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Towards Regional Economic Blocs: Are We There Yet?

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Towards Regional Economic Blocs: Are We There Yet?

Executive Summary

The formation of regional economic blocs is seen by some as a potential threat to multilateral liberalization and to smaller trading nations, such as Canada. However, increasing polarization of the global economy around the "triad" of the United States, the European Union and Japan might not be as pervasive as is popularly reported, despite the emergence of policy driven regionalism in Europe and, more recently, in North America. Moreover, even if substantial regionalization of the world economy is occurring, this does not necessarily pose a threat to globalization or multilateralism.

After examining the questions of whether regional economic blocs are emerging and what the potential implications of regional economic integration are for globalization and economic welfare, this Paper reaches three fundamental conclusions:

- regional economic blocs, if measured by actual trade and investment patterns, are not as easily defined as is sometimes suggested by more visible concepts based on legal or policy arrangements;
- globalization and regionalization are not mutually exclusive concepts or polar opposites and regionalization does not necessarily imply net world welfare losses; and
- although there is evidence indicating the existence and possible emergence of powerful regional trading centres, rapid tri-polarization of the global economy is not yet evident to the extent that is popularly reported.

It is important to note that trade agreements do not imply trading blocs. It is possible to have a trading bloc without an agreement or to have an agreement without a bloc. Only economic factors determine economic blocs; by themselves, political and legal agreements are indicative only of political or legal integration. It is also important to understand that policy makers should not be concerned about the formation of economic blocs for any reasons other than their effects on welfare. For example, the trade effects of regionalization are important only because they affect welfare. Therefore, it should be understood that trading blocs, or other forms of economic regional integration are not, *de facto*, nefarious.

Regionalization and globalization are often thought of as being antitheses. However, they can be logical, mutual reactions to the same micro-economic stimuli. Regional integration agreements, like natural regionalization, need not be counter-productive to multilateral liberalization and, depending on the starting point, the welfare implications of such agreements might be positive even for countries outside

the region, when dynamic factors are taken into account. The narrow view that regionalization and globalization are pure substitutes is too simplified to be realistic in the context of the global economy.

Analysis of intra-regional trading relationships in this Paper leads to the conclusion that trading blocs, with the exception of Europe, are not yet prevalent in the global economy. Extra-regional trade is still an important part of international economic transactions. North America experienced an increase in regional trade integration between 1987 to 1993, but this change co-exists with a longer-term trend of declining integration. Although 1987 may be seen in the future as a turning point to increasingly regionally integrated trade patterns in North America, it is still too early to predict the efficacy of such observations. The North American data are, of course, dominated by the U.S., with Canada showing a much higher level of integration with the U.S. than vice versa. The data for Asia show a steady increase in intra-regional trade relative to total trade over the sample period 1960 to 1992, but Asia still engages heavily in extra-regional trade. Europe is the only region which exhibits strong characteristics of a trading bloc over time, with *both high and increasing* intra-regional trade shares.

Analysis of international direct investment data for the three regions indicates that, again, only Europe can be considered to display a definite intra-regional consolidation. Both the U.S. and Japan, although heavily involved in investing within their geographic regions, nevertheless have undertaken significant extra-regional direct investment. However, European investors have also made major commitments in North America. For example, the main holder of foreign direct investment stock in the U.S. is Europe, followed by Japan. Although there is evidence that intra-regional economic integration is occurring via cross-border direct investment, particularly for Europe, extra-regional integration is also being furthered through such investment.

Although it is a reality that the members of the triad possess unrivalled economic power, a country's (including Canada's) trade and investment policies should not be defensive, but should be determined by the tenets of economic efficiency and welfare maximization. Although the proximity to the economic powerhouse of the United States benefits Canada tremendously and our southern neighbour will remain a priority for policy makers, *exclusionary* regional policies should not be pursued. *Encouraging potential future trade and investment to and from different geographic areas based on their economic merits should remain the aim of competitive and liberal Canadian policies.* The benefits of regional integration must come from increased international competition, not protected markets. Otherwise, the potential benefits of integration, regional or global, will be undermined.

Moreover, the processes of globalization and regionalization involve competition not only among firms but also among *policy systems*. As the world economy becomes more integrated, Canada's policy systems, including macroeconomic and social policies, will need to be competitive and coherent in order to attract investment from increasingly "global" multinational corporations, including those currently based in Canada.

Finally, it should be noted that the idea of powerful economic blocs dominating a polarized world is not new. At this time, when the world is still dealing with the effects of the dissolution of one of the most insular trading blocs in modern history, the Soviet Union and the COMECON, it is important to remember that economic systems are not static. It was not long ago that the popular literature was examining the implications of a bi-polar world centred around the U.S. and the Soviet Union, with the USSR set to outshine the U.S.'s productive capacity. Although it might appear evident that tri-polarization is emerging today, as yet the trend is neither so robust nor so exceptional that the shape of the world economy fifty years hence can be predicted with certainty. Although tri-polarization might indeed be the way of the future, policies should remain flexible enough to respond to unforeseen changes.

Résumé

Certains voient la formation de blocs économiques régionaux comme une menace potentielle à la libéralisation multilatérale et aux nations commerçantes moins influentes comme le Canada. Toutefois, la polarisation croissante de l'économie mondiale autour de la « triade » États-Unis, Union européenne et Japon n'est peut-être pas aussi accentuée qu'on pourrait généralement le croire malgré la régionalisation accrue des politiques observée en Europe, et plus récemment, en Amérique du Nord. De plus, la régionalisation - même marquée - de l'économie mondiale ne menace pas nécessairement la mondialisation ou le multilatéralisme.

