central American Common Market (founded in 1960, but effectively dormant until 1993) and the South Asian Preferential Trading Agreement established in 1993 with the aim of forming a Common Market between Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

At the same time the international trading system has also deepened and widened. GATT discussions have extended for the first time into trade in services, intellectual property rights, and prospectively other industries like telecommunications; again this deepening has been signaled with a name change, as GATT has become the WTO. The widening has occurred largely as a consequence of the collapse of the formerly centrally planned economies; and this is also reflected in the fact that all but nine of the 33 agreements notified to GATT since 1990 have been concluded with Central and East European countries.<sup>2</sup>

The search for an economic explanation for this new proliferation of RTAs begins with a number of negatives. The intellectual case for free trade is as strong as it has always been - which is to say fairly strong - but not obviously any stronger, although the rediscovery of possible externalities in the growth process and the ability to model these rigorously (e.g. Rivera-Batiz and Romer (1991a,b), and Grossman and Helpman (1991)) has added intellectual respectability to the traditional arguments linking trade liberalization and growth. Still, it would be difficult to believe that the growth in RTAs is the policy counterpart to the proliferation of academic papers on trade and growth. Nor has the debate as to whether RTAs are to be preferred on theoretical or empirical grounds to an admittedly imperfect global trading system been resolved in such a way so as to pave the way for an explosion in the number of RTAs.<sup>3</sup> In fact, the debate remains lively but unresolved, though lately with the Uruguay round concluded, all parties seem to be swaying towards accepting RTAs as a useful accompaniment to the WTO. But in any case, the amount of time and effort expended by policy-makers and bureaucrats in concluding trade agreements seems disproportionate to the gains or losses that, at least on the face of it, could be anticipated from most RTAs. NAFTA, for example, involved

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<sup>2</sup> Figures from WTO (1995).

<sup>3</sup> See Winters (1996) for a recent survey of this literature.

relatively small changes to Mexican trade policy, and minuscule changes to US policy, yet managed to dominate US political debate in late 1993.<sup>4</sup>

The question therefore arises: is there more to an RTA than meets the eye? Are there reasons a country might wish to create or join a RTA beyond the simple desirability or otherwise of the provisions of the RTA itself? Could the entry of a country into a RTA change the incentives, and hence the behavior, of that country, other countries, or the private sector in ways beyond the actual provisions of the RTA? And insofar as the RTA does alter future incentives and behavior, how does it change the expectations of all the parties involved?

There does seem to be a general if ill-defined belief on the part of many policy-makers, and among a number of academics as well, that there is more to RTAs than the traditional gains from trade; hence the term "New Regionalism." Summarizing the conclusions reached in a conference on regional integration, Melo and Panagariya (1993) report that "it is increasingly recognized that regional integration goes beyond trade in goods, services and factors." There has been remarkably little work, nonetheless, that examines rigorously either the theoretical or quantitative plausibility of these claims.<sup>5</sup>

This paper attempts to classify and assess the relative plausibility and importance of these "non-traditional gains" from RTAs. After a brief discussion of the traditional costs and benefits of regional agreements, I examine other possible mechanisms by which RTAs might benefit their members. In each case, I discuss the necessary conditions for such an explanation to make sense; give one or more stylized examples of specific types of policy where it might be applicable; examine real-world cases where the explanation might be relevant; and discuss the overall plausibility of the argument. I conclude with a comparison of NAFTA and the Europe Agreements between the CEE countries and the EU, viewed in this context.

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<sup>4</sup> Prior to NAFTA, the average Mexican tariff on US exports was about 10 per cent, while the average US tariff on imports from Mexico was less than 10 per cent. See Hufbauer (1992).

<sup>5</sup> Among the few papers that, with varying degrees of rigor, take up this question are Ethier (1996a,b), Gould (1992), Panagariya (1996), Perroni and Whalley (1994) and Whalley (1996).

## II. Theoretical Mechanisms

This section sets out a number of possible theoretical mechanisms by which an RTA could have real effects beyond the actual provisions of the RTA. We first start out with a short review of the traditional gains and losses from RTAs.

### A. *Traditional Gains*

#### 1. Trade Creation and Diversion

In one of the classic demonstrations of the theory of the second best, Jacob Viner (1950) showed that a move to free trade between two countries that maintained their respective external tariffs toward the rest of the world could leave them worse off. The argument relied on showing that as a consequence of liberalizing trade with only a subset of its trading partners, the country could switch from a relatively lower cost producer to a higher cost producer, potentially decreasing welfare for all. This negative effect on world efficiency was given the term "trade diverting".

Some observers (e.g. Krugman (1991)) argue that something like this has been the effect of EC enlargement on agricultural trade. Southern European countries now buy grain and other products from relatively high-cost European sources rather than from the lower-cost providers on the other side of the Atlantic or Australasia. Northern European countries buy Mediterranean products like olive oil or more labor intensive products from Southern Europe rather than from cheaper sources in Northern Africa. This effect could be even more pronounced in the context of a customs union, which requires the equalization of external tariffs also: indeed, one of the main arguments used against EC entry in the UK was that it would result in price *increases* for dairy products previously purchased primarily from New Zealand.<sup>6</sup>

Nonetheless, Krugman goes on to argue that most RTAs are likely to entail relatively low welfare losses resulting from trade diversion, since the countries involved are often geographical neighbors and hence already engage in a sizable amount of trade. However, for that very reason, RTAs may result in substantial redistributive losses in the form of tariff revenue for the country that is lowering its tariff barriers, as pointed out in

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<sup>6</sup> See Winters (1993) for an evaluation of EC integration.

Panagariya (1996).<sup>7</sup> Since in reality it is most often less developed, smaller, or economically weaker countries that are making the largest reductions in their protectionist structures, this redistributive cost is most likely to be borne by them. If this is indeed the case, our earlier question is even more pressing. Why are we seeing so many RTAs, especially those involving smaller countries with a larger more powerful partner? How can we explain that in these agreements it often seems that the smaller countries are making the bulk of the concessions?

## 2. Terms of Trade

In addition to possible distributional effects resulting from reductions in tariff (or quota, for that matter) revenue, there may generally be another distributional effect associated with an RTA. This time it occurs at the expense of third parties. To see this note that if as a result of this agreement all prices are left unchanged, with tariffs eliminated on RTA members but maintained on all other countries, then the RTA countries will buy more from one another, each RTA country will substitute away from consumption of her own goods, and all RTA countries will substitute away from consumption of goods bought from non-member countries. Although the net effect on the demand of each RTA country is ambiguous (since own demand has fallen but member demand has increased), if goods are sufficiently strong substitutes the demand for third party goods will decrease. Thus, in order to clear markets the price of third-party goods will have to fall which (as long as no member country's price decreased by too much) will create a positive terms of trade effect for the member countries.<sup>8</sup> Thus, this potential "beggar thy neighbor" effect of RTAs can make the latter an attractive proposition for potential members despite any negative trade diversion effects on member countries.

