

Regionalism in World Politics

REGIONAL ORGANIZATION AND
INTERNATIONAL ORDER

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Regionalism, Globalization, and World Economic Order

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THERE are two, apparently contradictory, metaphors which pervade contemporary commentary on the nature and trajectory of the world political economy. First, there is the view of the world economy as increasingly defined by three macro-regions or blocs which are largely self-sufficient (though marked by high levels of intra-regional interdependence) and increasingly competitive or even 'warring'. Second, there is a more benign but equally powerful and popular metaphor of the 'globalization' of economic activity. This presents a picture of a world in which economic agents, particularly transnational firms, are increasingly indifferent to political boundaries, competing in 'global markets' and satisfying the demands of consumers whose tastes are increasingly homogeneous.

The regionalization metaphor is one in which politics predominates over economics, in which 'Europe', 'North America', and 'East Asia' battle for economic and ultimately geopolitical predominance.¹ In contrast, the globalization metaphor is one in which rational economics triumphs over the irrational, old-fashioned, international politics of the struggle for power. Both views are founded upon the presumption that the world political economy after the Second World War was characterized by a hierarchical, statist structure founded upon American hegemony, though each differs fundamentally in its view of the structure which is replacing this hegemonic order. The regionalization metaphor implies that

I would like to thank Andrew Hurrell and Bryce Harland for comments on an earlier version of this chapter.

¹ See Lester Thurow, *Head to Head: The Coming Economic Battle among Japan, Europe and America* (London: Nicholas Brealey, 1992), and Jeffrey A. Hart, *Rival Capitalists: International Competitiveness in the United States, Japan, and Western Europe* (Ithaca, NY: Cornell UP, 1992).

the balance of forces in the world political economy is shifting away from 'multilateralism', underpinned by a global American hegemony, towards a system based upon competing regional blocs, each dominated by a regional hegemon. Globalization implies that there is a general shift underway which has favoured markets and firms rather than states, and that the hegemony of one or a few states is unlikely to constitute an adequate basis for world economic order.

Given the wealth of data that is used to support each of these metaphors, it is increasingly difficult to discern which of them, regionalization or globalization, better describes our present situation. According to the GATT, 52 per cent of world trade in 1990 was intra-regional, or within trading blocs.² In the United Nations *World Economic Survey 1991*, it is argued that:

The most noteworthy example of this trend is to be found in the trade pattern of the European Community. Intra-trade between Canada, Mexico and the United States is greater than this area's exports to any other region and the intra-trade of the Asia-Pacific area is at least as large as its interregional flows. Today the question is not whether these blocs will be formed, but rather how encompassing they will be and how to ensure that they will not harm the trading system.³

In contrast, the UN's *World Investment Report 1992* suggests that the increasingly central role of transnational firms in the world economy necessitates that we do away with our state-centric understanding of the world economy.⁴ The globalization metaphor differs fundamentally from the regional one in suggesting that political geography, far from becoming more important in the structure of the world economy, is gradually being eroded as transnational firms and a global market-place increasingly operate irrespective of national boundaries. As Kenichi Ohmae writes:

The nation state has become an unnatural, even dysfunctional, unit for organizing human activity and managing economic endeavor in a borderless world. It represents no genuine, shared community of economic interest; it defines no meaningful flows of economic activity.⁵

² GATT, *International Trade 90-91*, vol. ii (Geneva: GATT, 1992), 8.

³ United Nations, *World Economic Survey 1991* (New York: UN, 1991), 60.

⁴ United Nations, *World Investment Report 1992* (New York: UN, 1992), 6.

⁵ Kenichi Ohmae, 'The Rise of the Region State', *Foreign Affairs*, 72/2 (Spring 1993), 78. For further examples of the globalization literature, see his *The Borderless World: Power and Strategy in the Interlinked Economy* (London:

Good metaphors are aids to the understanding of a reality which is always complex and untidy.⁶ The metaphors of globalization and regionalization usefully point to certain forces at work in the contemporary world political economy. In important respects, however, as this chapter will argue, they are misleading as representations of a broader reality. On the one hand, the regionalization literature focuses excessively upon the supposed regionalization of international trade, overlooking the growing dominance of short- and long-term international capital movements over trade flows and the ways in which this has reinforced economic interdependence between regions more than within them. On the other hand, the globalization literature focuses largely upon firms and the way in which they structure economic relationships, including trade and technology flows, in responding to market demand. As a result, this literature often underplays the various ways in which the existence of political boundaries influences the flows of economic activity.

Second, both regionalization and globalization are slippery and imprecise concepts, reducing their value as metaphors. For example, writers in the globalization school such as Ohmae do not always reject regionalist forces out of hand, but rather tend to focus on the way in which natural, global-orientated, economic micro-regions rather than the big three macro-regions are emerging. Examples of these economic micro-regions include Baden-Württemberg, Silicon Valley, Hong Kong and Southern China, and the 'growth triangle' between Singapore, Jahore, and Indonesia, areas which may or may not fall within the boundaries of existing nation states.⁷ As for globalization, the notion of an all-encompassing process is contradicted by the fact that of the 25 per cent of world investment flows which go to the developing world, fully two-thirds goes to just ten developing countries.⁸ A large proportion of the world's population remains more or less untouched by the forces of globalization said to characterize our time.

Fontana, 1992); OECD, *Globalisation of Industrial Activities* (Paris: OECD, 1992); Richard O'Brien, *Global Financial Integration: The End of Geography* (London: RIIA/Pinter, 1992).

⁶ On the use of metaphors in economics and the social sciences in general, see Donald N. McCloskey, *The Rhetoric of Economics* (Madison: University of Wisconsin Press, 1986).

⁷ Ohmae, 'Rise of the Region State', 79-81.

⁸ UN, *World Investment Report 1992*, 2.

Third, this chapter will argue that while regionalizing and globalizing tendencies are both at work in the contemporary world, these tendencies are at present more symbiotic than contradictory. In many ways, the protectionism and macro-regional posturing that is clearly visible in recent times is a response, if inadequate, to many of the changes underway in the world economy associated with globalization. Regionalism increases the necessity for large firms to become 'insiders' in other regions, promoting globalization. In turn, increased foreign competition across a broad range of industries has prompted the USA and EC to pursue regional alternatives in an effort to alleviate problems of adjustment and to promote non-economic regional objectives. The biggest and most important change has been in US policy. For the first time since the Second World War, the USA is actively pursuing its own regional policy, rather than playing its traditional post-war role of ensuring that the regionalism of others, particularly Europe's, remains reasonably compatible with multilateralism in international economic relations. Whether this shift in US policy will tilt the balance dramatically towards regionalism in a manner not seen since the 1930s will be discussed in the final section.

The structure of this chapter is as follows. First, in keeping with the broader theme of this book, I will consider what the concepts of 'economic regionalism' and 'economic regionalization' might mean. Second, I will briefly outline what I consider to be the main factors behind the new economic regionalism. Third, I will discuss whether the world economy is in fact becoming more regionalized, or whether the concept of globalization is a more adequate description of the changes underway. Finally, I will consider the impact of these changes upon the management and stability of the world economy.

1. 'ECONOMIC REGIONALISM' AND 'ECONOMIC REGIONALIZATION'

A basic distinction that needs to be made is between economic regionalism as a *conscious policy* of states or sub-state regions to co-ordinate activities and arrangements in a greater region, and economic regionalization as the *outcome* of such policies or of 'natural' economic forces.

The most common definitions of economic regionalism focus attention on the formation of preferential trading arrangements between groups of countries within a geographic region. Such arrangements are commonly termed 'trading blocs'.⁹ However, in principle, economic regionalism extends from goods and market integration between neighbours (in the form of preferential trade areas, free-trade areas, and customs unions) to goods and factor market integration (common markets), to market and policy integration (economic and monetary unions), to complete economic (and political) union.¹⁰ The working definition of economic regionalism I will use here is *the design and implementation of a set of preferential policies within a regional grouping of countries aimed at the encouragement of the exchange of goods and/or factors between members of the group*. The goals at which such arrangements aim will vary. Also left ambiguous is the extent to which such groups are intended to provide definition to the economic relations of members with third countries. Where regional arrangements provide for the development of common policy tools such as common external tariffs, monetary union, and so on, the possibility of acting as a unified whole in international economic relations becomes a possibility.

Although economic regionalism is by definition discriminatory *vis-à-vis* the rest of the world and hence opposed to the principle of non-discrimination which is the basis of multilateralism, *malign* and *benign* forms of regionalism are commonly distinguished (even if the distinction may depend upon the eye of the beholder). Benign regionalism might be defined as regional arrangements which, in the process of the voluntary swapping of mutual preferences between the group's members, do not at the same time increase barriers to economic exchange with the outside world. The basic point is that the intent is not consciously to reduce the welfare of outsiders (or indeed insiders). Malign regionalism is often associ-

ated with the policies of Germany and Japan in the 1930s of forcing bilateral economic agreements upon weaker countries in order to establish a discriminatory trade and financing network in which they would dominate. However, there is no reason why malign regionalism should involve involuntary behaviour, since, if a large trading group were to raise tariffs *vis-à-vis* the outside world at the same time as reducing barriers to internal trade so as to exploit their increased market power, we would presumably also want to call this malign regionalism. Malign regionalism may be a consciously beggar-thy-non-neighbour policy amongst a group of countries within a geographic region.

Tolerance and even support for benign regionalism was an important part of the post-war international economic order. Although Article I of the GATT established the principle that member states should accord unconditional most-favoured nation status (i.e. non-discrimination) upon all other members, the founders of the GATT went so far as to build regionalism into the post-war rules on international trade in the form of Article XXIV. In part because of the example of apparently benign customs unions like Benelux (negotiated in 1944), it was felt that customs unions and free trade areas (FTAs) ought to be an exception to the general principle of non-discrimination, recognizing 'the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements'. Article XXIV contained clauses that were meant to ensure that GATT-sanctioned regionalism was of a benign rather than malign form. Customs and free-trade areas should be completed 'within a reasonable length of time', should cover 'substantially all the trade' between the parties, and should not raise barriers to the trade of non-members.¹¹

Regionalism in the Western world economy was entrenched in practice by American support of the first moves towards Western European integration. After US attempts to establish the Bretton Woods system in the early post-war years failed, the USA promoted a solution more in keeping with its security objective of anchoring

⁹ e.g. Jeffrey J. Schott, in his 'Trading Blocs and the World Trading System', *The World Economy*, 14/1, (Mar. 1991), 1-2, defines a trading bloc as 'an association of countries that reduces intra-regional barriers to trade in goods (and sometimes in services, investment and capital as well)... seek[ing] to (1) generate welfare gains through income and efficiency effects and trade creation; (2) augment negotiating leverage with third countries; and (3) sometimes promote regional political co-operation'.

¹⁰ The classic work in this field is Bela Balassa, *The Theory of Economic Integration* (London: Allen & Unwin, 1961).

¹¹ See John H. Jackson, *The World Trading System: Law and Policy of International Relations* (Cambridge, Mass.: MIT Press, 1989), 141, and Jagdish N. Bhagwati, 'Regionalism versus Multilateralism', *The World Economy*, 15/5 (Sept. 1992), 535-55. Article XXIV 3(d) also noted that 'Advantages accorded by any contracting party to adjacent countries in order to facilitate frontier traffic' was allowable.