Après avoir examiné les questions de l'émergence de blocs économiques régionaux et des effets potentiels de l'intégration économique régionale, les auteurs du présent document tirent les trois grandes conclusions suivantes :

- les blocs régionaux, lorsque mesurés par les structures des échanges et des investissements réels, ne sont pas aussi facilement définissables qu'on le croit parfois par des concepts plus visibles basés sur des arrangements juridiques ou politiques;

- la mondialisation et la régionalisation ne sont pas des concepts qui s'excluent mutuellement ou qui se situent aux antipodes, et la régionalisation ne réduit pas nécessairement le niveau de vie réel au plan mondial;

- la tripolarisation rapide de l'économie mondiale n'est pas encore aussi évidente qu'on le croit généralement, malgré les signes montrant l'émergence possible de grands centres commerciaux régionaux.

Il est important de noter que les accords commerciaux n'impliquent pas nécessairement des blocs commerciaux. Il est possible d'avoir un bloc commercial sans accord commercial, et inversement. Seuls les facteurs économiques déterminent les blocs économiques; les accords politiques et juridiques ne révèlent à proprement dit qu'une intégration politique ou juridique. Il faut aussi comprendre que les responsables des politiques ne devraient pas s'inquiéter de la formation de blocs économiques, sauf pour leurs effets sur le niveau de vie. Par exemple, les effets commerciaux de la régionalisation ne sont importants que parce qu'ils affectent le bien-être. Il faut donc comprendre que les blocs commerciaux, ou d'autres formes d'intégration économique régionale, ne sont pas nécessairement néfastes.

La régionalisation et la mondialisation sont souvent vues comme des antithèses. Mais elles peuvent être des réactions logiques et concertées à des stimuli micro-économiques identiques. Les accords d'intégration régionale, comme le phénomène naturel de régionalisation, n'entravent pas nécessairement la libéralisation multilatérale. Selon leur genèse, ces accords peuvent avoir des effets positifs sur le bien-être, même dans des pays extra-régionaux, lorsque les facteurs dynamiques sont pris en compte. Le point de vue étroit voulant que la régionalisation et la mondialisation ne soient que des substituts est trop simpliste, et n'exprime pas la réalité de l'économie mondiale.

L'analyse des relations commerciales intra-régionales faite dans ce document mène à la conclusion que les blocs commerciaux, à l'exception de l'Europe, ne sont pas encore prédominants dans l'économie mondiale. Le commerce extra-régional est toujours une partie importante des opérations économiques internationales. L'Amérique du Nord a connu une intensification de l'intégration commerciale régionale entre 1987 et 1993, mais la tendance à plus long terme va en sens inverse. L'année 1987 sera peut-être considérée comme un point tournant de l'intégration croissante des structures des échanges commerciaux en Amérique du Nord, mais il est encore trop tôt pour prédire le bien-fondé de telles observations. Les données pour l'Amérique du Nord sont évidemment dominées par les États-Unis, le Canada montrant un bien plus fort degré d'intégration avec les États-Unis que ce n'est le cas des États-Unis avec le Canada. Les données pour l'Asie montrent un accroissement constant du commerce intra-régional par rapport au commerce global entre 1960 et 1992, mais l'Asie commerce encore beaucoup avec des pays extra-régionaux. L'Europe est la seule région qui a nettement les caractéristiques d'un bloc commercial en formation où les parts des échanges intra-régionaux, déjà *élevées*, ne cessent de *s'accroître*.

Une analyse des données sur les investissements étrangers directs pour les trois régions indique que seule l'Europe peut encore une fois être considérée comme montrant nettement les signes d'un regroupement intra-régional. Les États-Unis et le Japon, quoiqu'investissant massivement dans leurs régions respectives, ont réalisé d'importants investissements directs extra-régionaux. Toutefois, les investisseurs européens sont aussi fort actifs en Amérique du Nord. Aussi, ce sont les pays européens, suivis du Japon, qui détiennent la plus large part des investissements étrangers directs aux États-Unis. Il semble qu'une intégration économique intra-régionale soit en train d'être réalisée par le biais de l'investissement direct transfrontières; mais, surtout dans le cas de l'Europe, ce type d'investissement favorise aussi une intégration extra-régionale.

Il est vrai que les membres de la triade détiennent une puissance économique inégalée; mais les politiques commerciales et financières d'un pays (comme le Canada) ne devraient pas être de nature défensive, mais plutôt être déterminées par les impératifs de l'efficience économique et de l'optimisation du bien-être. Notre proximité du géant économique américain nous avantage énormément et notre voisin du sud continuera d'occuper une place prioritaire dans nos politiques, mais nous ne devrions pas poursuivre de politiques régionales *exclusives*. *L'encouragement des possibilités d'échanges commerciaux et d'investissements éventuels avec différentes régions sur la base de leurs avantages économiques devrait rester le grand objectif de politiques canadiennes favorisant la compétitivité et l'ouverture*. Les avantages de l'intégration régionale doivent provenir d'une concurrence internationale accrue, et non de marchés protégés. Autrement, les avantages potentiels de l'intégration — régionale ou mondiale — seront minés.

De plus, les processus de mondialisation et de régionalisation supposent une concurrence non seulement entre firmes, mais aussi entre *régimes de politiques*. Étant donné l'intégration croissante de l'économie mondiale, les régimes de politiques du Canada, y compris les politiques macro-économiques et sociales, devront être concurrentiels et cohérents pour attirer les investissements de sociétés multinationales de plus en plus « mondiales », dont celles déjà établies au Canada.