## 3. Increasing Returns and Increased Competition

A largely unmitigated beneficial effect that may be expected from RTAs stems from the increased size of the market leading to greater productive efficiency for any industry with economies of scale. Indeed, as Krugman notes:

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<sup>7</sup> See also Bhagwati (1993) for a critique of this position.

<sup>8</sup> This point was made early on by Mundell (1964). See Winters and Chang (1996) for an assessment of these terms of trade effects from Spain's accession to the EC.

“When the European Common Market was formed in 1958, substantial trade diversion seemed a likely outcome. What turned the arrangement into a strong economic success was the huge intra-industry trade in manufactures, and the associated rationalization of production, that the Treaty of Rome made possible.”<sup>9</sup>

Note that this factor would make RTAs relatively more attractive for small countries than large ones. Such countries may expect to reap substantial benefits from the increased market size resulting from a RTA, particularly if prior to the RTA that country's firms were producing solely for the domestic market. In addition, they would also see the traditional benefits associated with increased competition. Since small countries will benefit more than larger countries - because they are starting at a lower base - from economies of scale and increased competition, we would expect to see them attach a higher priority to joining a RTA.

#### 4. Investment

The need to attract foreign investment (and stimulate domestic investment) is increasingly cited as an impetus for RTAs (see, for example, Balasubramanyam and Greenaway (1993)). This is not surprising, since investment flows between countries have increased dramatically in recent years, and are of particular importance to developing countries, especially as the importance of public sector concessional lending has decreased. A RTA could stimulate investment flows both *between* its constituent member countries, and from *outside* the RTA, in a number of ways:

- by reducing distortions in production within the two countries, it could increase the overall quantity of investment made by investors in member countries;
- by increasing the size of the potential market, it could increase the quantity of investment made both by domestic and outside investors. This effect is particularly important for “lumpy” investments, like a factory, that might only be economic above a certain size;
- in the case of a customs union, by creating a single market within a common external tariff wall, it may increase the incentive for foreign investors to engage in “tariff-

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<sup>9</sup> Krugman (1991) p.9.



jumping” if the common external tariff is higher than the preexisting tariff for some individual member.

It is not the purpose of this paper to examine these effects in detail. However, it should be noted that a number of the explanations described below for "non-traditional" gains from RTAs are of particular importance in relation to investment. Since the incentive to invest, for both domestic and foreign investors, depends crucially not only on current trade policies, but on future trade policies, on the nature and level of uncertainty, and on the general macroeconomic and political environment, any effects that RTAs may have in these areas are likely to be particularly relevant to investment.

## ***B. Time inconsistency***

### **1. Economic**

One way in which the entry of a country into a RTA could provide it with non-traditional benefits is if it allows the country to pursue policies that are welfare improving but time-inconsistent in the absence of the RTA. A well known idea in the economic literature, first introduced in the seminal paper of Kydland and Prescott (1977), is that a government that maintains policy discretion will be tempted every so often to "surprise" the private sector and that this temptation undermines the credibility of optimal government policies. Hence adherence to rules (that somehow bind) will restore credibility and lead to superior outcomes.

In the arena of international trade, the time inconsistency problem is faced if there exists a temptation of surprise trade policy actions when other first-best instruments are unavailable. This may well lead to many governments finding themselves in suboptimal equilibria if they are unable to bind themselves to some credible promise not to intervene.

Staiger and Tabellini (1987) examine credibility issues arising from the temptation of the government to use tariffs as a redistributive tool in the face of a terms-of-trade shock to transfer income from workers with low marginal utility of income to those with high marginal utility of income. The relocation of workers is assumed to involve a loss in marginal productivity, hence a terms of trade shock can result in less than full mobility of workers leaving wages unequal across sectors. Consequently, the government may be

tempted to intervene by using trade policy to reduce the wage differential between sectors.

To the extent that the government's intervention is anticipated by workers, the wage-differential that results in equilibrium will be the same, serving only to decrease the number of workers that exit the injured sector. In the face of this, for a large set of parameters, the optimal policy for the government to pursue is free trade. This policy, however, will be time inconsistent if the government cannot commit to it by, for example, credibly setting up trade policy rules in advance. The reason for this is that while anticipated trade policy does not serve to change the income distribution, unanticipated protection does. This provides the government with an incentive to surprise the private sector and the latter, knowing this, no longer finds the ex-ante optimal policy of free trade credible. The time consistent equilibrium is given by a tariff level that is fully anticipated and such that the government no longer has any further incentive (because of large distortions) to surprise. This time consistent equilibrium is inferior to the free-trade equilibrium which, in the absence of some binding mechanism, cannot be attained.

The story told above is but one of many possible ways to generate plausible time-inconsistency problems from international trade policy.<sup>10</sup> As another simpler example, consider the case of a country whose optimal policy is to open itself up to foreign investment. Once foreign investment has been made, however, the country has the ability to "confiscate" it (in practice, "confiscation" might be through the imposition of a greater regulatory or fiscal burden). Suppose that, for a sufficiently "impatient" government, it would, in fact, be optimal to engage in such confiscation. If the country is unable to commit to abstaining from this action, foreign investors, perceiving this time-inconsistency problem, will simply not invest, and the country will be worse off than if they had invested and it had not confiscated the investment.

What is the possible contribution of a RTA to solving any set of time-inconsistency problems? First, in order for the RTA to be a valid mechanism to solve some time-inconsistency problem, the following conditions must be fulfilled:

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<sup>10</sup> See Staiger (1995) for a review.

- the policies in the absence of a RTA must be time-inconsistent - that is, they must be optimal ex ante, but not ex post - at least with sufficient probability to be a material concern;
- the cost of exit from the RTA must be high enough to outweigh the gains from simply abrogating it and returning to the time-consistent policy.

Are there some set of policies for which a RTA fulfills these conditions? On the whole, my answer to this is in the affirmative. Below I evaluate how an RTA may contribute to solving time inconsistency problems within the context of two different set of policies: (a) trade and (b) other domestic reforms.

#### *a) Trade Policy*

Unilateral liberalization of a country's economy, even for a small economy, is unlikely to be a time consistent policy. The temptations to provide protection to some sector in the economy, either for income distributional reasons, for political economy concerns, or for terms-of-trade considerations, are likely to be large. While protection and subsidies may be extended in only a few sectors at a time, over longer periods of time an economy is bound to become severely distorted.<sup>11</sup> A RTA, by making the cost of even a small deviation from an agreed trade liberalization large, makes these small temptations that culminate in an overall greatly distorted economy, easier to overcome. Thus, a country in a RTA will face the cost of either exiting from the agreement, or an agreed upon large punishment from the other members, should it extend protection to some particular sector of its economy.