Western Europe in a firmly anti-Soviet alliance. The European Payments Union (EPU) and the European Coal and Steel Community (ECSC), both established at the beginning of the 1950s, represented the first major steps on the road towards regional integration. Although EPU was necessarily portrayed to American critics as a 'stepping-stone' towards the return of the European currencies to full convertibility rather than an abandonment of Bretton Woods, the ECSC clearly represented permanent discrimination, and the US supported a GATT waiver in the face of substantial criticisms by European non-members.¹²

Economists have usually been less enamoured of regional economic agreements than foreign policy makers. This is particularly true of regional trading arrangements, where economists have tended to see regional trading blocs as, at most, a second-best alternative to world-wide, multilateral trade liberalization. Some staunch supporters of multilateralism see Article XXIV as having allowed the entry of the beast of regionalism into the temple of multilateralism.¹³ In terms of economic theory, the question of what is benign (welfare-increasing) and what is malign (welfare-decreasing) is less straightforward than in the common-sense formulation outlined above. The theory of customs unions and FTAs which emerged in the 1950s began from the point that since customs unions involved both reduced protection (within the group) and increased relative protection (towards non-members), it was not clear that a presumption that this would be welfare-enhancing was justified. The seminal work in this field was Jacob Viner's *The Customs Union Issue*, which established that the desirability of customs unions or FTAs depended on the circumstances.¹⁴

Further work suggested that much depended upon whether the countries involved in a preferential economic grouping were 'natural' trading partners, due to complementarity of production structures and a large share of world trade.¹⁵ In such a case, *trade creation* might be significant, whereby a reduction in intra-union tariffs increases efficiency and growth as demand shifts from less

efficient domestic production towards more efficient partner-country production. A customs union or FTA was also more likely to increase global welfare if initial levels of protection between partner countries were high, and subsequent levels of protection *vis-à-vis* the outside world were low. On the other hand, *trade diversion* could also occur whereby the increase in relative protection *vis-à-vis* the rest of the world was sufficient to shift demand away from imports from efficient third countries to imports from a less efficient partner country. Whether such arrangements would raise or lower overall world welfare would depend upon the balance of these two effects. The subsequent literature built on the distinction between trade creation and diversion, although the consensus remained that trading blocs were a second-best option, with the ideal bloc being the whole world since there would be no scope for trade diversion.

The issue of whether economists should favour higher forms of regional monetary and policy integration was less clear-cut. As Cooper has noted, economic theory has been able to say relatively little about the size of the 'optimal geographic area of policy jurisdiction'.¹⁶ Arguments were made that externalities and economies of scale meant that optimal jurisdictional areas are greater than the borders of existing countries for some public goods, though the likelihood of significant diseconomies of scale after some point suggested that the optimal area was likely to be smaller than the world economy. Much would depend upon the particular area of policy; the optimal jurisdiction for policing or environmental policy may be very different from that for monetary policy, for example. To take the example of monetary union, states within a geographic region might form an 'optimal currency area' if they have similar economic structures (and hence are less likely to suffer asymmetrical economic shocks), and if they enjoy a high degree of intra-area factor mobility (and hence are more able to adjust to asymmetrical shocks if they occur).¹⁷

There are also some political economy reasons why regional

¹² Gardner Patterson, *Discrimination in International Trade: The Policy Issues 1945-1965* (Princeton: Princeton UP, 1966), 75-90.

¹³ Kenneth W. Dam, *The GATT: Law and International Organization* (Chicago: University of Chicago Press, 1970), 290.

¹⁴ Jacob Viner, *The Customs Union Issue* (London: Stevens & Sons, 1950).

¹⁵ See Willem Molle, *The Economics of European Integration* (Aldershot: Dartmouth 1990), ch. 5.

¹⁶ Richard N. Cooper, 'Worldwide Regional Integration: Is there an Optimal Size of the Integrated Area?', in *Economic Policy in an Interdependent World* (Cambridge, Mass.: MIT Press, 1986), 123-37.

¹⁷ It is arguable that the EMS countries perform better on the first criterion than the USA, though less well on the second. It has been argued, however, that economic diversity can actually favour monetary union, as shocks are neutralized as they hurt one part of the region while favouring others.

arrangements might be more optimal for some purposes. First, the interaction of history and geography may favour the emergence of regional cultural, economic, legal, and political commonalities, which may help neighbouring countries to reach agreement over difficult issues, particularly those related to regulation and the distribution of costs and benefits. There may also be a history of co-operation on non-economic issues which could facilitate the emergence of regional economic institutions, and redistribution mechanisms to compensate losers. Security factors may also play a major role in underpinning regional co-operation; certainly, in the presence of severe security dilemmas, regional economic relations are likely to be very uncooperative. It might also be argued, against the grain of a discipline that has become used to the notion that co-operation in international relations tends to derive from hegemony, that large inequalities in the power and economic weight of countries in a region may not favour *regional* economic co-operation. Smaller states may be concerned that economic integration will lead to loss of sovereignty and identity, and they may be more likely to pool sovereignty if they are not concerned about the potential for the dominance of one particular country within the bloc (although fear of the dominance of a non-member may provide an incentive towards integration).

Second, since distributional issues are likely to be more acute the larger the difference in income levels between countries, the fact that the pattern of global wealth tends to have a strong regional bias may mean that regional groupings are less likely to suffer from such problems. Third, transportation and communications costs are significant, which over time leads to the emergence of important complementarity of economic structure amongst neighbours, and which give important natural advantages to neighbours as trading partners. Fourth, as Kenneth Oye points out, regional agreements might mobilize domestic interest groups which favour open trade, creating a momentum towards inter-regional or multilateral liberalization.¹⁸

There is a final consideration. We have been discussing regionalism as public policy, working through a legal or institutional framework within a regional grouping. As noted earlier, this must be distinguished from the idea of the *regionalization of markets*, some-

¹⁸ Kenneth A. Oye, *Economic Discrimination and Political Exchange* (Princeton: Princeton UP, 1992).

thing which may result from regional policies but which may also have no necessary connection to government policies. The spatial aspects of market activity *within* a country such as the USA, for example, could be said to have an identifiable regional pattern. The mid-West specializes in agricultural products, California in high technology, entertainment, and defence, the North-East in manufacturing and finance, and so on. While such regional specialization is affected by the location of different layers of government and by various government policies, much is due to natural forces such as transportation and communication costs, historical accident, externalities, and economies of scale.¹⁹ Furthermore, as Ohmae suggests, there is no necessary reason why such regional patterns should coincide with existing international borders. Therefore, it is important to note that while regionalism as a policy might be said to aim at encouraging the regionalization of economic activity, natural market regions might exist even in the absence of such policies. This point will be taken up in Section 3.

2. WHAT EXPLAINS THE NEW REGIONALISM?

Since the mid-1980s, economic regionalism has made a come-back after a long period of retreat since the late 1960s. Its initial manifestations were in the North, with the beginning of negotiations on an FTA between the USA and Canada in 1986 and the passing of the Single European Act in the same year. It then spread out to the developing world, with the reinvigoration of long-stagnant regional economic schemes in Latin America and Africa. The momentum continued in the North, with the prospective eastward and northward widening of the EC and the creation of a European Economic Area (EEA) with EFTA, and the extension of the Canada-USA FTA (CUSFTA) to Mexico to create NAFTA. Finally, after a long period of dormancy, the stirrings of an Asia-Pacific economic regionalism began to be heard, largely in reaction to developments elsewhere.

It is tempting to see this new phase of economic regionalism as representing a fundamental shift in the world political economy that has deep underlying causes. However, some argue that the

¹⁹ For an interesting development of the spatial aspects of international and inter-regional trade and specialization, see Paul R. Krugman, *Geography and Trade* (Leuven and Cambridge, Mass.: Leuven University Press/MIT Press, 1991).

appearance of a new phase is little more than coincidence. For example, Ostry has argued that 'The [US-Canadian] FTA and Europe 1992 are very different in both genesis and nature. Indeed, their coincidence in timing is accidental, not planned.'²⁰ While Ostry accepts that 'coincidence' could have an important cumulative impact on the shape of the world economy, this would represent a secondary effect rather than a shift in underlying factors. Are there common factors behind the new regionalism? In order to consider this question, it is first necessary to outline very briefly the main variations of the new economic regionalism. The discussion will be confined largely to Western Europe, the Americas, and Asia Pacific, partly for reasons of space but also because what happens in these regions will be crucial for determining the strength of regionalist forces in the world political economy as a whole.

(a) *The Western Hemisphere*

1. *North America.* The most novel aspect of regionalism amongst developed countries in the 1980s was the turn to regionalism on the part of two of the staunchest traditional supporters of multilateralism in the West, Canada and the USA. Until the 1980s, regional initiatives by other countries were either tolerated by the USA or, in the case of Europe, promoted for specific (largely political) reasons. The implicit conventional wisdom was that the USA, as the champion of multilateralism and the GATT, ought not itself to indulge in a practice which was widely held to be at odds with the spirit of non-discrimination. Regionalism in an economically and politically 'unviable' Europe was one thing, but regionalism for the free world's superpower was out of the question. For both Canada and Mexico, the political arguments against economic integration with the USA have always been strong, given these countries' concern to protect their cultural and economic independence. Such fears, combined in Canada's case with its self-perception as a middle power supporting multilateralism, helped ensure that since the GATT was established, bilateral initiatives towards the USA were largely eschewed.²¹ In the course of the 1980s, the policies of all three countries changed direction.

²⁰ Sylvia Ostry, *Governments and Corporations in a Shrinking World* (New York: Council on Foreign Relations, 1990), 12.

²¹ The exception was the 1965 automobile pact with the USA.

The origins of a regional policy on the part of the USA lay partly in the debt crisis of the early 1980s, when the USA acted quickly in the Mexican crisis of August 1982 to ensure that a Mexican default did not materialize and thereby jeopardize US financial stability. However, it was the combination of policies which led to the appreciation of the dollar and the associated dramatic deterioration in the US trade deficit in the first half of the 1980s which created a real ground-swell for change in US policy. The pressure upon the Reagan administration to shift course became intense during the summer of 1985, and what emerged was a 'multi-track' policy which combined multilateral with bilateral and unilateral initiatives.²² The administration continued to push hard for the initiation of a new GATT trade round, but at the same time signalled its intention to utilize 'fair trade' legislation to press for changes in the trade practices of some of its most important partners, above all Japan. Along with such unilateral measures, the USA embarked on a series of bilateral measures which marked a more activist approach to trade policy than in the early 1980s.

In such a climate, the Reagan administration responded favourably to a Canadian proposal for a CUSFTA, using the bilateral, fast-track authorization contained in the 1984 Trade and Tariffs Act that had enabled the negotiation of an FTA with Israel.²³ CUSFTA was concluded in 1988. In 1990, the Bush administration also accepted Mexico's initiative to negotiate a bilateral FTA, leading to negotiations from 1991 which Canada decided to join, and which in summer 1992 led to the NAFTA agreement. Dominated by the USA, NAFTA involves the creation of the world's largest FTA, with a combined GNP of \$6.3 trillion and a population of 363 million in 1990.²⁴ From the US perspective, it was perceived that this might place additional pressure upon the recalcitrant Europeans and East Asians to make trade concessions to the USA which has not so far been forthcoming through the GATT process.

For Canada, a similar shift towards a twin-track policy was essentially a defensive one. Faced with growing US resort to administered protection, particularly in the form of the anti-dumping and

²² I. M. Destler, *American Trade Politics* (New York: Twentieth Century Fund and Institute for International Economics, 2nd edn., 1992), 124-5.

²³ Destler, *American Trade Politics*, 96.