Enfin, il faut noter que l'idée de puissants blocs économiques dominant un monde polarisé n'a rien de nouveau. Alors même que la communauté mondiale est encore aux prises avec les effets de la dissolution de l'Union soviétique et du

Comecon -- l'un des blocs commerciaux les plus insulaires de l'histoire moderne --, il est important de se rappeler que les systèmes économiques ne sont pas statiques. Il n'y a pas si longtemps, la littérature populaire examinait les incidences d'un monde bipolaire centré autour des États-Unis et de l'Union soviétique, en prédisant que l'URSS dépasserait la capacité de production des États-Unis. Il pourrait sembler évident qu'une tripolarisation est en train d'émerger, mais la tendance n'est encore ni assez marquée ni assez exceptionnelle pour permettre de prédire avec certitude la forme qu'aura l'économie mondiale dans cinquante ans. Il est possible que la tripolarisation soit la voie de l'avenir, mais les politiques devraient maintenir suffisamment de souplesse pour permettre l'adaptation aux changements imprévus.

1. Introduction

The formation of regional economic blocs is seen by some as a potential threat to multilateral liberalization and to smaller trading nations, such as Canada. Increasing tri-polarization of global economic relationships around a triad composed of the United States, Japan and the European Union is accepted as conventional wisdom and much concern has been raised over regionalization outpacing globalization as the pervasive global economic force.[1] But, to what extent is the world economy really becoming tri-polarized?

There are many potential indictors of regional economic integration, two of which are examined in this Paper: trade and direct investment. Trade is the primary measure of regionalization used in this Paper for several reasons. Trade is an important measure of international economic success and competitiveness and changes in trade flows can have direct effects on global economic welfare. Since trade is an important part of international economic transactions, the formation of trading blocs is an important part of regionalization of global economic activity. Although answering the question of whether regional trading blocs are forming around the triad does not answer the broader question of whether tri-polarization of the world economy is indeed occurring, it does go part way towards providing an answer and is an indicator of the strength of regionalization as a whole.

Trade data are more reliable, comparable and available than international investment data. Conclusions based on data pertaining to intra-regional investment require particular caution. The effects of international direct investment on both domestic employment and trade in both the home and host country are not well understood and are highly industry and case specific. Therefore, the welfare implications of trade regionalization are better understood and have been studied more closely than those of regionalized international direct investment, and it is these welfare effects which are the crux of whether regionalization should be a concern to policy makers. Since some welfare effects of international direct investment filter through trade, investigating trade patterns captures some of the effects of international investment.

[1]For example, S. Ostry, *Governments and Corporations in a Shrinking World*, 1990, outlines the popular concerns about regionalism and regional trading blocs, and C. McMillan, "Globalization: Multilateral vs. Regional Approaches to Trade Policy", in *Business and the Contemporary World,* Vol. VI., No. 3, 1994, is an example of the view that multilateralism is under threat from the increasingly powerful triad.

The negative connotation associated with regional trading blocs does not seem as prevalent for regional investment blocs. The main concern is that of smaller countries being "frozen out" of foreign direct investment because of regional free trade agreements. For example, multinational enterprises may choose to invest in any country within a free trade area, such as the NAFTA, and service all the economies in the region from that one location. This could be seen either as a boon to a country within the region, if it is chosen as the location, or as a detriment if it is not. In any case, foreign direct investment seems to be considered almost universally desirable, and considerable effort is undertaken to attract it. The concern with regionalized international investment centres around competition among countries for its finite supply and how regional economic agreements affect locational decisions by investors.

The purpose of this Paper is to determine whether economic blocs, measured in terms of actual trade and investment patterns, are emerging or growing. It should be noted that the definition of a "bloc" is not identical to that of a regional integration agreement, since regional trade agreements can exist among countries which do not engage in high levels of intra-regional trade. For example, North America should not be assumed to be a regional trading bloc as soon as NAFTA was signed; if it was not a bloc, in practice, the day before NAFTA was ratified, it would not be considered a bloc the day after. The only indicator of the existence of a regional trading bloc is intra-regional trade. The economic, not the legal or policy-oriented, indicators are those used in this Paper to determine whether international economic relationships are becoming more regionalized.

This Paper investigates the formation of regional economic blocs and regionalization in the following sections. The first deals with general economic concepts such globalization and regionalization and seeks to find an adequate working definition of trading blocs, as separate from the theoretical or legal definitions of customs unions or free trade areas, etc.. In the next section, a survey familiarizes the reader with current ideas in the literature. Various concepts of "blocs" are examined using the different methodologies in the works reviewed. This review highlights the complexity of the investigation and the requirement of choosing the appropriate indicators to measure the existence of a specific definition of trading blocs. Then, an empirical study of intra-regional trade in the three regions of North America, Europe and Asia is undertaken. This study attempts to determine whether regional trading blocs are emerging or growing in these three areas, using a methodology specific to testing for the definition of trading blocs settled upon in this Paper. A study of international direct investment patterns, similar to that of international trade patterns, is undertaken next to determine whether there are increasingly regional patterns in international investment. In the last section, general conclusions and policy implications are derived from the empirical evidence regarding trade and investment patterns and the findings revealed in the literature survey.