A question that must be asked here, however, is why this commitment could not be reached via some other easily available alternative policy, whether through GATT or some domestic alternative? The domestic alternative is relatively easy to argue against; it is difficult to think of ways that a government can easily and credibly bind itself to not giving protection to any sector. A more sophisticated counterargument is the observation that the private sector can itself punish the government if it undertakes gradual forays into protection. This punishment would be a "trigger strategy" whereby the observation of the

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<sup>11</sup> Status quo bias, arising for many reasons, may prevent protection from being taken away once it has been extended. See Fernandez and Rodrik (1991) for a model that provides one explanation for this.

government indulging in some such protection would trigger the expectation on the part of private agents that much more protection would be swiftly forthcoming. They would consequently immediately distort their production activities, thereby obtaining the expected protection sooner rather than later. The government, understanding the punishment that would be triggered by a small deviation into protection, would therefore refrain from it altogether. The problem with this argument is not its game theoretic correctness, but rather the immense amount of expectational coordination required on the part of atomistic agents. It is but one of many equilibria, and while cooperative behavior explained by trigger strategies is enlightening I think when applied to repeated interactions among several large agents, it is less persuasive in the context of a many small agent economy.<sup>12</sup>

Why GATT does not serve as a commitment device and yet a RTA does is more subtle. The answer, it seems to me, must lie in the differing incentives for countries to punish a deviating member within the two organizations. Within GATT the responsibility for singling out a culprit and, if the organization delivers a guilty verdict, delivering some retaliatory punishment, lies with the country(ies) that have been hurt by the action. In a large organization with a more diffuse trade structure, this incentive is likely to be much smaller for any single member, and the process likely to be much slower and the outcome more uncertain than within a regional agreement. There it is much clearer who has the responsibility to punish and the reputational loss from not doing so should accordingly be greater.

As an example of the above, suppose that, within a RTA such as Mercosur, Argentina does not (credibly) threaten to retaliate when Brazil attempts to protect some industry. The incentive for Brazil to engage in this behavior again, with some other industry in some other instance, will be correspondingly larger. Argentina, therefore, faces a high future cost from not retaliating. Within GATT, the country who offends next time or the set of countries who are hurt could very well be different, and the country responsible for not retaliating or not retaliating at the "correct" level may be less identifiable, making the cost from not retaliating correspondingly smaller. Thus the extent to which RTAs increases the importance of regional trade and makes unambiguous the set of partners

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<sup>12</sup> If the economy is characterized by few and large players, then again this trigger strategy becomes more persuasive. Furthermore, for problems that visibly affect the majority of agents in the economy such as inflation, it is easier to imagine how agents can coordinate on extreme equilibria.

who are to do the retaliation, all contribute to making the latter a superior enforcement mechanism to GATT.

An alternative way in which a RTA can render policies time consistent relies not on a RTA having a superior "punishment" mechanism than GATT, but instead on a RTA changing incentives in a way that differs from GATT. A prime candidate for this explanation is increased domestic and foreign investment.

Why might one expect to see investment increased for a partner to a RTA more than, say, under GATT? Precisely because, if credibly in place, a RTA gives preferential access to a given set of markets while GATT does not. Furthermore, it is precisely this preferential access and the additional investment that accompanies it that may turn trade liberalization from a unilaterally or multilaterally unattractive proposition for a given country (due to domestic political concerns, for example) into a politically feasible proposition.<sup>13</sup> Thus, trade reform which is infeasible without an RTA becomes feasible with one. This conclusion is reinforced if the RTA includes aspects of deeper integration, for example harmonization of the investment code, which are harder to negotiate multilaterally, but which can increase the attractiveness of freer trade.

#### *b) Other Domestic Reforms*

There seems, however, to be a feeling that the benefits of a RTA go beyond extending credibility solely in the area of trade reform and that it spills over into other micro and macroeconomic reforms. Whalley (1996), for example, asserts that a desire for increased credibility of domestic reforms was a central preoccupation behind the Mexican negotiating position on NAFTA.

“As such, it led to the outcome that Mexican negotiators were less concerned to secure an exchange of concessions between them and their negotiating partners, and were more concerned to make unilateral concessions to larger negotiating partners with whom they had little negotiating leverage as part of the bilateral negotiation. The idea was clearly to help lock in domestic policy reform through this process.”<sup>14</sup>

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<sup>13</sup> Ethier (1996a,b) examines models that develop similar conclusions. See also Maggi and Rodriguez-Clare (1996).

<sup>14</sup> Whalley (1996) p.16.

If these domestic reforms referred to above are clearly stipulated within the RTA and if, as in the case of trade liberalization, some punishment incentive exists, there is no reason to think that a RTA would not be able to serve as a commitment mechanism. However, this is not the case for most RTAs, including NAFTA, although the Europe Agreements between the EU and the CEE countries clearly contain elements of commitment to domestic policy reform.

It is harder to believe, however, that RTAs will help provide commitment power to policies that are not explicitly part of the agreement unless the agreement itself has changed the underlying incentives. Hence an expectation of a reformed monetary or fiscal policy on the basis of a RTA alone seems mistaken. The extent to which an economy within an RTA is more open than previously may arguably help discipline macroeconomic policies, although it may just as well provide greater temptations to manipulate exchange rates in the hope of increasing, if only momentarily, competitiveness.

For example, the coincidence of the establishment of Mercosur with radical domestic policy reforms has led some to suggest that its component countries are trying to entrench domestic policy discipline, particularly since these countries have a long history of failed attempts at domestic macroeconomic adjustment. But it is not clear whether the Real Plan in Brazil gains or loses in credibility because of Mercosur. On the one hand, the increased openness of the economy may increase the incentive to maintain fiscal discipline, since any increase in aggregate demand is likely to leak into imports rather than the demand for domestic products; on the other, it may make the maintenance of a fixed exchange rate more difficult, because the loss in competitiveness resulting from the combination of a fixed exchange rate and domestic inflation will lead more quickly to an import surge and a possible balance-of-payments crisis.

As an example of the first instance, by the early 1980s the French government discovered that it was no longer feasible for it to pursue macroeconomic policies that differed radically from that of West Germany (since domestic fiscal expansion simply leaked into an unsustainable current account deficit). The political result was an impetus towards greater macroeconomic policy coordination, now culminating in EMU. However, while it may be relatively easy to make the argument that it is difficult for an RTA to survive without some degree of fiscal and monetary discipline among the member countries, the history of earlier RTAs among developing countries (e.g. LAFTA which was signed in

1960 among all major Latin American countries, and CACM, signed the same year among four Central American countries) gives lie to the belief that a RTA will provide sufficient incentive for countries to do so.<sup>15</sup> The difference between the two experiences--EU success and some RTA failures--may lie with the differential in exit costs which could very well increase with the longevity of the agreement.