²⁴ Nora Lustig, Barry P. Bosworth, and Robert Z. Lawrence (eds.), *North American Free Trade: Assessing the Impact* (Washington, DC: Brookings Institution, 1992), 4.

countervailing duties contained in US fair trade legislation, Canada became increasingly concerned during the 1980s about the ability of GATT to protect the access of its exporters to their major market. Once the USA decided to open talks with Mexico on an FTA, it was inevitable that Canada would ask to join, since a bilateral US-Mexican FTA could undermine some of aspects of the CUSFTA and encourage a migration of footloose, US-orientated manufacturing industry from Canada to low-wage Mexico without any compensation for Canada.

Mexico, like Canada, also wanted to safeguard access to its major market, particularly important because of Mexico's shift towards export-orientation in the later 1980s. In addition, the Salinas government wanted to underline the extent and enhance the credibility of its economic reform programme by attaching itself to a reciprocity-based treaty with its powerful northern neighbour. Mexico's accession to the GATT in 1986 and its Framework Agreement with the USA in 1989 were steps in this direction, but the binding agreement involved in an FTA with the USA would provide a much more credible constraint against the reversal of reforms.²⁵ Naturally, there were fears in Mexico that free trade (or even significantly liberalized trade) with the USA could lead to major adjustment costs for large sections of Mexico's inefficient industry. However, Mexico's programme of unilateral trade liberalization since the second half of the 1980s had already led to considerable adjustment, so that the economic impact of NAFTA can be exaggerated.²⁶ The main source of gain to Mexico was expected to be increased foreign direct investment (FDI), due to the consequent attractiveness of Mexico as an export platform.

The recession of the early 1990s reduced support for NAFTA within the USA and Canada, though the Salinas government in Mexico seemed to be more dependent than ever upon the ratification of NAFTA as a key element in its economic strategy. This gave key lobby groups in the USA, particularly organized labour and environmental groups, the ability to insist upon revisions to the

²⁵ From 1970 to 1990, the share of Mexico's total imports coming from North America increased from 19½ per cent (from 51½ to 64 per cent for manufacturing imports), while the share of Mexico's total exports to North America increased from 25 to 52 per cent (GATT, *International Trade* 90-91, 15).

²⁶ See, in general, Lustig *et al.*, *North American Free Trade*, and John Whalley, 'CUSTA and NAFTA: Can WHFTA be far behind?', *Journal of Common Market Studies*, 30/2 (June 1992), 125-41.

NAFTA. With the electoral success of President Clinton at the end of 1992, and growing concern about the threat of a loss of manufacturing jobs to Mexico as a result of NAFTA, the USA initiated two major 'side-agreements' to NAFTA. Agreements on labour and environmental protection standards were reached in August 1993, including disputes-settlement procedures for the enforcement of such standards.²⁷ In the end, these were sufficient to reduce the influence of the powerful anti-NAFTA lobbies in the USA and Canada, allowing the final ratification of the agreement by the US congress in December 1993.

The novelty of NAFTA is that this is the first time that fair trade provisions on labour and environmental standards have been built into a regional trade agreement, and may well presage similar future US demands in other forums. NAFTA is also unprecedented because of the extent of the disparities in income between the partners. Unlike the EC, NAFTA has no redistribution mechanism to cope with the adjustment problems of poorer states and intra-regional regions; Mexico clearly understood that this would be unacceptable to the USA and Canada. Given the USA's more important extra-regional interests, and Mexico's and Canada's concerns about loss of sovereignty and identity, it is difficult to agree entirely with Schott that 'the North American trading bloc exhibits most of the basic characteristics of a successful trading bloc.'²⁸

2. *Latin America.* While it might be argued that free-trade agreements with Canada and Mexico were simply responses to requests from neighbours that were difficult to refuse, President Bush's Enterprise for the Americas speech of 22 June 1990, with its vision of Western hemispheric regionalism, underlined the new departure from previous US policy.²⁹ The USA offered to proceed by negotiating 'framework agreements' to serve as a basis for improved trading and investment relations.³⁰ Moves towards creating or renewing existing regional economic arrangements in Latin America have been driven by considerations which echo the motivations of Mexico and Canada. In essence, much of Latin

²⁷ See 'Side Deals on NAFTA give accord "Bite"', *Financial Times*, 14/15 Aug. 1993, and 'Negotiators End Impasse on American Trade Pact', *International Herald Tribune*, 14/15 Aug. 1993.

²⁸ Schott, 'Trading Blocs', 8.

²⁹ For further details, see Chapter 9 below.

³⁰ By early 1992, 29 such agreements had been signed since 1987, though this included groups like *Mercosur* and extra-regional countries like Singapore.

America has hoped to gain similar benefits from preferential access to the US market as Mexico, but they are driven by the additional concern that any country that is left behind could suffer considerably. The US market absorbs about 40 per cent of Latin America's total exports, but US market-access is particularly crucial for countries like Mexico, Venezuela, and those in the Caribbean and Central American areas. In addition, the Bush initiative gave and added impetus to a flurry of regional activity already underway in the late 1980s, including *Mercosur* and a range of subregional free-trade agreements.³¹

(b) Europe

Europe was by far the most successful example of economic regionalism in the 1950s and 1960s, largely because it was underpinned by broader, political goals. Even so, it hardly lived up to the strictures of Article XXIV of the GATT, and was mainly confined to trade in goods. Progress towards 'the abolition, as between Member States, of obstacles to freedom of movement of persons, services and capital' [Article 3 (c) of the Treaty of Rome] was very limited. Most of the 'integration' which occurred in the EEC during the 1950s and 1960s came in the form of high rates of growth in intra-industry trade in manufactures. Significant non-tariff barriers (NTBs) to trade remained, often related to government industrial policy, which included the promotion of national champions across a wide range of industries. This prevented a deeper kind of integration from emerging, in particular the development of significant levels of cross-border ownership and control of corporations in Europe. Furthermore, the increase in non-tariff barriers to intra-European trade in the 1970s associated with the economic crisis partly undermined the achievements of the 1960s.

In the mid-1980s, however, the EC embarked upon a new and vigorous phase of integration which did much to raise both hopes and fears of a powerful trend towards renewed regionalism in Europe. The Delors Commission's 1985 White Paper on *Completing the Internal Market* marked the beginning of this new phase, envisaging the removal of remaining barriers to the free movement of goods, services, persons, and capital by the end of 1992. A major

³¹ Edward Best, 'Latin American Integration in the 1990s: Redefinition amid Uncertainty', *International Review of Administrative Sciences*, 57 (1991), 611-40.

motivating force was the declining competitiveness of European industry relative to American and Japanese rivals, especially in technology-intensive sectors, with associated problems of high structural unemployment. With the signing of the Single European Act in February 1986, both self-sustaining economic recovery and renewed market integration gradually set in.³² In addition, what had begun as a deregulatory, supply-side programme eventually created a momentum for 'positive' integration that overturned, for a time, the pessimism of the 1970s and early 1980s.

An effect of the inward orientation of the debate over the Single Market was to raise fears abroad that the Single Market would be complemented by a 'Fortress Europe'; aimed at preventing third countries from enjoying the benefits of liberalization within Europe. Such fears were enhanced by comments made by the then Commissioner for External Affairs, Willy de Clerq, to the effect that foreign firms would not automatically receive the benefits of the liberalizing measures of the 1992 programme *unless* their countries offered 'reciprocal' access for EC firms.³³ While this position was later softened, the damage was done. Soon after, a debate over Economic and Monetary Union (EMU) ensued which led to revived prospects of monetary integration, resulting in the establishment of a timetable for monetary union at the Maastricht summit of December 1991. Meanwhile, the EEA agreement between the EC and EFTA in 1991 reinforced the perception of a solidifying economic bloc encompassing the whole of Western Europe. Events in the East soon led to the signing of Association Agreements between the EC and its eastern neighbours and appeared to hold out the long-term prospect of an even more radical widening of the Community.

However, 1991 proved to be the high point of the latest cycle of European integration, and the recession that set in over 1992-3 brought with it a swathe of major reversals. First, the limited popular support throughout Europe for the Maastricht Treaty, reflected in the débâcles of Danish and French referendums and the divisive debate in the UK, weakened the position of the pro-integ-

³² Loukas Tsoukalis, *The New European Economy: The Politics and Economics of Integration* (Oxford: OUP, 2nd edn., 1993), ch. 3.

³³ Stephen Woolcock, *Market Access Issues in EC-US Relations* (London: RILA/Pinter, 1991), 13-16; Gary Clyde Hufbauer (ed.), *Europe 1992: An American Perspective* (Washington, DC: Brookings Institution, 1990).

ration élites in the Commission and certain governments. Second, the growing inappropriateness of German monetary policy in the wake of reunification as the basis of interest-rate policy in the rest of Europe resulted in an ongoing crisis within the EMS from summer 1992 which culminated in the virtual collapse of the system in July 1993. The *de facto* floating of the French franc within wider 15 per cent bands, in combination with the earlier exit from the system of the Italian lira and pound sterling, underlined the extent of economic divergence within Europe, calling into question the viability of EMU and even the future of Franco-German economic co-operation.³⁴ The Swiss rejection in a referendum of the EEA agreement only further underlined the extent to which the momentum of the late 1980s and early 1990s had so rapidly dissipated, bringing with it a further period of Euro-pessimism. Whether this increased or decreased the tendencies towards a Fortress Europe, however, was unclear.

(c) *Asia Pacific*

For those East Asian countries which had concentrated upon exporting to rich Western markets in the post-war period, the sight of revived regionalism in Europe and the Americas, with its perceptible anti-Japanese tones, was a threatening one. This has led to a series of rather confused manoeuvres, some of which point to a regionalist impulse in the Asia-Pacific area. Indeed, some commentators have become fond of referring to 'Asia Pacific' as a coherent economic region which is coming to challenge Western Europe as the major regional grouping in the world economy. For example, Elk has written:³⁵

This diverse, but correspondingly complementary group of economies accounts for more than half of world GNP and almost 40 per cent of world trade. Close to 65 per cent of their exports are to each other; this is higher than the corresponding share for the European Community.

³⁴ The latter received another blow when only months earlier, the German government refused to follow the rest of the EC in retaliating against US restrictions on European firms bidding for telecommunications contracts, citing a German-US treaty which preceded the 1957 Treaty of Rome.

³⁵ Andrew Elk, 'Trade Policy Options for the Asia-Pacific Region in the 1990s: The Potential of Open Regionalism', *American Economic Review, Papers and Proceedings*, 82/2 (May 1992).

Such an impression, however, can be highly misleading.³⁶ Given the size of the Pacific and the undoubted dynamism of the economies which surround it, it is hardly surprising that the region accounts for such large proportions of world trade and output. Also, effective economic regionalism in the area has been almost completely absent in the post-war period, a legacy of Japanese imperialism before and during the Second World War and the continuing security problems which the region faces. Only ASEAN attempted to create a preferential trading arrangement after 1967, but this turned out to be totally ineffective.³⁷ The very success of Japan, the NICs, and even mainland China in penetrating markets in North America and Western Europe gives these countries an overwhelming interest in the multilateral trading system from which they have benefited. Their vulnerability to developments in Europe and North America has prompted a serious debate about how they ought to respond.