2. A Conceptual Framework

2.1 What is a trading bloc?

Although such international economic relationships as free trade areas, customs unions, common markets and economic unions are well-defined theoretically, the definition of a trading bloc is substantially more difficult to pin down. There are clear criteria that must be met in order for a group of countries to be considered part of a customs union or free-trade area, etc.. Many of these criteria are legal and policy-oriented. For example, for a free trade area, barriers to substantially all trade among members are removed, but each nation retains its own barriers to trade with non-members (the EFTA, for example). A customs union removes all barriers to trade among members and harmonises trade policies toward the rest of the world (the old EEC, for example). Although these definitions are oversimplified and theoretical, i.e., all barriers to trade among non-members might not be removed and there can be lengthy lists of exceptions and non-traditional barriers, there are at least definitional criteria with which to judge whether a group of countries more closely resembles a free trade area or a customs union.

A trading bloc, however, is not defined by policy positions or legal arrangements. The U.S.-Israel free trade agreement is a good example of a politically motivated, legal arrangement which does not constitute the formation of a bloc. The term "bloc" has been used loosely to refer to anything from a free trade area to complete economic and monetary union. A bloc implies a certain amount of exclusion of non-members that can either be a natural fallout of informal bloc formation or the result of more formal agreements. For example, the OECD differentiates between trading "blocs" and trading "centres" in the following way:

> Strong trade growth in the regions which are home to the three largest traders - the European Community, the United States and Japan - in combination with important and dynamic inter-regional trade flows among the three, suggest a situation not of evolving trade blocs, with

> the inward orientation which the term "bloc" connotes, but of evolving trade centres with world-wide commercial interests.[2]

Membership in a bloc does not imply that there is a either a formal or informal agreement, strategy or policy that includes some countries and excludes others; membership in a bloc can result from such uncontrollable factors as geographic proximity, natural transportation linkages, cultural biases, etc.. Blocs are not necessarily nefarious.

In the absence of a clear, accepted economic definition, this Paper broadly defines a trading bloc as a relationship within which a certain percentage of member countries' trade is with each other. This percentage is arbitrary, but relatively high. An emerging trading bloc would imply that member countries' trade with each other is increasing relative to their trade with the rest of the world. Increasing absolute levels of trade among the member countries do not indicate the emergence of a bloc if trade with the rest of the world is also increasing. It is the *share* in total trade that must be considered.

Blocs only emerge when economic interactions cross national boundaries within one geographic region and intra-regional international trade shares are high. This leads to the question of what differentiates the definition of a country from the definition of a bloc. Since the formation of national borders is political and arbitrary by nature, the definition of trading blocs is arbitrary as well. An economic and trade union, i.e, unification or harmonization of trade, fiscal and monetary policies, is automatically achieved within countries when they form. Therefore, the formation of blocs is somewhat of an artificial concept and concern since it deals only with trade between, and not within, nation-states and the welfare implications of only this type of regionalization of trade. When, or if, Europe becomes a complete economic union with unified monetary and fiscal policies, it will take on the economic appearance of being one country. The international community does not consider the threat of the U.S. (a confederation of somewhat independent states) being a large trading bloc in and of itself, with the same concerns the formation of a European trading bloc raises.

Nonetheless, the concern about emerging trading blocs is valid because there are potential negative welfare effects flowing from the development of a tri-polar economy centred around the U.S., Japan and Europe. However, the implications of limiting trade are not confined to a reduction in extra-regional international interactions

[2]N. Plessz, *The Economic Effects of Regional Integration*, OECD, TD/TC(93)15/ANN6, February 1994, pp.3-4.

by this triad. Any country which closes itself off from trade affects the efficiency of the *world* trading system and economic welfare. The U.S., as a large, powerful and relatively self-sufficient nation, is a good example of a country whose lone actions have formidable balance of payments and welfare implications for the rest of the world.

Although some authors maintain that all other variables, such as geographic proximity, cultural ties, etc., must be controlled for when testing for a regional bias, this Paper does not discriminate among these effects.[3] It is not concerned with the causes of regionalization as a factor separate from regional economic growth which spurs intra-regional trade, but only with the extent of the intra-regional trade and *de facto* bloc formation. Indeed, isolating and quantifying the causes is difficult, requires many assumptions, and yields only weak conclusions. This Paper is concerned only with whether regional economic blocs, measured by trade and investment flows, are emerging, strengthening or weakening, and the implications for Canada.

2.2 Regionalization and trading blocs

Regionalization is often considered to be the opposite of globalization and counter-productive to it. In this light, trading blocs, as part of the phenomenon of regionalization, were deemed to be detrimental to globalization and a result of regional bias overriding global efficiency. The emergence of trading blocs was thought to be linked to a weakening of the multilateral system, and part of an entrenchment of a tri-polar power structure that would become increasingly centred around the U.S., Japan and Europe, to the detriment of smaller, weaker nations. However, regionalization and globalization need not be antitheses; they can be parallel reactions to the same economic stimuli. Regionalization could even be the logical result of increased globalization, not a defensive reaction against it.

When investigating regionalization, it is important to recognize that it is not always, nor must it necessarily be, a political or legal phenomenon. There is a difference between a *de jure* process driven by political forces and a natural, *de facto*,

[3]Regional bias is the effect of regional economic agreements or other regionalism not explained by economic factors. If regional bias exists, then countries within the region will trade and invest more with each other than can be explained by such economic factors as comparative advantage, growth rates and geographic proximity. Since changes in intra-regional trade and investment shares capture all these economic effects, they are not a measure of regional bias.

economic phenomenon driven by the same microeconomic forces which drive globalization.[4]

As a *de jure* phenomenon, regionalization can be implemented though different methods, such as preferential trade agreements, customs unions and deeper economic integration leading up to, and including, the formation of a single country.[5] As a *de facto* process, regionalization is driven by economic forces such as international competitiveness and cost minimization. Like *de jure* regionalization, *de facto* regionalization can strengthen the region's growth, and stimulate extra-regional trade and investment as well as intra-regional trade and investment.