## 2. Political

The time inconsistency arguments discussed above assume implicitly that the objective function of the country does not change. Perhaps more interesting is the case where the provisions set out in the RTA are not time-inconsistent for the government at the time that it signs them, but it fears that a subsequent government might not have the same objective function. In this case, the government is not tying its own hands - since it would not want to backtrack on the provisions in the RTA even if it could - but it is tying the hands of an alternative future government.

For example, consider a country with two political parties; a "liberal" one and a "protectionist" one. If the liberal party is in power, it may wish to sign a RTA to prevent the protectionist one from reversing trade liberalization when in power. Here, the analytics are little different, but it need not be the case that the provisions of the RTA are inconsistent with the objective function of the government that signs it; only that they are inconsistent with that of some potential future government.

However, in this case there are likely to be additional effects. The RTA may not only affect the incentives of the protectionist party if it takes power, but may also affect the probability of it taking power in the first place. In principle, this effect could operate in either direction. It could be the case that electors perceive that if the protectionist party does take power it will not be able to implement its policies except at great cost; this may tend to reduce its chances. On the other hand, if electors are also making policy choices on other dimensions - suppose free trade is popular, but the government is generally unpopular - then electors may be more willing to vote for the protectionist opposition, knowing that it will not be able to implement protectionist policies in practice.

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<sup>15</sup> See Genberg, H and F. Nadal de Simone (1993) for an analysis of how import substitution practices and fiscal and monetary policy led to a failure of these agreements.

This explanation relies on similar, although less restrictive (since the policy itself need not be time inconsistent for the given objective function), basic conditions to the economic time-inconsistency one; the policies contained in the RTA must be time-inconsistent under some possible future course of events, the RTA must effectively constrain such policies, and the cost of exit must be large.

One case where the political time-consistency argument clearly has some relevance is the EU. While the EU, which is far "deeper" in terms of its coverage than any other RTA, is a special case, its recent and likely future widening has some broader relevance. EU membership has always been seen - both by existing and prospective members - as a way of committing a country to "Europe"; by which is meant not only, and not even primarily, trade liberalization within Europe, but membership in the European political system of liberal democracy. This applied not only to the initial formation of the EU, which had the clear political objective of constraining Germany, but also in the accession of Greece, Portugal and Spain (each formerly governed by authoritarian regimes of the right) and in the Europe Agreements (designed to lead to eventual accession) with the countries of Central and Eastern Europe (formerly governed by authoritarian regimes of the left). It is also visible in the "conditionality" attached to the EU's recent customs union agreement with Turkey (covering human rights and free speech issues).

It seems to me that something similar may also at work in the recent spate of Latin American RTAs. Newly democratic countries after many years of authoritarian rule have actively sought to cement a new relationship among governments by entering into trade agreements of various sorts. But besides being a celebratory event of some kind, is there some commitment added to democracy by entering into one of these agreements? Although, in general, it seems rather difficult to see why, some agreements, such as Mercosur, have followed the EU lead in making democracy a necessary condition for membership. That these are not necessarily vacuous clauses was demonstrated in April 1996 when Mercosur foreign ministers warned a Paraguayan general contemplating a coup that diplomatic and economic isolation would follow.<sup>16</sup> In addition, these agreements may help to deepen ties and more easily exchange information among democratic neighbors and to avoid conflicts among traditionally more pugnacious members (such as Chile and Bolivia).<sup>17</sup>

<sup>16</sup> See the Mercosur supplement in *The Economist*, 12 October 1996, vol. 341, #7987.

<sup>17</sup> See Schiff and Winters (1996) for an analysis of the formation of RTAs as an optimum response to security problems among its members.



### C. *Signaling*

An alternative to the time-inconsistency explanation is the signaling one. Here there is no need for the provisions of the RTA to be time-inconsistent, but the prime motivation for entering the RTA is not the provisions of the RTA itself, but the fact that entering the RTA at all is only optimal in certain circumstances; and the country wants to persuade others that those circumstances do in fact prevail.

For example, consider a country which could have two types of government: liberal or protectionist. In fact, it has a liberal one, but this is not immediately apparent to outside observers. Potential investors are not particularly interested in the exact provisions of any RTA, but they do care about the type of government. In that case, entering the RTA may be a way for the government to signal to investors that it is in fact a liberal one.

Alternatively, the government may wish to signal not its type but something about the underlying condition of the economy: for example, the prospective competitiveness of its industry, or the sustainability of the exchange rate. Suppose for example that the country wishes to attract investment to the manufacturing sector, but investors do not know if the sector is likely to be competitive and hence worth investing in. But if entering the RTA would be very costly for the country if the sector is in fact uncompetitive, then the RTA may signal to foreigners that it is not, and hence stimulate investment. Similarly, if the government believes (and has greater information) that the currency is correctly valued, but financial markets are unconvinced, entering a RTA could signal the government's belief (since entering an RTA with an overvalued exchange rate would be damaging to domestic industry).

Finally, the RTA may provide a signal not of the policies of the individual governments but of their future relations. If private investors are uncertain about the relationship between two governments, and if they fear the reimposition of trade barriers between the two countries, then they may only be prepared to invest in one or both if the two countries signal their future good relations by signing a RTA. This may be particularly relevant to RTAs between developing countries, which historically have not been very successful, and which are often motivated by the desire to attract foreign investment.

There are two key conditions for a signaling explanation to make sense:

- there has to be a significant information asymmetry. That is, the government has to have superior knowledge, either about its own preferred policies, or about the economy, than other agents;
- there has to be a significant cost to entering the RTA, at least for some hypothetical governments in some circumstances.

Unlike the first explanation, it is not necessary for there to be a significant cost of exit from the RTA, but rather a cost of entry. This argument at least in theory has some degree of plausibility. There are certainly transaction costs for policy-makers in joining a RTA, which typically requires an immense amount of negotiating time and effort; this is particularly relevant for developing countries which may have only a small amount of the necessary expertise, with competing claims on this resource.<sup>18</sup> Governments may have at the least to invest political capital in facing down domestic opponents of the RTA; political capital which may represent a sunk cost if it could not be recouped through withdrawal.

The information asymmetry condition is most likely to be met in cases where there is a significant degree of doubt about the government's commitment to liberalization and/or reform. It is thus most likely to be relevant to countries that have previously had relatively protectionist policies, or where liberalization attempts have failed in the past, like the Mercosur countries.