Unsurprisingly, recent calls for an East Asian economic bloc of substance have attracted little firm support. In the wake of the December 1990 breakdown of the Uruguay Round negotiations and moves towards regionalism in Europe and North America, Malaysia called for the establishment of an economic bloc in the form of an East Asian Economic Caucus, to include Japan but not the USA, Canada, Australia, or New Zealand. However, US hostility to the idea has made it difficult for important countries in the region to support the EAEC. The USA has also held out the possibility of reaching bilateral FTAs with particular countries in East Asia and Australasia. As a result, the most that has been possible is a joint Australia-Japan initiative to create the all-inclusive Asia-Pacific Economic Council (APEC) in 1989, which has confined itself to declarations of support for the GATT, for a continuing US-Japanese dialogue on trade problems, and the sharing of information across a wide range of areas. This initiative received a boost in November 1993 when President Clinton affirmed his commitment to the APEC process at the Seattle APEC summit.

Hopes for an equivalent of the OECD for the Pacific (OPTAD) or a Pacific FTA (PAFTA) have not materialized. At a high-profile

³⁶ On this theme, see Gerald Segal, *Rethinking the Pacific* (Oxford: OUP, 1991), esp. 'Conclusions', 369-91, and Rosemary Foot's chapter in this volume.

³⁷ Marcus Noland, *Pacific Basin Developing Countries: Prospects for the Future* (Washington, DC: Institute for International Economics, 1990), 140-1.

regional conference in Indonesia in August 1993, for example, delegates could reach little agreement as to whether future co-operation should take place within the context of an East Asian grouping or a broader Asia-Pacific context, which would include North America. Suspicions of the intentions of the USA, Japan, and China on the part of other countries would seem to preclude significant progress within a wider forum.³⁸ In spite of the agreement at the Bogor APEC summit of November 1994 to create an FTA by 2020, considerable disagreement over the specifics of trade liberalization remains. The only real sign of movement has been in the limited grouping of ASEAN, which in 1991 reached agreement to create a FTA in manufactures over fifteen years, but this is unlikely to have more than a limited impact on trading patterns.

What, if any, are the common factors behind this apparent trend towards economic regionalism in the Americas, Europe, and, to a very limited extent, Asia Pacific? There are at least four main factors which might be identified: the end of the Cold War, the shifting balance of world economic power, economic reform in developing countries, and the growing importance of non-tariff barriers to trade.

1. *The end of the Cold War.* The end of the Cold War is a general factor behind the shifting patterns of the global political economy in recent years, though its complex effects are often difficult to discern.³⁹ First, and most obviously, it is eroding the common security linkages which helped to underpin post-war economic co-operation between Western Europe, the USA, and Japan. Second, the end of the Cold War has increased the salience and the visibility of conflict between different forms of capitalism in Europe, East Asia, and America.⁴⁰ The Cold War facilitated economic co-operation between the USA, Western Europe, and East Asia and emphasized what they had in common; these two factors have combined to reduce the likelihood of economic co-operations at the global or inter-regional level. Third, the collapse of the Soviet threat has pushed traditional and non-traditional security threats arising from political and economic instability *within regions* up the agenda. These include weapons proliferation, mass migration,

and threats arising from poverty, drugs, and environmental disasters—illustrated, for example, by the importance of migration and environmental issues in US policy towards Mexico.

Finally, assessing the impact of the end of the Cold War upon the European integration project is highly speculative, though in Europe it has already raised particular concerns about the long-term role of Germany. In the short run, it has concentrated attention upon the region and in the eyes of other countries raised the prospect of a much wider European Community than has ever been contemplated. For many developing countries, who traditionally feared marginalization during the Cold War, the creation of the European Bank for Reconstruction and Development and the focus upon problems of transition in the former Eastern bloc have exacerbated such fears.

2. *The shifting balance of world economic power.* The long-heralded retreat from globalism on the part of a declining America can be seen as another fundamental cause of the new regionalism. Consistent with this view is the idea that the post-war world economy was constructed and managed by the American hegemon, and that US decline brings with it increasingly powerful centrifugal forces which push the world political economy towards the kind of competitive disorder which reigned in the interwar period.⁴¹ Whatever the shortcomings of the theory of hegemonic stability, there has been an undeniable trend in US policy since the early 1970s towards disenchantment with 'free-riding allies' and multilateral institutions such as the GATT, and towards unilateralism and bilateralism in US trade and macroeconomic policies.⁴² The shift to a multi-track trade foreign economic policy by the USA enables it to use the leverage available to it to greater effect, which means more 'balanced' outcomes and an enhanced ability to enforce compliance. At the same time, the threat of US unilateralism has increased the incentive for smaller countries of regional groupings highly dependent upon the USA to secure preferential access to the American market through bilateral agreements. Most importantly,

³⁸ For a critique of this theory, see Andrew Wyatt-Walter, *World Power and World Money: Hegemony and International Monetary Order* (Hemel Hempstead/New York: Harvester Wheatsheaf/St Martin's Press, 2nd edn., 1993).

³⁹ See Jagdish Bhagwati, 'Aggressive Unilateralism: An Overview', in J. Bhagwati and Hugh T. Patrick (eds.), *Aggressive Unilateralism: America's Super 301 Trade Policy and the World Trading System* (Ann Arbor: University of Michigan Press, 1990).

⁴⁰ See e.g. Thurow, *Head to Head*.

⁴¹ East Asia Disputes the Road to Growth', *Financial Times*, 13 Aug. 1993.

American decline, in combination with the end of the Cold War, has led the USA to depart from its post-war policy of encouraging economic regionalism in Europe while refraining from regionalism itself.

The other side of the coin of American decline has been the rise of Japan and East Asia. The economic threat from Japan and the NICs is felt acutely in both North America and Europe. This competitive threat and the large bilateral trade surpluses Japan and East Asia enjoy with North America and the EC have increased pressures for protection and measures to enhance the competitiveness of and increase market-access for American and European firms. As Paul Krugman has noted, the widespread notion that Japan is an unfair trader 'has done a great deal to undermine the perceived effectiveness and legitimacy of the GATT in the USA and Europe. So the great advantage of regional pacts is that they can exclude Japan.'⁴³ While this is an exaggeration, since both the USA and EC have used the threat of protection to induce Japanese firms to substitute local production in Western markets for exports from Japan, one objective of regionalism in the West (and even in East Asia) has been to increase pressure upon Japan to make various market-opening concessions. Such pressure, given the limited importance of tariff barriers, has come primarily in the form of rules of origin, local content rules, dumping and countervailing duties, about which Article XXIV is silent.⁴⁴

3. *The shift towards 'outward orientation'.* The failure of debt-financed import-substitution policies in much of Latin America, South Asia, and Africa, and the striking success of the outward-orientated policies of East Asia, has led to a generalized shift in the developing world towards favouring rather than discriminating against exports. This has increased the need to gain access for their manufactured exports in Western markets, at a time when protectionist pressures in the West have been growing and when Central and Eastern European countries are attempting to do the same. In turn, this has led to a greater willingness to negotiate bilateral or regional deals with the largest trading partners.

⁴³ Paul R. Krugman, 'The Move to Free Trade Zones', Paper presented to a symposium sponsored by the Federal Reserve Bank of Kansas City, Policy Implications of Trade and Currency Zones', 23 Aug. 1991, 36.

⁴⁴ See John H. Jackson, 'Regional Trade Blocs and the GATT', *The World Economy*, 16/2 (Mar. 1993), 121-31.

Second, access to large markets is also crucial for attracting export-orientated foreign direct investment, another area in which developing-country attitudes have undergone a major shift in recent years. This has also led to a growing perception of the dominance of American, German, and Japanese multinational firms in foreign-investment flows to lower-wage countries within their respective regions. At the end of 1991, 63 per cent of Mexico's stock of inward investment was owned by American firms, with the UK and Germany at 6 per cent each being the next most important investors.⁴⁵ The gradual erosion of the legacies of the Second World War have perhaps been most important for Japanese and German foreign investment. There is a strong perception that Japanese firms are carving out a *de facto* regional economic division of labour through foreign direct investment, taking advantage of lower wage costs in other countries to ensure the competitiveness of the labour-intensive parts of the manufacturing process, while retaining higher value-added activities in Japan. Similarly, in countries such as the Czech Republic and Slovakia in Central Europe, there was growing concern after 1989 that German firms would dominate foreign ownership of important parts of their industries. A regional bias to outward investment might over time increase the regional orientation of German and Japanese foreign policy.

Third, due to the often acute credibility problems of economic reform in many developing and transforming economies, reciprocal and binding regional economic arrangements with more powerful partners can often signal greater commitment to a path of economic reform than can other gestures such as joining the GATT.⁴⁶ Finally, regional agreements between developing countries can also be a means of increasing their limited bargaining power in bilateral negotiations with larger countries. For many export-orientated countries, however, regional solutions may at best constitute a form of minimal insurance policy should multilateral trade break down.

4. *The growing importance of non-tariff barriers to trade.* The

⁴⁵ Lusting *et al.*, *North American Free Trade*, 7.

⁴⁶ In the GATT, the concession to developing countries which relieved them of the obligation of reciprocity actually helped to marginalize them and to reduce the credibility of economic reform programmes. Regional agreements, being based upon reciprocity and with greater scope for enforcement on the part of more powerful members, have the benefit of 'tying one's hands'. For a general discussion, see Dani Rodrik, 'Credibility of Trade Reform: A Policy Maker's Guide', *World Economy*, 12 (Mar. 1989), 1-16.

success of the GATT in reducing tariff barriers to manufacturing trade to very low levels in major countries has focused attention on remaining non-tariff barriers (NTBs) to trade since the end of the Kennedy Round. The widely perceived failure of the GATT to deal adequately with rising levels of NTBs in the 1970s, despite the codes negotiated during the Tokyo Round, has eroded support for multilateralism, especially in the USA. This failure owes much to the fact that the problem of NTBs often goes to the heart of the role of the modern state in the economy, such as government procurement practices, subsidies, standards-setting, and increasingly to basic social organization and practice (as with Japanese *keiretsu* corporate relationships, for example). Not surprisingly, cultural and philosophical differences between the USA, East Asia, and Europe on such issues have often been significant, which has hampered agreement. While the agenda of the Uruguay Round explicitly aimed at increasing the relevance of GATT rules and enforcement mechanisms to contemporary trade problems, the slow rate of progress and broken deadlines reinforced pessimism about the future of multilateralism.

It is sometimes claimed that within regions, greater cultural and historical affinities can sometimes facilitate agreement on such issues, the Single Market programme in Europe being the prime example.⁴⁷ In Europe and North America, countries have looked to regional arrangements where the problem of the lowest common denominator may be less acute. Yet this argument can be overdone, since affinities between countries do not always coincide with geographical propinquity, and it betrays a tendency to overgeneralize the European example. The greater importance of non-tariff barriers has also increased the tendency to bilateralism in trade policy, and the Structural Impediment Initiative talks between the USA and Japan being an example. American officials also claim that through NAFTA the USA obtained better intellectual property protection from Mexico than they had been able to obtain through the GATT, but this owes less to regional affinities than to an asymmetry of bargaining power which the USA does not enjoy in the multilateral forum. Higher common denominators may also be found within the OECD, between the USA and EC on a number of issues,

⁴⁷ Albert Bressand, 'Beyond Interdependence: 1992 as a Global Challenge', *International Affairs*, 66/1 (Jan. 1990).

and between countries such as the Cairns Group of agricultural exporters.

There are therefore a number of important factors behind the rise of the new economic regionalism, most of which appear to be structural in nature and which are unlikely to disappear in the foreseeable future. While this has not undermined completely the forces in favour of multilateral approaches to international economic co-operation, Bhagwati is probably correct in his assessment that: 'As the key defender of multilateralism through the postwar years, [the US] decision now to travel the regional route (in the geographical and the preferential senses simultaneously) tilts the balance of forces away at the margin from multilateralism to regionalism.'⁴⁸ However, it ought to be added that part of the US objective in pursuing such policies has been to increase its bargaining power in multilateral forums—possibly successfully in the case of the Uruguay Round of the GATT. Although this twin-track strategy suggests that regionalism and multilateralism may not be mutually incompatible, there is an obvious danger that it could reinforce the temptation in the USA and elsewhere to pursue regional policies at the expense of multilateral ones.