De facto economic integration can either precede *de jure* integration, result from *de jure* integration or be maintained independently of *de jure* regional integration. The Canada-U.S. free trade agreement is one example of considerable *de facto* integration preceding *de jure* integration, at least from the Canadian perspective. The history of the early EEC furnishes an example of a *de jure* regional agreement facilitating considerable *de facto* integration.[6] Economic integration, however, need not be related to *de jure* measures and *de jure* agreements are not needed in order for trading blocs to develop. For example, it was the private sector that led economic integration in the Asia-Pacific where there continues to be a lack of *de jure* regional ties, despite considerable *de facto* integration. However, it is likely that, in future, *de facto* integration will increasingly lead to formal *de jure* relationships, because of the need for stability in the international economic environment in which multinational firms increasingly operate and invest.

From a game theory perspective, there are two very distinct views on whether trading blocs reinforce or deter trade liberalization in general. Some theorists argue that a smaller number of players, i.e., three regional blocs, would make cooperative solutions easier to reach compared to negotiations that included over 100 countries as parties to the GATT/WTO. This is the "building block" hypothesis. The opposite view is that the ability of powerful players within blocs to benefit if inter-bloc bargaining fails, makes cooperative solutions less likely. This is the "stumbling block" hypothesis. It is worth noting that the trade data do not substantiate the fears of

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[4]C. Oman, *Globalisation and Regionalisation: The Challenge for Developing Countries*, OECD, 1994, p. 16.

[5]The pursuit of this type of *de jure* regionalization can be called regionalism.

[6]Oman, *op. cit.*, p. 67.

powerful, "warring" trading blocs. The growth of inter-regional trade over the last decade has been about as strong as intra-regional trade and there is considerable argument that, in any case, the formation of "natural" or *de facto* trading blocs is not likely to have detrimental effects on global trade.[7]

2.3 Why are we concerned with blocs?

There is a concern among policy makers and economists that the regionalization of trading relations could pose a threat to multilateral liberalization. This concern has become more prevalent following such events as the EU's pursuit of the Single Market, the Canada-U.S. FTA and the NAFTA. The main concern focuses on the erosion of the principle of non-discrimination and the danger of trade wars between the blocs in which smaller, less powerful trading nations, would be adversely affected.[8] Most of these concerns are underpinned by concerns for economic welfare and efficiency.

Obviously, if regionalism and regionalization were considered to be pareto superior to multilateral free trade and globalization, there would be no concern over their welfare effects.[9] The fact that multilateralism is believed to be the most efficient and beneficial route to follow in negotiating international trade rules leads to the concern over increasingly powerful blocs that would divide the world into three separate spheres of influence, diminishing world welfare and economic efficiency. This might not, however, be the case. There is a significant body of work that indicates that regional agreements might be complementary to multilateral agreements.[10] They might act as "test beds" which go further and faster in liberalizing than multilateral agreements could have. These agreements can then pave the way for further multilateral liberalization. Even if regional agreements are thought to substitute for multilateral agreements, and therefore to be counter-productive to broad liberalization, if there is little hope of achieving a multilateral agreement as

[7] *Ibid.,* p. 28.

[8] P. Lloyd, "Regionalisation and World Trade", *OECD Economic Studies,* No. 18, Spring 1992, p. 8.

[9] If regionalization were accepted to be pareto superior to multilateralism and globalization, this would imply that it was the welfare-enhancing economic arrangement. An economic arrangement is considered pareto superior if at least one agent is made better off, and no agent is made worse off, by it. Every agent must be at least as well off as before the arrangement.

[10] For example, Lawrence, *op. cit.*, Lloyd, *op. cit.* and Oman, *op. cit.*

broadly liberalizing as the regional agreement then there is no real harmful substitutive effect.[11]

- Trade Creation and Trade Diversion: A More Complicated Story With Global Firms and Economies of Scale[12]

Theoretically, the welfare effects of regional economic arrangements that could lead to the formation of trading blocs are negative if they are more trade diverting than trade creating. If the existence of these blocs hinders multilateral trade barrier reduction, the welfare effects would be different than if their effect were complementary or neutral. Historically, it was thought that, since free trade led to the most efficient utilization of resources and maximized world output and welfare, then any movement towards free trade must also increase welfare. Seminal work by Viner (1950) brought to light the possibility of negative welfare effects due to trade diversion of regional integration agreements (more specifically, customs unions).[13] Today, Viner's conclusions are considered logical but limited, and the trade diversion versus trade creation argument has been found to be too simplistic to reflect real world situations accurately. However, to explain the limitations of the theory and eventually the empirical evidence, one must first understand the basic ideas behind trade-creating and trade-diverting customs unions.

First, it is important to note that only *static, partial equilibrium* effects are measured by analyzing trade creation and trade diversion.[14] This is an important limitation. Trade creation occurs when a nation that is a member of a regional trade agreement (RTA) replaces some of its domestic production with *lower cost* imports from another member country. This occurs usually because the lower cost imports had been subject to a tariff or other trade barriers prior to the implementation of the RTA. Trade creation leads to a greater specialization based on comparative advantages, greater economic efficiency and welfare gains for member countries. This kind of trade-creation also benefits non-member countries since it increases the real income of the members which increases their demand for imports from the rest of the world.