#### ***D. Insurance***

Another way in which a FTA can contribute to the welfare of its members is if it seen as providing at least one of them with insurance against possible future events. This may also help to explain why some agreements, particularly those involving a large and a small country, have the smaller entering on worse terms.

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<sup>18</sup> For example, it appears that the binding constraint on EU membership for several central European countries is currently neither political nor macroeconomic, but the institutional and legal changes needed to bring these countries up to EU standards. Of course, some bureaucracies may give positive weight to using resources in this fashion thus invalidating the use of this mechanism as a signal in those cases.

For example, consider a country which faces macroeconomic uncertainty, say about the level of real wages, which are not perfectly flexible. If real wages increase more than anticipated, it would like to devalue to improve competitiveness and avoid a fall in output and employment. However, if it does so one or more of its trading partners may impose trade restrictions. The fear of such an eventuality can explain why this country could seek to enter into a RTA with that trading partner on relative unfavorable terms, but with the provision that devaluation would not provoke a protectionist response. The unfavorable terms of the RTA then constitute a type of insurance premium paid by one country to the other. Alternatively, the situation need not be asymmetric; whichever country experienced an adverse shock would be allowed to devalue.

Perroni and Whalley (1994) hypothesize that smaller countries might seek to join a RTA as insurance against a generalized (world) trade war in which they would be the largest losers. In return for this insurance, the small countries offer the larger countries largely non-trade benefits such as greater intellectual property protection. Alternatively, another inducement to join a RTA could be to obtain insurance against a major trading partner arbitrarily imposing, say, health standards. These would more easily be appealed in the context of a RTA than under GATT. These benefits, though, would have to be weighed against the costs of becoming more dependent on a larger partner, which might cause a small country to be more vulnerable both to the possible reimposition of protection (and hence in a weaker bargaining position) and to economic fluctuations in the larger country. These factors would push a country to try to diversify rather than deepen its trade.

Raff (1996) has a related interpretation of the Canada-US FTA as insurance, in this case, against a trade war between the two countries that is generated by multiple equilibria in a bargaining game. In this interpretation, a RTA is a means of binding the parties to a cooperative way of "playing the trade game" that avoids conflicts.

Similarly, Whalley (1996) sees the Canada-US agreement as a way for Canada to obtain arrangements that would limit the application of US safeguard measures and in turn give the US some assurance that Canada would not return to policies in energy and investment that had been adverse to US interests. And Flam (1995) estimates that Austria, Finland, and Sweden, which recently joined the EU, would benefit very little from liberalized trade with their trading partners (since, under the European Economic Area provisions, they already effectively had free trade with the EU countries) but would have to make

significant net transfers to the EU budget. Again, an insurance argument is one way that the decision of these countries to join the EU can be explained.

In most of the interpretations proffered above, what is missing is an explanation of what allows a RTA to guarantee an outcome. To the extent that there is no incentive to exit from the RTA, or to impose contingent protection, this is not a problem. And, both in the case of a possible global trade war and in terms of helping ensure a cooperative outcome, it is not clear that there is any such incentive. Moreover, the insurance explanation may help to explain, in part, why we may be witnessing a flourishing of RTAs now and in the 70s.<sup>19</sup> If some group of countries, say the EU, has independent reasons (e.g. decreasing the likelihood of another European war) for forming an agreement, then the very fact of their doing so may cause a chain reaction. Other countries, fearing more protectionist responses from "fortress Europe", - and seeing the number of potential alternative trade partners, and hence the gains from diversification, reduced - decide to form their own regional block thus provoking yet more countries to do so. The recent deepening and widening of the EU, which at least in part is a response to political concerns, could have been the "trigger" this time around.

One may argue, however, that since most RTAs, including NAFTA, allow the imposition of contingent protection (anti-dumping duties, etc.), and make exemptions for "national security" (which in practice, as the case of the U.S. Helms-Burton Act shows, countries may attempt to interpret broadly), the insurance role of a RTA may be severely limited. Some of these actions, however, can be seen as the outcome of the multi-sided provision of insurance in which all members, under special circumstances, get to claim protection (which is what these contingent protection clauses allow). Total arbitrariness in claiming the need for this protection is restricted both by the greater accountability implicit in a agreement with a small number of parties (relative to WTO) and by the repeated game nature of the accord.

A different and less benign view of the domino effect theory is that, in a period in which low wage countries are increasingly competing for developed country markets, this is a propitious moment for the latter to obtain significant concessions from the former by playing off their fears of being left out in the cold. Thus, the fear here is not of suffering adverse terms of trade, but rather that the favored (i.e. lower protectionist barriers) low

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<sup>19</sup> See Ethier (1996a,b) for attempts to endogenize regional responses.

cost supplier will be whichever country signs the RTA with the large country. That country will become significantly more attractive to investors than the remaining low cost countries. This has smaller countries scrambling to enter RTAs with larger partners and making significant concessions in order to do so. Bhagwati (1991), for example, cites then President of Mexico Salinas as stating that a factor pushing Mexico towards a RTA was the fear that European investment would be diverted to Eastern Europe once it is integrated with the European Community. As Salinas put it at an early stage of the NAFTA negotiating process:

What we want is closer commercial ties with Canada and the United States, especially in a world in which big regional markets are being created. We don't want to be left out of any of those regional markets.<sup>20</sup>

The insurance explanation is less convincing in the context of agreements between developing countries. For example, in the event of a global trade war or of a resurgence of protectionism in the major developed export markets of the CARICOM or Mercosur countries, they would all be in the same boat; to a lesser extent this is likely to be true of any major macroeconomic shock. They are thus not particularly logical candidates to "insure" each other nor do either of the domino theories explain why these countries would enter into agreements with one another.

### *E. Bargaining Power*

The desire to increase bargaining power with respect to third parties is often cited as a reason why countries may wish to join a RTA. The reasoning behind this is the belief that these countries should in fact have greater bargaining power combined than separately; and that the RTA is the good way for them to coordinate their positions (in other words, that it reduces the transaction costs involved in reaching an optimal negotiating position). This explanation is more convincing for a customs union, which has a common external tariff, than a free trade area, which does not. A good example may be Mercosur; the incentive here to coordinate is large because the vast bulk of Mercosur's trade is still extra- rather than intra-regional, so there could be significant gains to greater coordination of trade policies with respect to third countries.

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<sup>20</sup> As cited in Perroni and Whalley (1994), p. 4, from *The Globe and Mail*, April 10, 1990, p. B1.