3. THE WORLD ECONOMY: REGIONALIZATION OR GLOBALIZATION?

If there is a discernible trend towards economic regionalism as a policy, to what extent has the world economy become more regionalized? In addition, how do present claims as to the regionalization of the world economy sit with other claims about the powerful forces of globalization at work? Since the regionalization of the world economy is crucially dependent upon what happens in the three most important regions, North America, Europe, and East Asia, the discussion that follows will focus upon these three areas. This is largely because of the economic weight of these regions in the world economy; as in the 1950s and 1960s, regionalism in Latin America and Africa is unlikely to have a major impact on the shape of the world political economy and is in many ways a response to regionalism elsewhere.

⁴⁸ Bhagwati, 'Regionalism versus Multilateralism', 540.

It is important to point out at the beginning that one of the hazards of the literature in this area is the difficulty of agreeing upon standard definitions of different regional groupings. The GATT places Mexico in 'Latin' rather than 'North' America, while the UN does the reverse. The UN talks of 'Asia Pacific' mainly in terms of Japan, the NICs, and ASEAN, while 'Asia' for the GATT stretches from Afghanistan to North-East Asia to Australasia. Such variations can produce very different results, and there is a tendency to use definitions that support particular arguments. In the tables that follow, inconsistencies are avoided where possible but are noted where they are forced by the availability of data.

(a) Trade

As has already been noted, the idea that the 1980s saw a significant regionalization of international trade is widespread. Table 1 shows that on the face of it, this is justified, particularly in the case of the EC and East Asia, where intra-regional trade jumped significantly in the second half of the 1980s. However, this phenomenon is less sinister than at first it might appear. For the EC, the second half of the 1980s saw a vigorous investment boom after a long period of stagnation, which provided large benefits to an already highly integrated group of trade partners, but also to the rest of the world. In the 1973-84 period, when the European economy's performance was much poorer than in the 1950s and 1960s, intra-EC trade grew more slowly than imports from third countries.⁴⁹ The strengthening of the European economy in the second half of the 1980s led to the re-emergence of the trend towards growing intra-regional trade ratios, a trend which had always been consistent with increased trade with the rest of the world.

As for East Asia, an interesting pattern that has emerged since 1955 is that while the share of Japan's exports going to the East Asian region has not shown a general tendency to increase, its regional imports have grown particularly rapidly since 1970.⁵⁰ However, this is related to Japan's post-war structure of trade, importing raw materials from developing countries while exporting

⁴⁹ Alexis Jacquemin and André Sapir, 'European Integration or World Integration?', *Weltwirtschaftliches Archiv*, 124 (1988), 131.

⁵⁰ Albert Fishlow and Stephan Haggard, *The United States and the Regionalisation of the World Economy* (Paris: OECD, Mar. 1992), tables 3 and 3a.

TABLE 1. Regional trade patterns: EC12, North America, and East Asia (\$bn.)

	1980	(%)	1985	(%)	1991	(%)	% of regional GNP (1991)
EC12							
Total trade [(X+M)/2]	731.9	100	656.8	100	1,413.6	100	25
Of which:							
Intra-regional	383.3	52	351.4	54	842.1	60	15
Trade with ROW	348.7	48	305.4	46	571.6	40	10
Trade with North America	62.5	9	69.0	11	116.5	8	2
Trade with East Asia	32.8	4	36.0	5	111.0	8	2
North America							
Total trade [(X+M)/2]	319.0	100	380.5	100	637.4	100	10
Of which:							
Intra-regional	104.9	33	143.2	38	241.0	38	4
Trade with ROW	214.1	67	237.3	62	396.4	62	6
Trade with East Asia	60.4	19	97.7	26	172.6	27	3
Trade with EC12	58.6	18	69.7	18	112.2	18	2
East Asia							
Total trade [(X+M)/2]	252.9	100	324.4	100	737.7	100	16
Of which:							
Intra-regional	89.1	35	124.5	38	332.0	45	7
Trade with ROW	163.9	65	199.9	62	405.7	55	9
Trade with North America	56.3	22	93.1	29	169.2	23	4
Trade with EC12	30.1	12	36.7	11	112.5	15	2

Note: North America = USA, Canada, Mexico; East Asia = Japan, Singapore, Taiwan, Hong Kong, South Korea, Indonesia, Malaysia, Philippines, Thailand, China (mainland).

Source: GATT, *Direction of Trade Statistics Yearbooks*; Republic of China (Taiwan), *Statistical Yearbook 1991* (Executive Yuan, 1992).

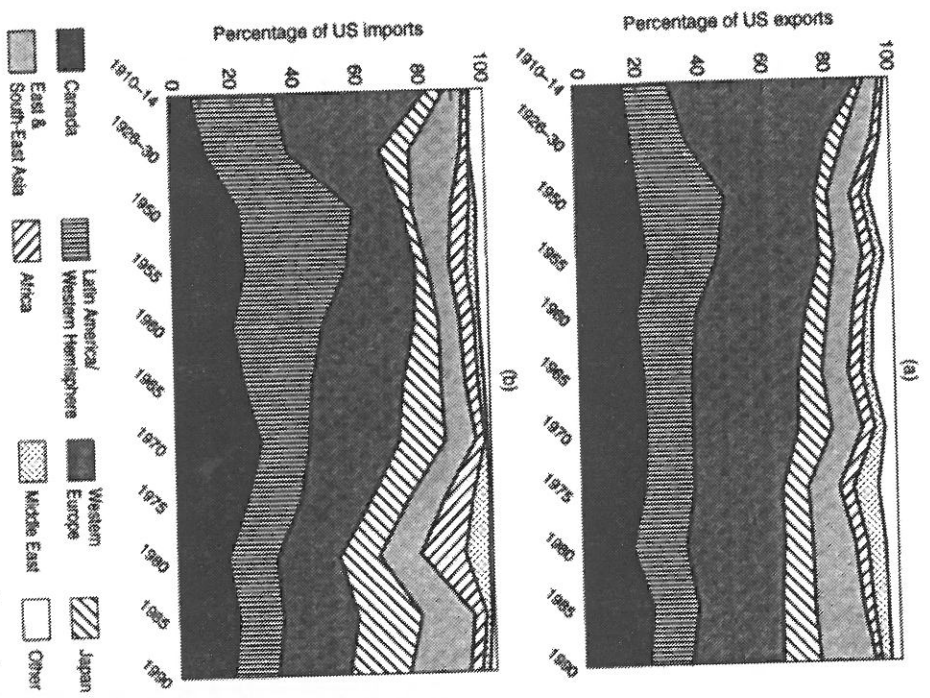


FIG. 1. US Merchandise (a) exports and (b) import, by region, 1910-1990

Source: US Dept. of Commerce, *Statistical Abstract of the United States* (various years)

manufactures mainly to OECD markets, particularly the USA. Although this is now changing, the region's manufacturing exports continue to be especially focused on the North American market. This is particularly true for Japan, but also the four NICs: the USA and Canada took on average 30 per cent of the NICs' exports in 1989, while Japan took only 11 per cent. The general lack of enthusiasm for a regional trading bloc in East Asia is therefore understandable even on purely economic grounds, despite the growing levels of intra-industry trade in the region.

For North America, Figure 1 shows how the importance of US trade with Canada has stayed reasonably constant since 1950, while intra-hemispheric trade with Latin America (particularly imports from Latin America) has declined over the past four decades. Trade with Europe has declined since the beginning of this century (though only marginally since 1950), while trade (particularly imports) with Japan and East Asia has shown rapid growth. This has prompted some to talk of the USA becoming a Pacific rather than an Atlantic economy. Rather, it seems that the US trading pattern has become more broadly diversified over the course of the century, with no one region playing a dominant role in US exports or imports—a feature confirmed by the ratification of NAFTA and the US support for APEC in late 1993. What has remained striking for the North American region as a whole is the extent to which it remains dependent upon extra-regional trade. However, this masks an important asymmetry: Canada and Mexico send about 70 per cent of their exports to the USA while the USA only sends about 25 per cent of its exports to Canada and Mexico. Thus, while Canadian and Mexican moves to secure FTAs with the USA are understandable, the USA's newfound interest in regional economic arrangements is a more complex phenomenon.

A final point is worth making about the supposed regionalization of international trade. Most trade in the world economy is driven by income: the big importers are the richest countries. A crude illustration of this is shown in Table 2. What it shows, however, is how much geography matters as well. Countries that are neighbours tend to trade with each other much more than does the rest of the world.⁵¹ When this is taken into account, European trade does not look excessively regionalized compared to the trade of

⁵¹ Clearly, other factors such as complementarity of economic structure and trade policy regimes will also affect trading patterns.

TABLE 2. *Network of world trade (1990) with 'gravity' calculations*

Origin region	Destination region															
	North America	G NA (%)	USA (%)	G USA (%)	Latin America	G LA (%)	Mexico	G Mex (%)	Western Europe	G WE (%)	Germany	G Ger (%)	Eastern Europe/ USSR	G EEU (%)	Africa	G Afr (%)
North America	178.0	191	93.7	498	55.8	272	18.6	442	125.0	51	25.7	50	5.3	22	9.0	66
USA	83.0	594			54	351	18.2	578	112.9	62	22.9	59	4.24	24	5.7	56
Latin America	68.6	261	64.7	307	19.8	342	1.5	155	33.4	49	9.3	64	8.5	127	1.7	44
Mexico	19.1	401	18.9	496	1.8	216			3.6	29	0.6	23	0	0	0.1	14
Western Europe	127.7	45	110.8	48	28.8	46	5.1	39	1164.2	155	233.1	199	45.4	62	54.0	129
Germany	32.1	43	29.2	49	8.0	49	1.5	44	294.9	191			32.3	17	10.0	91
Eastern Europe/ USSR	2.9	9	2.5	10	6.9	97	0.2	14	62.3	74	13.6	76	76.9	939	3.5	74
Africa	13.2	79	12.2	92	1.7	46	0.1	13	50.8	117	10.3	112	2.9	69	5.9	242
Middle East	19.0	81	18.2	97	7.9	153	0	0	34.2	56	4.1	32	4.2	71	69	3,293
Asia	210.4	150	193.7	172	15.4	50	2.4	38	148.4	40	45.8	59	13.8	39	13.3	65
Japan	97.7	192	89.5	219	7.2	64	1.1	48	63.7	48	20.4	72	3.3	26	4.3	58
World	619.7	100	495.8	100	136.3	100	27.9	100	1618.2	100	341.9	100	157.1	100	90.5	100
% World imports	17.8		14.2		3.9		0.8		46.4		9.8		4.5		2.6	

TABLE 2. (cont.)