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[11]Lloyd, *op. cit.,* p. 8.

[12]The following two sub-sections draw heavily on D. Salvatore, *International Economics,* 1983.

[13]J. Viner, *The Customs Union Issue,* 1950.

[14]Salvatore, *op. cit.*, p. 234.

Trade diversion occurs when lower cost imports from non-members of a regional trade agreement are replaced by higher cost imports from a member economy. This occurs because the elimination of a tariff within the RTA lowers the cost of importing products from member economies below the cost of importing from the source outside the union which is still subject to tariffs. Trade diversion has a negative impact on welfare because it shifts production from a more efficient, lower cost producer outside the union to a less efficient producer inside the union.

Thus, a customs union can result in trade creation and trade diversion, and the net world welfare effect depends upon the relative weights of these two effects. The welfare of non-member economies will unambiguously decline if trade resulting from efficient production has been diverted away from them. So, although welfare may increase in the union, it might decrease in the rest of the world and only the relative magnitudes of these two effects will determine whether there is net welfare loss or gain.

Whether the trade diverting or creating effect dominates depends on many factors. Generally, trade creation and increased welfare is more likely to dominate the higher the preunion trade barriers, the lower the union's barriers with the rest of the world, the greater the number of and larger the size of countries forming the union, the more competitive (rather than complementary) the countries, the closer the countries are geographically, and the greater the preunion trade and economic relationship among potential members. In theory, the European Economic Community was an ideal candidate to be a trade creating, rather than trade diverting, customs union because the original member countries fulfilled almost all the above criteria. The case is less clear when applying the theoretical criteria to the NAFTA, since, for example, Mexico is more of a complementary country of a smaller size and the number of member countries is small.

- The Dynamic Benefits

As stated earlier, trade diversion and trade creation are only static, partial equilibrium effects. Important dynamic effects can also result from RTAs. These include increased competition, the exploitation of economies of scale, stimulus to investment and the more efficient utilization of economic resources[15].

The reduction in trade barriers between member economies can increase competition in industries that may have grown "fat" or non-competitive behind the

[15] *Ibid.*, p. 240.

wall of trade barriers.[16] The exploitation of economies of scale is also made more possible within a union, if the markets of the member countries are individually too small to allow optimum firm size to be achieved. Although these economies could have been achieved by export before the union was formed, the reduction in intra-regional import protection makes this easier. Also, direct investment in other member countries allows economies of experience to be realized in subsidiaries and facilitates technological spillovers. Non-member countries may wish to invest within the union, either to circumvent tariffs or to take advantage of the newly expanded market and increasing returns as welfare increases within the union. The free flow of capital and labour within a union also leads to greater efficiency in the allocation of resources and smooths the difficulties of structural adjustment.

Globalization, led by increased foreign direct investment, might also have implications for the trade diversion effects of RTAs. Trade creation within the union could benefit third-country firms with production facilities in the region and trade diversion could harm member country firms with production facilities in third countries which are exporting to the region.[17] Therefore, globalization can complicate the welfare implications of RTAs. Also, the measurement of trade diversion and creation becomes more difficult in the presence of decreasing costs as trade liberalization causes changes in the production of all affected countries.

Today, it is generally believed that trade diversion and trade creation are simply examples of types of broader terms of trade and volume of trade effects which can be brought about by RTAs. The traditional concept of trade diversion focused exclusively on the importing member country and missed potential welfare gains to other members and third countries. Some of the positive effects that might outweigh trade diversion include changes in the volume of production and income, changes in the terms of trade with the rest of the world and changes in the volume of trade with members and non-members.[18] For example, the value of imports from a non-member country to a member country of an RTA might not fall even if trade diversion predominates, because increased income within the member countries can lead to an increased demand for imports, some of which could be supplied by non-member countries.

[16]One potential problem is that oligopolies or monopolies could form within the union just as they did within the member countries, allowing similar non-competitive practices and excessive profits.

[17]Lloyd, *op. cit.*, p. 24,

[18]*Ibid.*, p.24.

In summary, we care about growing regionalization not because of trade effects, specifically, but because of the welfare effects they represent.[19] Generally, new theories and econometric techniques, though unreliable and dependent upon some unrealistic assumptions, have shifted the emphasis away from the trade diversion and terms of trade effects to the longer-run dynamic trade liberalization and real income effects. In this light, it becomes more likely that regionalization can be welfare increasing for the world as a whole and need not be counterproductive to global integration.

3. Some Evidence from the Literature

3.1 Introductory note

Studies which examine the phenomenon of blocs, both trade and investment, are surprisingly varied in focus, scope and hypotheses. Some econometric studies attempt to isolate the impact of regional bias separate from other economic factors, such as geographic proximity and relative growth rates of member economies . Some studies on the EU use different means to try to compensate for country accessions. Other studies examine raw data to track broad trends over time. These variations in methodology and focus lead to problems with comparing the conclusions of different

[19]It is difficult to measure accurately the welfare gains to member economies of a RTA. Plessz (1993) cites that Balassa (1967) estimated that the total net effect for the EEC was less then 0.1 per cent per annum of EEC GDP. Incorporating economies of scale in manufacturing industries, but still using essentially partial equilibrium analysis, Owens (1983) obtained much larger benefits, cumulatively totalling 3 to 6 per cent of the GDP of the EC-6. Plessz also cites other studies of the welfare effects of RTAs, finding that the common feature is that the welfare gains are quite small, even if the trade effects appear relatively important. This phenomenon can be attributable to the lack of realism of the assumptions of perfect competition and constant returns to scale of most of the models. More recently, computable general equilibrium (CGE) models which incorporate non-competitive market structures and scale economies, have estimated welfare gains for Canada involving Canada-U.S. integration that were 2-3 times higher than those obtained under perfect competition. These scenarios, however, are still considered to be unreliable. (N. Plessz, *op. cit.,* p.7.)