A related but logically distinct position is that in order to increase the slow pace of negotiations in GATT, countries such as the US played the "regional card". This last explanation, if central, should mean that as multilateral negotiations pick up steam, the importance of regional agreements should abate, which to date they show no sign of doing. Furthermore, it is difficult to think that some of the agreements entered into solely by relatively small countries should be able to pressure, in any way, the pace or direction of multilateral negotiations. Multilateral negotiations in the WTO are driven almost entirely by the "Quad" group (the US, EU, Canada and Japan); insofar as developing countries have influence, it is when they speak collectively on a global basis, led by larger countries such as India.

Countries may also seek to join an existing RTA to enhance their bargaining power with its current members. The most obvious example of this is the progressive movement of most of the former European Free Trade Agreement (EFTA) countries into the EU. Although the EEA Agreement effectively instituted free trade between EFTA and the EU, it also obliged the EFTA countries to accept existing EU standards and case law. Seeing that they were getting most of the benefits and costs of the EU, but with no say in how those benefits and costs were determined or distributed, most of the EFTA countries quickly opted for full membership. Of course, the strength of the relative bargaining positions meant the EFTA countries had to join largely on the EU's terms, but they evidently believe the long-term gains will outweigh any costs.<sup>21</sup>

#### ***F. Coordination Device***

Finally, an additional political economy explanation for free trade agreements in general is that they serve as a coordination device for those who stand to gain from trade liberalization. In particular, it is often argued that the gains from liberalization are widely distributed, uncertain, difficult to quantify, and perhaps longer term, while losses are immediate, visible and fall on specific and identifiable sectors. Coordination is thus likely to be much more difficult for those favoring free trade than those opposing it. A proposed RTA can therefore serve as a political focal point for pro-free trade forces.

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<sup>21</sup> These countries became net contributors to the EU budget and were obliged to harmonize their agricultural policies with the CAP. In return, they gained voting rights in future EU decisions.

Again, why the RTA should be the coordination device rather than multilateral agreements such as GATT is the relevant question here. If part of the problem in mobilizing forces in favor of free trade is that there is uncertainty as to who will be the gainers from liberalizing, this uncertainty may be significantly reduced in a regional rather than world wide context. The only problem with this argument is that the identity of the losers should also be that much more easy to figure out. Still, the reduction of uncertainty could make risk-averse individuals more favorable to an RTA than a multilateral venture. Furthermore, RTAs have very clear internalization of reciprocity, so that it is easier for a country to ensure that a concession on its part will elicit a counterpart from another country, benefiting itself.

A different way in which a RTA can serve as a coordination device is in making tradeoffs between different policy areas. For example, the US may fear that free trade with Mexico may lead to downward pressure on US environmental and labor standards; this in turn could lead to political pressure in the US to reintroduce protection against Mexican exports. Both sides might therefore benefit if the US commits to continue its relatively open trade policy with Mexico, while Mexico commits to improving labor and environmental standards. NAFTA provided a mechanism for both sides to do so. Furthermore, it is far more difficult to pursue such initiatives in a global context, as it is necessary to deal with multiple issues as well as numerous countries, which may have widely varying standards. This is illustrated by the current lack of success on the part of those countries - notably France and the US - which are trying to put labor standards on the WTO agenda.

### **III. Comparison of NAFTA and the Europe Agreements**

Having discussed the theoretical mechanisms that might affect a country's incentive to join a RTA, and the plausibility of the conditions necessary for these mechanisms to apply, we now examine two recent RTAs, and provide a brief comparison.

#### **A. *NAFTA***

NAFTA is an example of particular interest in the light of the above discussion, for a number of reasons:

- the degree of liberalization involved was relatively low, because trade flows between the US, Mexico and Canada were already relatively free. In particular, the extent of US trade liberalization was very small; insofar as significant concessions were made, they were on the Mexican side;<sup>22</sup>
- as a consequence, economic estimates of the direct macroeconomic effects of NAFTA on the US were tiny (of the order of a few tenths of one percent of GDP over a decade, and a few tens of thousands of jobs, less than the margins of error in the quarterly national accounts statistics);<sup>23</sup>
- yet NAFTA aroused strong political opposition in the US, while it was relatively popular in Mexico, and was regarded as by far the most important economic priority by Mexican policymakers (in Canada it was largely a non-issue, since the principal political battle over trade liberalization had been fought over the Canada-US FTA).

This suggests that “non-traditional” gains (or losses) are likely to have been a significant factor behind NAFTA.

A number of authors have made arguments relating to the time-consistency or insurance mechanism set out above to explain Mexico's desire to join NAFTA, despite the small direct gains found by most estimates (e.g. Whalley (1996)). However, it is not all clear what types of domestic policy reform were involved. NAFTA does not cover macroeconomic policy at all, so it is difficult to see how it could have operated as a commitment device. If it was intended as such, it does not appear to have been effective in this instance, since NAFTA did not ultimately work to make Mexican fiscal and monetary policy more credible, as the 1994 devaluation demonstrated.

Nor did NAFTA cover domestic microeconomic reforms such as privatization or deregulation; indeed Mexico has made relatively little progress in these areas since NAFTA, recently backtracking on its commitment to privatize the state petroleum monopoly. It does commit Mexico to some fairly modest provisions with respect to the observance of existing labor and environmental law; but since these provisions were

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<sup>22</sup> See, for example, Hufbauer (1992).

<sup>23</sup> See, for example, National Commission on Employment Policy (1992).



inserted at the request of the US, and were the least attractive part of the package from the Mexican point of view, this is presumably not relevant.

The political time consistency argument has also been advanced as an impetus behind NAFTA. For example, Gould (1992) argues that NAFTA will "weaken domestic political pressures from special interest groups to reverse trade liberalization." But domestic political pressures to reverse reform in Mexico never focused primarily on trade in any case; policies such as privatization and labor law reform, not covered by NAFTA, were and are far more controversial. On the other hand, after the recent Peso crisis, Mexican tariffs on other countries outside NAFTA increased sharply. Had the agreement not been in place, it is arguable that the tariff increase would have been across the board (although that would also have permitted the increase to be smaller). So, I would accord the time consistency argument some validity, although it may have been more of an unforeseen consequence than an intended effect. It is perhaps more plausible to argue that Mexican policymakers were trying to signal, to US and other foreign investors, that domestic policy reforms were likely to continue, and that the underlying health of Mexico's private sector was good.