Origin region	Destination region										
	Middle East	G ME (%)	Asia (%)	G Asia (%)	Japan	G Jap (%)	World	% World exports	Intra-trade (%)	Extra-trade (%)	(%) World GNP
North America	12.10	87	133.0	126	61.3	173	525.3	15.1	33.9	66.1	27.0
USA	13.31	128	119.1	150	52.8	200	393.1	11.3	21.1	78.9	24.5
Latin America	1.80	46	13.7	46	9.4	94	148.0	4.2	13.4	86.6	4.3
Mexico	0.30	42	1.9	35	1.9	105	26.8	0.8	6.7	93.3	1.0
Western Europe	44.80	105	119.8	37	42.7	39	1612.8	46.3	72.2	27.8	30.4
Germany	9.40	84	33.2	39	10.8	38	421.1	12.1	70.0	30.0	6.6
Eastern Europe/ USSR	2.40	50	20.6	56	4	33	181.7	5.2	42.3	57.7	12.1
Africa	2.10	85	5.7	30	3.8	60	93.7	2.7	6.3	93.7	0.8
Middle East	7.00	200	52.1	196	31	349	132.0	3.8	5.3	94.7	2.8
Asia	22.30	106	358.1	224	82.4	243	791.2	22.7	45.3	54.7	22.1
Japan	9.10	120	98.2	255			286.9	8.2	34.2	65.8	14.2
World	92.40	100	703.0	100	234.6	100	3485.0	100.0	0.0	100.0	
% World imports	2.7		20.2		6.7		100.0				

Notes: 1. Mexico is included in Latin America; Turkey and Yugoslavia in Western Europe; Oceania in Asia.

2. 'Gravity' calculations ('G' columns) show each region's (country's) share of its total exports to another region as a percentage of the destination region's (country's) share of world imports.

3. 'Germany' means West Germany.

Source: GATT, *International Trade 90-91*, ii (Geneva, 1992); UN, *World Development Report*, 1992, table 1; IMF, *Direction of Trade Statistics Yearbook*, 1992; UN, *World Economic Survey*, 1992.

other regions. Western Europe (essentially the EEA) does 1.5 times more trade with itself than one would expect from its weight in international trade. However, Europe's major trading nation, Germany, does not look out of line if we compare it in this respect with Japan (Germany exports 1.9 times more to Western Europe than expected, but Japan exports 2.5 times more to Asia than expected). The USA exports 6 times more to Canada than expected, and 5.8 times more to Mexico, a much greater regional trade bias than Germany or Japan.

This point also accounts for much of the increase in the regionalization of trade flows in East Asia over the 1980s. That is, as the share of the region in world output has grown, we would expect its intra-regional trade ratio to increase without any increase in the regional 'bias' of its trade. Indeed, once account is taken of the growth in the region's share of world output, it appears to be the case that East Asia's regional trade bias (as opposed to that of the EC) actually fell over the 1980s.⁵² As regards Europe, the figures on trade as a percentage of GNP also suggest that the EC is much more open than the USA (Table 1). Extra-regional trade as a percentage of GNP is higher for the EC than for either the USA or Japan. However, this difference is largely eliminated if Western Europe is seen as a whole, since the EC's major trading partner is EFTA. It is also interesting that the oft-noted extra-regional trade dependence of developing countries is primarily due to their lesser weight in the world economy rather than an absence of regionalization. For example, Africa trades with itself more than two times what would be expected, suggesting a regional trade 'bias' greater than that of the EEA though much less than that of CUSFTA. This is also true for Latin America and Asia.

(b) Investment

Flows of foreign direct investment (FDI) have grown much more rapidly than trade in the 1980s and have thereby acted as an increasingly important motor for rising levels of economic inter-

⁵² Jeffrey A. Frankel, 'Is a Yen Bloc Forming in Pacific Asia?', in Richard O'Brien (ed.), *Finance and the International Economy*: 5 (Oxford: OUP/Amex Bank Review, 1991), 7-9.

TABLE 3. *FDI outflows for the USA, Germany, and Japan*

USA: Foreign Investment Outflows by Region, 1960-90 (%)															
	1960-65	1965-70	1970-75	1975-80	1980-85	1985-88	1988-89	1989-90	1990-95	Cumulative					
	5	70	5	80	5	7									
Canada	24	22	21	15	12	13	25	8	6	15					
Latin America	11	6	11	24	-71	23	18	32	19	17					
Mexico	0	0	0	7	-6	-0	4	4	4	2					
Western Europe	41	43	50	51	60	54	34	50	56	51					
Japan	2	3	4	3	20	8	12	2	5	5					
Other Asia	2	3	7	3	46	2	8	7	7	6					
Africa	4	4	-0	1	5	-0	-1	-1	-0	1					
Middle East	2	0	-11	7	16	-1	-1	1	1	1					
Other	13	18	19	-12	17	2	2	-4	3	2					
Total (\$bn.)	17.6	26.0	48.6	91.3	14.9	84.1	19.2	36.6	51.4	389.6					

Germany: Foreign Direct Investment Outflows by Region, 1985-90 (%)

	1985-90						
	1985	1986	1987	1988	1989	1990	Cumulative
US	59	55	70	52	25	14	40
Japan	1	1	1	1	1	1	1
France	4	3	7	6	10	7	6
Italy	9	8	2	6	3	4	5
UK	20	7	11	9	25	21	16
Netherlands	0	12	1	6	9	9	7
Benelux	4	2	1	6	11	17	8
Austria	2	1	2	4	2	2	2
Switzerland	0	3	1	5	-1	8	3
Ireland	0	0	0	0	6	13	5
Spain	0	8	3	5	8	6	5
Total							
(DMbn.)	13.0	14.6	10.7	16.3	18.0	26.4	99.0

Japan: Foreign Direct Investment Outflows by Region, 1980-9 (%)

Japan: Foreign Direct Investment Outflows by Region, 1980-9 (%)	1980					1985					1990-9					Cumulative				
	1980	1985	1986	1987	1988	1989	1980	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
US & Canada	34	45	47	46	48	50	47													
Asia	25	12	10	15	12	12	12													
Europe	12	16	16	20	19	22	19													
UK	4	3	4	7	8	8	7													
Other	28	28	27	20	21	16	20													
Total (\$bn.)	4.7	12.2	22.3	33.4	47.0	67.5	187.1													

Sources: USA—US Bureau of the Census, *Statistical Abstract of the United States*, various years; Germany—Institut der Deutschen Wirtschaft, *IW-Trends*, 19(2), 1992; Japan—OECD, *Economic Survey*; Japan 1989/90 (OECD, Paris).

dependence.⁵³ If there is only limited evidence for a regionalization of international trade, has FDI played a major role in the regionalization of the world economy?

What is clear is that the global distribution of income also weighs heavily in the pattern of FDI, though more so for manufacturing and services industries than for the extractive industries. As for the distribution of US trade flows, there has been a tendency over time for the distribution of US foreign investment stock to become less rather than more regionally orientated. In 1960, 68 per cent of US foreign investment stock was concentrated in North and South America, 21 per cent in Western Europe, and only 4 per cent in Asia. By 1990, this had changed to 33 per cent in the Americas, 48 per cent in Western Europe, and 11 per cent in Asia. Only in the later 1980s did flows to Mexico and Latin America begin to grow rapidly again, after a period of volatility and decline (Table 3). What is striking is the importance of Western Europe as a destination for US FDI flows, where local sales by US affiliates are much greater than US exports to Europe. As Table 4 shows, there is a lesser regional bias to US FDI compared to US trade, and Western Europe and Japan attract relatively more FDI than trade from the USA. The US penetration of the European economy is therefore much greater than trade figures alone suggest.

Looking at Japanese investment outflows in the 1980s, what is clear is how they have been increasingly concentrated upon North America and Europe rather than its region, in spite of the much faster growth of the East Asian economies (Table 3). The idea that Japanese corporations have concentrated upon carving out a regional sphere of economic influence in East Asia, facilitated by Japanese government aid, can be exaggerated, although it is true that over 80 per cent of Japanese FDI to developing countries in the late 1980s went to East Asia, contributing to the rapid industrialization of these countries. The most important factor in Japanese foreign investment has been in ensuring market-access to the major markets of North America and Europe (where Japanese firms have been underrepresented). The growing concentration of Japan's outflows to developing countries in its region is hardly anomalous when compared to the regional bias of US FDI (see Table 4). Also,

⁵³ UN, *World Investment Report 1992*, and DeAnne Julius, *Global Companies and Public Policy: The Growing Challenge of Foreign Direct Investment* (London: Pinter/KITA, 1990).

TABLE 4. USA, Germany, and Japan: FDI stock by region (%) (with gravity calculations for FDI and trade)

Destination region	Origin region								
	USA			Germany			Japan		
	USA FDI stock by region, 1990	USA: ratio of FDI share to region's share of world FDI	USA: ratio of trade share to region's share of world imports	Germany FDI stock by region, 1990	Germany: ratio of FDI share to region's share of world FDI	Germany: ratio of trade share to region's share of world imports	Japan FDI stock by region, 1991	Japan: ratio of FDI share to region's share of world FDI	Japan: ratio of trade share to region's share of world imports
North America	16	225	594	27	40	43	44	26	192
USA	NA	NA	NA	24	88	49	42	156	219
Latin America	17	336	351	6	93	49	12	265	64
Mexico	2	109	578	1	58	44	1	30	48
Western Europe	48	120	62	60	147	191	20	52	48
Germany	7	112	59	NA	NA	NA	2	27	72
Eastern Europe/ USSR	ND	ND	24	ND	ND	170	0	NA	26
Middle East	1	59	128	1	32	84	1	58	120
Africa	1	44	56	1	65	91	2	89	58
Asia	11	73	150	3	18	39	22	269	255
Japan	5	405	200	2	164	38	NA	NA	NA
World	100	100	100	100	100	100	100	100	100

Notes: NA = not applicable; ND = not disclosed.

Source: US Bureau of the Census, *Statistical Abstract of the United States*, various years; Deutsche Bundesbank, *Kapitalverflechtung mit dem Ausland*, June 1993; Japan, Ministry of Finance.

it may be due in part to the economic problems of Latin America during the 1980s, and this previously favoured destination may once again become attractive for Japanese corporations in the 1990s.⁵⁴ Finally, Fishlow and Haggard argue that growing penetration of East Asian countries by Japanese corporations only increases the concerns of smaller countries regarding Japanese economic domination, and may work against regionalism in East Asia.⁵⁵ This too is debatable, since the growth that has flowed from Japanese FDI might also serve to assuage concerns about Japanese intentions in the region.

In the EC, the combined effects of London's 'Big Bang' financial deregulation, the Single European Act, and EC enlargement spurred a considerable increase in cross-border mergers and acquisitions in the later 1980s.⁵⁶ This can be seen in the pattern of German FDI flows in the 1980s. In the mid-1980s, German investment flows were directed largely towards the USA, even more so than for Japan, though a strong regional pattern emerged in the late 1980s. However, European investment flows to the USA remain very important, and the dominant trend of the 1980s as a whole was investment by European (and Japanese) companies in America, hitherto a market in which foreign firms played a relatively limited role. This is particularly true for the EC's largest foreign investor, the UK, which far outstrips Germany in this regard.

Overall, then, flows of FDI have enhanced inter-regional more than intra-regional linkages in the world economy, which is somewhat at odds with the regionalization hypothesis. As so much recent management-studies literature has suggested, companies competing in global markets were increasingly likely to establish a local presence in the three main markets of the 'triad' during the 1980s. However, Japan as a destination for FDI remains, even more than in its trade, the big anomaly.⁵⁷

⁵⁴ On this subject, see Barbara Stallings and Gabriel Szekely (eds.), *Japan, the United States and Latin America* (Baltimore: Johns Hopkins UP, 1993).

⁵⁵ Fishlow and Haggard, *United States and the Regionalisation of the World Economy*, 34.

⁵⁶ See Stephen Thomssen and Stephen Woolcock, *Direct Investment and European Integration: Competition among Firms and Governments* (London: Pinter/RITA, 1993), chs. 2-3.