The popularity of imperfectly competitive models rests on the fact that they generate larger welfare gains, especially for smaller economies where competition is weak. The quantitative results, however, are very sensitive to specification of the models. "Consequently, they should be regarded as inductive thought experiments rather than reliable predictions but they have changed the perception of the benefits and costs of RTAs." (Lloyd, *op. cit.* pp. 26-7) Therefore, it is difficult to measure what welfare gains result from regional integration, even in the first order, and to determine who gains and who loses, if anyone, indirectly.

studies. However, a broad consensus seems to have emerged, even from studies undertaken for vastly different reasons.

Most work concludes that, although there may be a degree of tri-polarization, this does not mean that globalization has met its demise in the face of regionalization. The two phenomena are increasingly seen as being compatible. Extra-regional trade is still an important portion of trade and GDP for the triad. It is argued that it would be highly costly from an economic and welfare standpoint, for any country, or, more importantly, group of countries, to close itself off from outside trade and investment.

The findings of some major studies on regional trade and investment relationships are reviewed below. Although this is by no means an exhaustive survey, it is meant to be representative of the state of the literature to date, and to familiarize the reader with the many different approaches to defining and measuring regional relationships.

3.2 Some studies

- *Regionalisation and World Trade*[20]

In this comprehensive empirical study, Lloyd states that there are two distinct versions of the claim that world trade has become more regionalized. One is related to trade within Regional Trade Arrangements (RTAs) and the other to trade within more broadly defined regions such as Europe or the Pacific Rim. Lloyd examines the import trends in four OECD RTAs (EC, EFTA, Canada-U.S. and Australia-New Zealand).[21] The time period examined is 1961-89, covering almost 30 years of uninterrupted expansion in world trade and following the formation of the EEC and EFTA.

Lloyd measures regionalization by examining the share of intra-group imports in total group imports. In the presence of multilateral and unilateral changes in trade restrictions over the period, this measure captures the combined effects of unilateral, regional and multilateral policy changes. It also captures the effects of differences in the growth rates of countries on import demand and export supply, the effects of major price changes and changes in national preferences and technologies. An

[20]This section examines P. Lloyd, *op. cit.*.

[21]Although the Canada-U.S. FTA only entered into effect in 1989, Lloyd includes it as a single observation. The efficacy of his conclusions are not adversely affected.

increase in the intra-group share is, therefore, weak evidence of the isolated effects of RTAs on trade patterns.

Overall, Lloyd finds that the time series provided only very weak support of the hypothesis that RTA intra-group preferences increase the share of imports for traded commodities, once allowance is made for extensions of membership in the RTAs. One notable exception was agricultural products, an observation related to the EC/EU's Common Agricultural Policy. He finds that there is weak support for the broad hypothesis, mainly in the early years following the formation of the RTAs, but this trend did not continue into the 1980s.[22]

The contradiction between the expected increase in intra-group import shares and the observed trends that only weakly support such a hypothesis is explained by Lloyd to be related to the counteracting influence of multilateral and unilateral reductions in trade barriers over the time period. This non-regional liberalization may have had greater effects than commonly believed. Lloyd also attributes the discrepancy to a tendency to exaggerate the restrictiveness of non-tariff measures which apply exclusively or predominantly to third countries.

Multilateralism vs. Regionalism

Lloyd explores the theoretical reasons why multilateralism and regionalism could be either mutually beneficial or detrimental. He tests the hypothesis that the world is becoming more polarized around Europe, North America and Asia, in terms of trade flows. Although evidence of rising intra-area import shares, especially for Asia, is found, other factors are considered to override such evidence and Lloyd concludes that "there is no clear polarization of the world economy".[23] The dissolution of the Sterling Area, the system of British Imperial Preferences and the COMECON are cited as examples of the fluid and more dynamic nature of evolving and changing regional power centres.

Lloyd's general conclusion is that, despite a widespread perception of growing regional bias in trade, the empirical evidence does not support this view. Lloyd also concludes that regionalism need not be counter-productive to multilateralism, in any case. Although there is some evidence from game theory that powerful blocs can win trade wars at the expense of smaller countries, regional agreements can also provide

[22] *Ibid.*, p.22.

[23] *Ibid.*, p. 33.

an impetus or example for multilateral agreements. Although Lloyd recognizes that the intra-regional share of total world imports for Europe and Asia is increasing, indicating tri-polarization of trade, he states that the collapse of other, formerly powerful trading centres should put current developments in the context of a constantly evolving trade environment. There is, however, a more serious threat of increasing regionalism in the future, according to Lloyd, since the U.S. in particular has abandoned its historical opposition to new discriminatory arrangements.