The insurance explanation, however, does appear to fit Mexico's accession to NAFTA reasonably well:

- Mexico joined on rather unfavorable terms, securing very little in concrete tariff reductions or other concessions from the US. While this was not perceived as an insurance premium by US policymakers, Mexican ones may have perceived it as such. Again, this is particularly relevant in the context of foreign investment. To persuade US investors to take advantage of Mexico's low labor costs by investing in Mexico, it was necessary to reassure them not only that tariffs for Mexican exports to the US were low, but that they would stay low and that contingent protection would be less likely to be imposed;
- macroeconomic developments did indeed lead to a post-NAFTA devaluation of the Mexican peso, which in turn resulted in a dramatic expansion of Mexican exports to the US which at least mitigated the recessionary effects of the downturn in Mexican domestic demand. So the insurance - if insurance it was - paid out. Of course, we do not know how the US would have responded to this expansion in the

absence of NAFTA. But it must be at least plausible that there would have been greater pressure for a protectionist response.

Indeed, it is at least arguable that without NAFTA the US would not have provided the financial support to Mexico that enabled it to avert default in early 1995, and perhaps a much worse economic downturn. If this is the case, then NAFTA clearly yielded very large "insurance" benefits to Mexico (although without any ultimate net cost to the US, yet.).

However, it may be stretching the point to argue that this particular insurance mechanism was planned; there is no evidence that Mexican policymakers attached any significant probability to the devaluation of December 1994; instead, they were worried about potential protectionism in the US or perhaps third countries (as argued in Whalley (1994)), which has not in fact materialized, despite the huge swing in the trade balance in Mexico's favor that has resulted from the Mexican recession and devaluation. They may simply have been "lucky" enough to find themselves in the position of the homeowner who gets earthquake insurance thrown in with the normal fire and flood cover.

Non-traditional gains also played an important role from the point of view of the US. NAFTA was designed to serve a number of purposes, beyond any direct trade benefits:

- as a political reward for, and an investment in the long-term economic stability of, a friendly regime that was perceived to be supportive of US interests;
- as a way of reducing the pressures of illegal immigration. The argument here was that giving Mexico relatively free access to US markets would increase investment and employment in Mexico, and hence improve the Mexican labor market;
- as a potential improvement in the US bargaining position with respect to the EU and Japan in multilateral trade negotiations. While Mexico's share of world trade is small, it does represent a significant share of U.S. external trade, and NAFTA may at least have signaled that the U.S. could attempt to substitute the OECD with trading partners elsewhere, especially in Latin America.

On the other hand, US opponents of NAFTA saw primarily the traditional "losses" from free trade; that is, downward pressure on the wages of relatively low-skilled workers in the US and reduced investment in labor-intensive industries.

## **B. Europe Agreements**

The Europe Agreements between the CEE countries (the Czech Republic, Slovakia, Bulgaria, Poland, Hungary and Romania) and the EU, concluded in 1993, are an interesting contrast to NAFTA. They are similar in a number of respects:

- they were between much larger developed economies and much smaller emerging economies;
- they "contain significantly fewer concessions by the large countries to smaller countries than vice versa"<sup>24</sup>
- the direct effects of the trade liberalization provisions were relatively small.

However, as will be seen, there are also some important differences.

As with NAFTA, the pure trade liberalization provisions of the Europe Agreements were not likely to have a substantial effect on CEE-EU trade. While Wang and Winters (1991) and Hamilton and Winters (1992) found that EU-CEE exports were much smaller - by a factor of 2 to 10 - than could be expected on macroeconomic and geographic grounds, trade barriers were not the primary cause: using 1989 data, Aghion et al. (1992) estimated that the potential effect of complete removal of trade barriers would only be an expansion of about 40 percent in CEE exports to the EU, more than half of which was in agriculture, while other estimates were even lower.

However, between 1989 and 1992, without complete liberalization, trade expanded by more than 50 percent, most of which was in sectors like manufactures where tariff barriers were not that high in the first place<sup>25</sup>. This suggests that EC trade policy has not been the primary factor behind the observed trade expansion. This does not in itself

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<sup>24</sup> Perroni and Whalley (1994).

<sup>25</sup> Portes (1993).

logically imply that EC trade policy could not affect trade volumes, but it does suggest that other factors are probably more important.

Unlike NAFTA and most other RTAs - and unlike other agreements between the European Union and less developed or emerging economies - the Europe Agreements contain major provisions which will effectively bind the domestic economic policies of the CEE countries. The Agreements effectively require the application of EU competition policy law to trade between the EU and the CEE countries; questionable practices are to be judged by reference to EU law. Given the shaky legal structures of the CEE countries, and the importance of their trade with the EU, this amounts to little less than the wholesale extension of EU competition policy to the CEE countries.<sup>26</sup>

One area where this is particularly important is that of state aids - government subsidies or tax breaks targeted to particular industries. The Commission has been taking an increasingly aggressive line against state aids within the EU, and since many likely recipients of state aids in the CEE countries will be potential exporters to the EU, this policy could - after an initial transition period - be exported to the CEE countries. This could well provide benefits for the CEE countries, because it will help them avoid a downward auction of tax breaks and subsidies designed to compete for foreign investment. The Europe Agreements therefore could be viewed as a binding mechanism for the CEE countries to commit not to engage in such an auction in a way in which agreements simply among themselves - since the cost of exit would be much lower - would not.

The Europe Agreements also had a much stronger political element than NAFTA. Both the EU and the CEE countries wanted to lock in a political commitment to democracy in the CEE countries; since the promise of eventual EU membership implied in the Agreements (although it was not set out in the Agreements, it was endorsed by the 1993 Copenhagen Summit) was conditional on the continued democratization of the CEE countries, the cost of exit to these countries as a consequence of a reversion to authoritarianism would not just be the loss of the benefits, if any, of the Agreements, but the loss of the prospect of eventual EU membership. On both political and economic grounds, the time consistency argument therefore appears much stronger for the Europe Agreements than for NAFTA.

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<sup>26</sup> Though since EU member states retain jurisdiction over competition policy if only the domestic market is affected, the CEE countries will do so as well.

By contrast, the insurance one appears less persuasive. Perroni and Whalley (1994) argue that the Agreements represent a purchase of insurance on the part of the CEE countries against a global trade war. However, in the light of the text of the Agreements, this does not seem persuasive. In the areas where the chances that an increase in EU protectionism - whether for internal reasons, or because of a global trade war - could genuinely damage the economies of the CEE countries - most importantly agriculture and one or two other "sensitive" sectors like steel - the EU has written in effective "get-out" clauses that enable it to reimpose protection under special circumstances.<sup>27</sup>

#### **IV. Conclusion**

As the above discussion makes amply clear, RTAs differ hugely in their scope, coverage and motivation, and there may very well not be any "one-size-fits-all" explanation of their recent proliferation. However, some common themes do emerge. In particular, the increasing importance of international investment flows of private sector capital, both for developed and, especially, developing countries, has increased the need for countries not just to put the right policies into place, but to provide certainty and credibility as to the direction of future policies and about the economic environment more generally. It is no coincidence that this is the common thread running through the various theoretical mechanisms described above; commitment, signaling and insurance mechanisms all have the practical effect of reducing uncertainty or increasing credibility, whether about future national or international economic policies or events, or about political developments.