⁵⁷ On this, see Robert Z. Lawrence, 'Japan's Low Levels of Inward Investment: The Role of Inhibitions on Acquisitions', *Transnational Corporations*, 1/3 (Dec. 1992), 47-75.

(c) *Money and finance*

There has been some degree of regionalization in the structure of the international monetary system since the breakdown of the Bretton Woods system in the early 1970s, which was based primarily upon the dollar. The main development in this regard is that despite limited periods of unilateral floating, a growing number of West European countries gradually came to peg their currencies to the Deutschmark rather than the dollar. Although the 'Snake' and subsequently the EMS have provided only very limited insulation from periodic dollar crises since the early 1970s, they have created a zone of relative monetary stability in Europe, at least until 1992.

However, it is important not to exaggerate this shift. Although the mark has become the world's second reserve currency after the dollar, in part the result of the expansion of intra-EMS intervention by European countries, mark assets accounted for only 18 per cent of world foreign-exchange reserves at the end of 1991, while dollar assets represented 56 per cent (the share of the ECU in official reserves was only 5 per cent.⁵⁸ Even within Europe, the dollar remains by far the most important reserve currency. The recent breakdown of the EMS also suggests that there are important limits to the possibility and desirability of fixed exchange-rate systems in the context of continued economic divergence between countries and high levels of short-term capital mobility.

There has been no equivalent emergence of a so-called 'yen zone' in East Asia. It is true that smaller countries in East Asia increased their holdings of yen foreign reserves from 14 per cent of their total reserves in 1980 to 17½ per cent in 1989, above the current world average of 10 per cent.⁵⁹ In addition, many have accepted the logic of growing trade dependence upon Japan and pegged their currencies to a basket in which both the dollar and the yen play an important role. The proportion of borrowing in yen for the region has also increased significantly, though in part this is due to dollar depreciation. However, the high level of trade dependence of the NICs on the US market and the limited political and economic integration in East Asia has prevented the emergence of an East

⁵⁸ Bank for International Settlements, *62nd Annual Report, 1991-1992* (Basle: BIS, 1992), 101.

⁵⁹ Frankel, 'Is a Yen Bloc Forming?', 16.

Asian version of the EMS. Hence, while the influence of Tokyo upon interest rates in the region has increased over time due to the liberalization of East Asian financial markets, 'overall its influence is as yet no greater than that of New York'.⁶⁰

In addition, the continuing dominance of the dollar in the international monetary system and of US financial markets and dollar instruments in the global financial system suggests that the regionalization of money and finance has been very limited.⁶¹ The gradual removal of exchange controls has particularly promoted inter-regional short-term capital mobility, mainly between the USA, Japan, and Europe (and there, mainly the UK). The three main financial centres, London, New York, and Tokyo, are much more connected to each other than to other regional financial centres. Short-term international capital flows are concentrated upon dollar-mark and dollar-yen cross-rates and much less upon intra-regional exchanges. Indeed, the argument has been made that geography is of decreasing importance in an increasingly global financial market, due to the role of modern technology and communications.⁶² However, the agglomeration of financial industry in the big three international financial centres suggests that geography remains crucially important, even though these centres are increasingly interlinked. It is also a major reason why direct investment flows in services industries such as banking and insurance (which even for the Japanese came to constitute the majority of outward FDI in the 1980s) are primarily inter-regional, focused on the major financial centres in different time-zones. Indeed, financial services are probably the best example of an industry in which the major firms do indeed tend to have a major presence in all three areas of the triad.

We have seen that the evidence in favour of the simple regionalization hypothesis is not strong. Economic interdependence has continued to rise in recent decades, increasingly driven by short- and long-term capital flows rather than trade. However, at the macro-level, this if anything has enhanced *inter-regional* economic linkages rather than *intra-regional* ones. The possible exception to this trend is Western Europe, where the regionalization of markets is more pronounced. However, Europe is not exceptional

on trade if viewed as a bloc; is a major host for foreign multinationals; and, like Japan, has enjoyed a rapidly expanding ownership stake in the US economy in the 1980s. Furthermore, the long-term trend for the US economy has been towards increased openness *vis-à-vis* the rest of the world and increased importance of extra-regional linkages. Thus it might be argued that the globalization of the US economy, to the extent that it has been associated with growing concern about American decline, has been a cause of the USA's newfound enthusiasm for regionalism.

Nor, however, is the metaphor of globalization entirely helpful. The continued importance of geography for investment patterns belies superficial views of the globalization process, with the bulk of countries effectively marginalized from this process. The simple fact is that the world's big economies are located in North America, Europe, and East Asia, and the large firms that dominate economic activity emanate from and gravitate towards these economies. However, the growing importance of FDI as a motor of economic interdependence varies considerably by industry. As we have seen, international competition in the wholesale financial services industry is largely of an inter-regional kind. The bulk of activity is located in the large 'global' centres of London, New York, and Tokyo, each of which plays a regional role (this is least true, perhaps, of Tokyo). In general, the rise of inter-regional FDI is partly due to the increasing importance of services in the world economy, since a local presence in services often necessitates market penetration through FDI rather than through exports. The trend since the 1970s towards the deregulation of important service industries from banking to telecommunications has also contributed significantly.

A further factor which tends to be underestimated in the literature is the implications of greatly increased exchange-rate instability since the early 1970s. This has been a major stimulant to the wholesale financial services industry, with consequent effects upon foreign investment in this sector. In manufacturing industry, the risk of sustained misalignment of currencies, against which financial hedging techniques are inadequate, increases the value to firms of foreign production and supply networks in major markets. To the extent that the key exchange-rate risks have been of an inter-regional kind (between the dollar, the yen, and the European currencies), this has encouraged a 'triadic' pattern of investment by

⁶⁰ Frankel, 'Is a Yen Bloc Forming?', 17.

⁶¹ Wyatt-Walter, *World Power and World Money*, ch. 7.

⁶² O'Brien, *Global Financial Integration*.

multinational firms. In 1993-5, large Japanese manufacturing firms, which remain on average much more dependent upon exports than upon foreign production as a means of accessing foreign markets than their US and European counterparts, have been highly vulnerable to the exceptional strength of the yen. This has increased considerably the relative attractiveness of foreign over domestic investment.⁶³

Even apart from exchange-rate considerations, for much manufacturing industry such as automobiles and machinery, the importance of transport costs and proximity to important customers often means that FDI is more efficient as a strategy for market entry than exports. More generally, the inter-regional orientation of FDI flows also results from the oligopolization of so many of the important industries in the major economies, as Alfred Chandler has pointed out. The existence of very high barriers to entry in many of the US industries in which large firms came to dominate domestic and often international production by mid-century meant that it was unsurprising that challengers to US firms usually came from outside the USA, often because foreign governments provided them with initial protection from US competition. Having achieved adequate economies of scale and scope, these European and Japanese firms then came to challenge US firms across a range of markets, including the American market. FDI could also provide an important means of pursuing oligopolistic strategies, placing pressure upon and reducing the profits of major competitors in key markets. Thus, the 1970s saw not only substantial increases in import penetration of the US economy, but also much more rapidly growing inward investment into the USA.⁶⁴

Of course, inter-regional investment flows may also be encouraged by protectionism, as has apparently been the case with Japanese investment in the USA and EC in recent years. In addition, foreign firms may gain important leverage with foreign governments by investing within their political jurisdictions, facilitating the participation of affiliates in R & D programmes, in government procurement contracts, and in greater equality of treatment *vis-à-vis* domestic firms. An important element in this is that Europe (except-

⁶³ 'Coping with Yen Shock', *International Business Week*, 30 Aug. 1993, 16-18.

⁶⁴ See Alfred D. Chandler, Jr., *Scale and Scope: The Dynamics of Industrial Capitalism* (Cambridge, Mass.: Harvard UP, 1990), 599-620.

tionally) has increasingly engaged not only in regional trade protection but also 'regional technonationalism'.⁶⁵ That is, the increasing perception in Europe of a need for a common response to the challenge presented by US and Japanese firms in high-technology sectors has led to the adoption of publicly subsidized, collaborative R & D programmes aimed at enhancing the competitiveness of European firms. The foreign (i.e. non-European) firms which have gained substantial access to such programmes are those, like IBM and Ford, which have important manufacturing and R & D facilities within Europe.

While investment outflows from the major economies has tended to be more inter-regional than intra-regional, we have also seen that there remains a substantial bias to FDI within regions. There are a number of reasons for this. For industries in which transport costs are considerable, such as raw materials, there is an obvious incentive to locate mines and processing plants close to major markets (where there is a choice). This probably accounts for the regional orientation of much US and Japanese FDI in primary industry, though the high levels of investment in the oil-rich Middle East are an obvious exception. Also, barriers to entry in manufacturing and service industries, particularly those of a cultural or social kind, may sometimes be less within regions. American manufacturing firms, having established themselves in a particular (micro-) region of the US economy, usually expanded first to other regions within the USA, before venturing abroad, typically in the first instance to the UK. Another factor has been the growing demand for just-in-time delivery in manufacturing industries since the 1970s, which favours the geographical proximity of supplier to customer firms, promoting an intra-regional network of investment.

While trade protectionism has tended to promote inter-regional flows of investment, other forms of government interference can promote intra-regional investment patterns. For example, states often react to the increasing ease of firms establishing 'trans-plant' operations within their territory (so as to avoid trade protection) by imposing constraints such as rules of origin and of local content. Such investment-related forms of protection are increas-

⁶⁵ Candice Stevens, 'Technoglobalism vs. Technonationalism: The Corporate Dilemma', *Columbia Journal of World Business* (Fall 1990), 42-9.

ingly, at least for the EC and NAFTA, defined on a regional basis, which can allow firms to take advantage of intra-regional wage differentials while satisfying host-region demands concerning sourcing and production. As has been clear in the electronic and automobile industries in the EC, this can encourage firms to establish local value-added production and sourcing arrangements more quickly or more extensively than they might otherwise do for purely commercial reasons. Traditional suppliers to large Japanese car firms have often followed the assemblers to the USA and Europe. Of course, central to such convergence of regional policies and corporate strategy, given the importance of intra-firm trade to the modern industrial corporation, is regional trade liberalization itself. For example, US affiliates in Mexico account for nearly 40 per cent of Mexico's total trade with the USA.⁶⁶

Thus, while access to major markets seems to be the most important incentive for FDI, as confirmed by surveys of multinational firms,⁶⁷ this seems to produce both a predominance of inter-regional FDI flows in the world economy as well as a clear tendency for firms to establish *intra*-regional production and sourcing networks. Good examples of this are the regionalized networks operated by Japanese and American multinational automobile companies in the USA and Europe. Increasing competition and the rising fixed costs of certain corporate activities such as R & D increases the incentives for firms to access foreign markets, while the communications revolution due to digital technology may increase the ability of managers to control multinational operations.⁶⁸ Nevertheless, no industries are completely 'footloose' or global in orientation, and the realities of business and politics work to ensure that strong inter- and intra-regional patterns of trade and investment emerge. Above all, it is important to emphasize the way in which corporate strategy and regional policies interact to produce both 'globalization' and 'regionalization' in the patterns of trade and investment.

⁶⁶ UN, *World Investment Report 1992*, 2.

⁶⁷ See e.g. Emergency Committee for American Trade, *Mainstay II: A New Account of the Critical Role of U.S. Multinational Companies in the U.S. Economy* (Washington, DC: ECAT, July 1993), 7, and the evidence presented in Thomsen and Woolcock, *Direct Investment and European Integration*, chs. 3-4.

⁶⁸ See OECD, *Globalisation of Industrial Activities*.