RTAs can therefore serve a useful economic purpose above and beyond the direct gains from trade liberalization by reducing such uncertainties and by enhancing credibility - whether they be of a stable legal environment in Poland, continued access to US markets for Mexican products or a "local" market of sufficient size for a new plant in Uruguay - and hence making it easier for the private sector to plan and invest. Indeed, in some cases the reduction in uncertainty resulting from a RTA may even be a necessary precondition to realizing gains from liberalization at all.

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<sup>27</sup> Portes (1993).

Nonetheless, before any further conclusions can be drawn about the actual qualitative and quantitative relevance of these non-traditional benefits from RTAs, it seems necessary to examine the actual provisions of different RTAs closely: what is its scope and coverage? What, if any, is the enforcement mechanism? How and in what circumstances can it be amended? How might it have changed the behavioral incentives of different agents in the economy? These questions are particularly important when we wish to assess the effect of the RTA not directly on trade provisions, but indirectly on incentives, expectations, and future policies.

This paper concludes with a word of caution. Even if RTAs do provide non-traditional benefits this paper does not argue nor intend to leave the impression that these are thereby a good thing. There have been in the past many persuasive voices that have argued the possible costs that a proliferation of RTAs may entail.<sup>28</sup> Nonetheless, independently of whether they are beneficial or detrimental from a world welfare point of view, it is still important to understand what benefits or costs they are providing to their own members and the sources of their apparently increased attractiveness.

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<sup>28</sup> See Bagwell and Staiger (1996) for an analysis of positive and negative effects of regional agreements.

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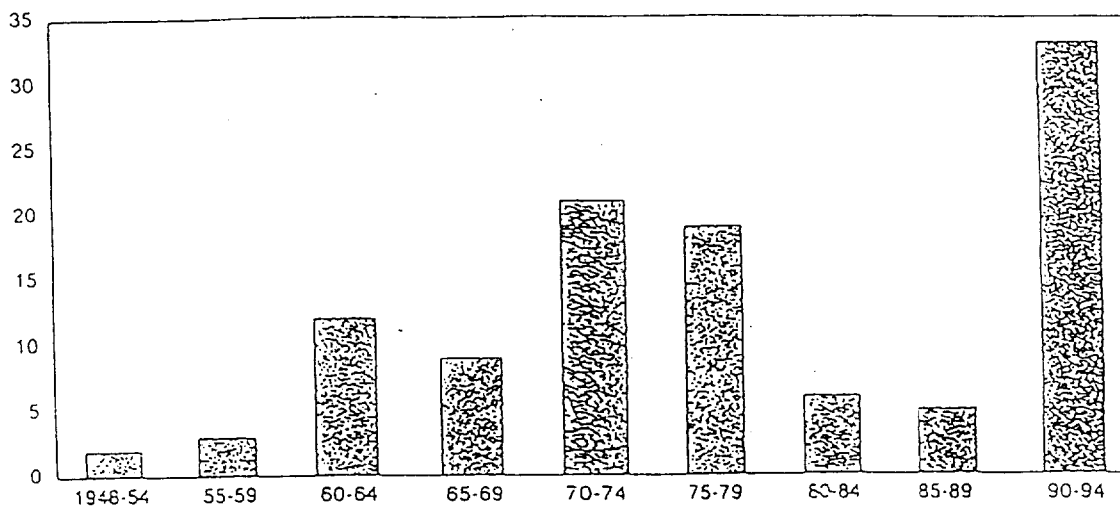
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Chart 1: Number of regional integration agreements notified to GATT, 1948 to 1994



Note: Data are taken from Appendix Table I and include agreements notified under Article XXIV or the Enabling Clause. A notification may include one or more related agreements involving the same group of countries; for example, the treaties establishing the European Economic Community and European Atomic Energy Community, signed in 1957, are counted as a single notification. Figures include agreements which are not currently in force.

Source: WTO (1995).

**Table 1**

Regional Integration Agreements Notified to GATT/WTO and  
in force as of January 1995 as listed in WTO (1995)

***RECIPROCAL REGIONAL INTEGRATION AGREEMENTS***

**EUROPE**

European Community (EC)

Austria	Germany	Netherlands
Belgium	Greece	Portugal
Denmark	Ireland	Spain
Finland	Italy	Sweden
France	Luxembourg	United Kingdom

Free Trade Agreements with

Estonia	Latvia	Norway
Iceland	Liechtenstein	Switzerland
Israel	Lithuania	

EC Association Agreements with

Bulgaria	Hungary	Romania
Cyprus	Malta	Slovak Rep.
Czech Rep.	Poland	Turkey

European Free Trade Association (EFTA)

Iceland	Norway	Switzerland
Liechtenstein		

EFTA Free Trade Agreements with

Bulgaria	Israel	Slovak Rep.
Czech Rep.	Poland	Turkey
Hungary	Romania	

Norway Free Trade Agreements with

Estonia	Latvia	Lithuania
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Switzerland Free Trade Agreements with

Estonia	Latvia	Lithuania
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Czech Republic and Slovak Republic Customs Union

Central European Free Trade Area

Czech Republic and Slovenia Free Trade Agreement

**NORTH AMERICA**

Canada-United States Free Trade Agreement (CUFTA)

North American Free Trade Agreement (NAFTA)

**LATIN AMERICA AND THE CARIBBEAN**

Caribbean Community and Common Market EC EC  
(CARICOM)

Central American Common Market (CACM)

Latin American Integration Association (LAIA)

Andean Pact

Southern Common Market (MERCOSUR)

**MIDDLE EAST**

Economic Cooperation Organization (ECO)

Gulf Cooperation Council (GCC)

**ASIA**

Austria-New Zealand Closer Economic Relations Trade  
(CER)

Bangkok Agreement

Common Effective Preferential Scheme for the ASEAN  
Free Trade Area

Lao People's Dem. Rep. and Thailand Trade Agreement

**OTHER**

Israel-United States Free Trade Agreement

Slovak Republic and Slovenia Free Trade Agreement

***NON-RECIPROCAL REGIONAL INTEGRATION AGREEMENTS***

**EUROPE**

EEC-Association of certain non-European countries  
and territories (EEC-PTOM II)

EEC Cooperation Agreements with

Algeria	Lebanon	Syria
Egypt	Morocco	Tunisia
Jordan		

ACP-EEC Fourth Lome Convention

**ASIA**

Australia-Papua New Guinea Agreement

South Pacific Regional Trade Cooperation  
Agreement (SPARTECA)

Source: WTO (1995)