4. IMPLICATIONS FOR THE MANAGEMENT AND STABILITY OF THE WORLD ECONOMY

The conclusion that trends towards regionalization and globalization are symbiotic more than contradictory raises an important question about how this affects the management and stability of the world economy. In particular, there was a growing concern in the early 1990s that despite evidence of growing inter-regional linkages in the world economy, regionalism might nevertheless develop a cumulative momentum. This raised the spectre that for the first time since 1945, regionalism and multilateralism threatened to operate in divergent directions. Even though this fear has been reduced with the eventual success of the Uruguay Round, we need to assess the likelihood of this outcome, and to ask whether it would represent such a negative development.

As already suggested, the experience since 1945 has been that regionalism and multilateralism for the most part have coexisted reasonably successfully. The most important reason for this was that US leadership during the Cold War period limited the negative tendencies of the most important manifestation of regionalism, that in Western Europe. Where the USA was unwilling to push the Europeans towards rough compatibility with the GATT, such as in agriculture during the 1950s and 1960s, the result was severely negative. When the European Community was taking shape in the early 1960s, US pressure and the existence of the GATT helped to tip the balance in favour of Western European countries inside the EEC (such as Germany and Benelux) and those who had decided for the time being to remain outside (above all, the EFTA countries), who favoured the creation of a Community relatively open to the rest of the world.

European regionalism in the 1960s and early 1970s implied more than just a damage-limitation exercise for multilateralism, however. The emergence of a powerful European trade grouping armed with a Common External Tariff prompted the US itself to offer much deeper cuts in its own tariff protection than it would otherwise have done, leading to the successful Kennedy Round outcome which substantially reduced the diversionary effects of the CET.⁶⁹ Similarly, the USA initiated both the Tokyo and Uruguay Rounds

⁶⁹ John W. Evans, *The Kennedy Round in American Trade Policy* (Cambridge, Mass.: Harvard UP, 1971).

when the EC was embarking upon new phases of enlargement. Finally, the trade and investment boom that integration helped to maintain led to considerable benefits for third-country exporters of manufactures, though especially for the large number of American multinational firms that established a local presence in the Community.

The boom in Western Europe in the second half of the 1980s coincided with the latest liberalizing phase of European integration and finally enabled the EC to accept US proposals in 1986 for an extremely ambitious agenda for the Uruguay Round. The EC found it difficult to contain the liberalization measures of the Single Market Programme fully within the borders of Europe, again in part because of American pressure. For example, the reciprocity provisions of the Second Banking Directive of 1989, largely responsible for the talk about Fortress Europe, prompted discussions with the USA which led to a watering down of the provisions.⁷⁰ The EC's recent Utilities Directive, which envisages an open market for government utilities procurement within the Community, also prompted a major dispute with the USA which ultimately led to a market-opening compromise. Although American pressure has helped to reduce the cost of European integration perhaps mainly for US firms, the benefits to others have been considerable, perhaps in part because intra-regional liberalization creates domestic political coalitions which can also favour and encourage broader liberalization. Also, a powerful European bloc helps to constrain tendencies towards unilateralism in the USA.

It has been during periods of slow growth that European integration has been weakest and the tendencies to protectionism strongest. The period from the first oil shock to the early 1980s saw both a stagnation of regionalism as well as major world recessions, slow growth of international trade, and rising protectionism. The weak state of the world economy in the depths of recession in 1982 created both pessimism in Europe about economic 'sclerosis' and an EC refusal to embark upon the new GATT 'Reagan Round' that the Americans were proposing. In difficult times, the EC tends to become cautious and introspective and finds it difficult to embark upon either multilateral or regional liberalization. The response is usually the opposite in the USA, where the executive branch tends

⁷⁰ Carter H. Golembe and David S. Holland, 'Banking and Securities', in Hufbauer, *Europe 1992*.

to take export-promotion initiatives to deflect rising demands for import protection. Thus, the USA tends to meet European resistance to trade liberalization at the time when the American political system needs it most.

Hence, it is not entirely surprising that as the pressures of protectionism have risen within the USA since the 1980s, frustration with the EC has grown to the point where the USA now pursues trade liberalization on a number of fronts simultaneously. Yet European recalcitrance and introspection is not the only cause of this shift in US strategy. In contrast to Europe, where regionalism in the form of the Community was seen as an antidote to perceived German and Soviet aspirations to hegemony and could therefore be actively promoted, in East Asia after 1945 the containment of Japanese power was achieved by the undermining of macro-regionalism. US economic and political hegemony in East Asia ensured that Japan and other East Asian countries were integrated into the world economy primarily through their exporting to the US market. This has had some important negative consequences in the longer term.

First, the rise of Japan has considerably complicated the management of the world economy, since its relationship with the USA and Europe is highly unbalanced compared with the US-European relationship. The low levels of foreign penetration of the Japanese economy led to growing tension with Japan's major trading partners and a weakening of their commitment to the GATT, as well as making for an asymmetrical dependence that only increases Japanese resentment of Western pressure. Second, unlike in Europe where the promotion of regional integration forced Germany and its neighbours to come to terms with the past and to seek solutions, Japan's rise has complicated relations with its region. The smaller countries simultaneously resent the relative closedness of the Japanese economy and yet fear the consequences of dependence upon Japanese capital and technology.

In summary, it may be difficult to extrapolate from the experience of a positive and largely reinforcing relationship between regionalism and multilateralism after 1945 to a general principle. That is, this positive relationship was essentially the product of the unique circumstances surrounding the European-American relationship during the Cold War era. There is no necessary reason to suppose, as have many American writers, that regionalism might be a building-block to multilateralism when it is also pursued in East

Asia and North America.⁷¹ Much depends upon events in the Pacific-Asia region as the balance of the world economy shifts further away from the US-European axis to the North American-Asian axis. It may be true that the perceived success of the APEC summit in Seattle in December 1993 prompted the necessary movement for agreement in the GATT Uruguay Round negotiations later that month.⁷² However, it is unclear that a positive relationship between regionalism and multilateralism can be maintained in the longer term, outside of the constraints of a common Cold War alliance and in presence of deep economic asymmetries. At present, most countries in East Asia favour the continued economic and political engagement of the USA in the region, as a counterweight to real or perceived Japanese and/or Chinese hegemonic aspirations. But the debate over 'open vs. closed' regionalism in East Asia is not yet resolved, and the potential effects of any further US attempts to prevent regionalism in Asia through either APEC or a divide-and-rule strategy of selective FTA agreements are difficult to discern.

While supporters of US regional policy claim that NAFTA can help reinforce US demands for GATT reform and promote multilateral liberalization, it is also apparent that it has allowed important lobby groups to increase protectionist measures in important areas. For example, under NAFTA, the minimum local content ratio for automobile production in North America will be increased from 50 per cent (as under CUSFTA) to 62.5 per cent. Also, given the difficulty of achieving progress within the Uruguay Round, it is unclear as to how effective the threat of regionalism by the USA was in pushing other countries towards multilateral trade liberalization. Regionalism also strikes a chord with isolationist and nationalist elements in the USA, who equate the US support of multilateral institutions such as the GATT with the exploitation of America by its erstwhile allies in Europe and Asia. US regionalism is confusing precisely because it can appeal to both protectionists and free-traders, who support it as a means to different goals.

⁷¹ See e.g. the argument of Robert Z. Lawrence, 'Emerging Regional Arrangements: Building Blocks or Stumbling Blocks?', in O'Brien, *Finance and the International Economy*: 5.

⁷² C. Fred Bergsten, 'Sunrise in Seattle', *International Economic Insights* (Jan./Feb. 1994).

Therefore, it is debatable whether NAFTA is much more useful than as part of a new relationship with Mexico. As we have seen, the US is a global trader and investor, with a great stake in multilateral agreement on the treatment of trade in goods and services, of multinational firms, and of intellectual property. Nor can regionalism be seen as an easier option, as the tortuous negotiations with Mexico and Canada have shown. Moreover, since most of the USA's regional neighbours are developing countries, there are severe limits to the possibilities of American regionalism. The political difficulties involved in closer integration in the presence of large income disparities have been demonstrated in the case of NAFTA, while no other countries enjoy the political profile that Mexico does in US policy. As a result, any US 'regional' strategy would be likely to degenerate into a series of bilateral FTAs that have limited overall coherence, either geographical or economic.

The limitations of regionalism as a strategy for the USA do not ensure its demise, particularly as it increases the possibility of protective regionalism elsewhere. But would the further tipping of the scales away from multilateralism towards regionalism really be so detrimental to the management and stability of the world economy, as liberal international economists claim? International relations theory says little about this, though it is generally held to be negative in its impact. Liberals naturally favour the promotion of global economic interdependence as a means of promoting international order, while realists presume that order typically derives from the hegemony of one country in the international political economy. Accordingly, regionalism is generally perceived as a fracturing of the post-war international economic order, raising the prospect of a destabilizing conflict between three competing, great-power-dominated blocs.

The literature on co-operation suggests that agreement between states is more likely in small groups, which has implications for the assessment of regionalism. We saw earlier that the European model suggested that non-tariff barriers might be best dealt with, at least initially, in a regional context. However, the lowest-common-denominator problem associated with the GATT and other multilateral bodies does not necessarily imply the superiority of regional forums *per se*. In fact, there is no good reason why optimal jurisdictions have to be regional in nature, since similar levels of economic development might be much more important as a facilitator of

international agreement than neighbourliness. Larger forums can also overcome problems of large numbers through coalitions; the GATT is essentially dominated by the USA and EC, with other countries forming coalitions to gain leverage (as with the developing countries or the Cairns Group).

A further shift away from multilateralism towards regionalism would be likely to promote further defensive behaviour on the part of multinational firms, who would continue to strive to improve their local or regional credentials as a means of limiting the impact upon their market access. If such firms become less dependent upon inter-regional exports as a result, this might reduce their incentives to lobby for open trade (and for policies to promote exchange-rate stability) between regions. However, most major corporations remain wedded to the principle of open markets because of their high propensity to engage in international trade and their desire for flexibility. Inter-regional trade can sometimes help such firms to defuse protectionist pressures, as non-traditional exports by Japanese affiliates from the USA and Europe back to Japan eventually might. The real danger is that the proliferation of national and regional rules of origin and local content will lead to a competitive scramble between the regions for the high value-added parts of the development and production chains of multinational firms. Hence there is a strong case for the considerable reinforcement of Article XXIV of the GATT, as discussed, to limited effect, within the Uruguay Round.⁷³ The shift in US policy towards the pursuit of regionalism markedly reduces the chances that this will be achieved.

The biggest losers in any such shift towards regionalism would be the Japanese, and the poorer countries in general, who remain much more dependent upon exports as a source of accessing the larger economies. Of all the large countries, the Japanese are most dependent upon extra-regional exports for their continued prosperity. The problem is of course much more acute for developing countries. Most of the contemporary regionalism in the developing world is a response to the growing difficulties of penetrating the increasingly protected big markets in the North.⁷⁴ If this access is increasingly denied, the rapid progress many developing countries

have made in recent years towards externally orientated economic policies will be jeopardized. For most developing countries and for developed countries outside of the major regions like Australia and New Zealand, regionalism is no substitute for multilateral trade liberalization. It is inevitable that Mexican-style opportunities will only be extended to the lucky few.

⁷³ See Jackson, 'Regional Trade Blocs', 129-30.

⁷⁴ Rolf J. Langhammer, 'The Developing Countries and Regionalism', *Journal of Common Market Studies*, 30/2 (June 1992), 211-31.