- *The Economic Effects of Regional Integration*[24]

In this 1993 study for the OECD, Plessz finds that there is no fundamental inconsistency between globalization and regionalization, and that regionalization is the consequence of geographical closeness, cultural similarities, political affinities, traditional economic links and other factors that are taken into account in the strategies of multinational companies.[25] Regionalization, therefore, can go hand-in-hand with globalization. To support this argument, Plessz quotes the GATT Secretariat (1990) which found that:

> If the Middle East and Africa are excluded from the calculation (due to such factors as depressed oil prices and debt), inter-regional trade expanded faster than intra-regional trade in each of the three regions. Strong trade growth in the regions which are home to the three largest traders - the European Communities, the United States and Japan - in combination with important and dynamic inter-regional trade flows among the three, suggest a situation not of evolving trade blocs, with the inward orientation which the term "bloc" connotes, but of evolving trade centres with world wide commercial interests.[26]

It is suggested that world integration has continued at a good pace, along with, and perhaps (but not necessarily) despite, regional integration.

Plessz cites several studies that cast doubts on the strength and pace of regional integration. European regional integration has occurred since the establishment of the EC and the share of intra-EC trade has significantly increased

[24]This section outlines N. Plessz, *op. cit.*.

[25]*Ibid.*, p. 3.

[26]*Ibid.*, pp. 3-4.

since 1958. Although the evidence suggests a strong effect of EC integration, one important contributing factor was the numerous extensions of EC membership which would naturally expand intra-area shares. In fact, Plessz finds that, despite rising intra-regional trade shares, in recent decades all regions (Europe, North America and Asia) traded a rising proportion of their GDP with the rest of the world, indicating the progress of world integration.[27]

Plessz also examines the results of an econometric "gravity" model. In this model, the volume of trade between any pair of major countries is proportional to their economic size and inversely proportional to the distance separating them. Membership in the same regional group is also assumed to have a potential incidence. The most interesting finding is that, of the major regions, only East Asia produces a statistically significant positive coefficient for the period studied. This means that, despite the absence of formal integration agreements, only the intensity of trade relations between countries of East Asia needs some kind of regional bias explanation, other than those outlined in the model. For the EC, U.S.-Canada and U.S.-Mexico, regional bias proved to be insignificant.

- *European Integration or World Integration*[28]

In this 1988 study, Jaquemin and Sapir examine European integration and address the question of whether European integration or world integration is the prevalent force in the EC. They split the sample period into an early period (1960-1968) and a later period (1970-1984). By examining apparent consumption of manufactures for the four largest EC member economies (Germany, France, Italy and the UK) between 1973 and 1984, they conclude that European countries' apparent consumption out of domestically produced goods was decreasing over that period. They also conclude that, although intra-community imports did rise over the period examined, so too did extra-community imports.[29] However, in the period 1960-1968, the increase in the share of intra-Community imports outpaced the increase in the share of extra-community imports during the early years of economic

[27]*Ibid.*, p. 4.

[28]This section follows A. Jacquemin and A. Sapir, "European Integration or World Integration", *Weltwirtchaftliches Archiv*, No. 124, 1988, pp. 127-39.

[29]Apparent consumption is defined by Jacquemin and Sapir as domestic production net of exports plus intra-Community imports plus extra-Community imports.

integration.[30] The reversal of the increase in intra-area trade, which takes place in the second period, underlines the continued importance of international integration; after the initial shock of regional integration and further accession into the Community by other nations is taken into account, the world integration process is seen to have dominated. Throughout both periods, the share of domestic production in apparent consumption decreased. World integration did not cease as a result of membership in the EC, but (presumedly inefficient) domestic producers suffered. There was found to be external as well as internal trade creation, consistent with the dynamic effects of regional liberalization.

In a related empirical study, Jacquemin and Sapir examine the trend of intra-European integration for the years 1973 and 1983.[31] Although they admit that the data available were thin and sometimes inconsistent, they come to the conclusion that "the EC countries are becoming increasingly involved in a process of world-wide division of labour at the expense of European integration...".[32] This is consistent with their work cited above on regional trade integration.

- *European Economy: The European Community as a World Trade Partner* [33]

A section of the European Commission's yearly publication, *European Economy*, (1993) examines regional integration and trade in the European Community.[34] An important conclusion of the work is that the intra-regional trade share of total trade for the EC has increased significantly since 1958. Although the evidence suggested a strong effect of EC integration, other factors, such as competitiveness and the many extensions of EC membership, were found to have played an important part in this integration. For example, the UK's accession in 1973 significantly increased the intra-area import share between 1973 and 1983.[35]

[30] Jacquemin and Sapir, *op. cit.*, p. 131.

[31] A. Jacquemin and A. Sapir, "International Trade and Integration of the European Community: An Econometric Analysis", *European Economic Review*, No. 32, (1988), pp. 1439-49.

[32] *Ibid.*, p.1448.

[33] Examined here is the Commission of the European Communities, *European Economy: The European Community as a World Trade Partner*, No. 52, 1993.

[34] *Ibid.*, pp. 21-25.

[35] *Ibid.*, p. 24.

The conclusion reached concerning the effects of regional integration on world trade is that the evidence strongly suggests that the process of EC integration was beneficial to both the Community and its trading partners, i.e., it was trade creating. This was a result of substantial multilateral trade liberalization which might not have occurred without the emergence of the EC.[36] However, half the share of extra-EC trade is accounted for by trade with regional partners, the EFTA, Eastern Europe and southern neighbours.

- *Is Japan Creating a Yen Bloc in East Asia and the Pacific?* [37]

This study by Jeffrey Frankel addresses the question of whether a yen bloc is forming in Pacific Asia by examining trade and financial relationships. The author notes that the rapid outward-oriented growth of Japan, followed by the Asian NICs and some of the other ASEAN countries, is a remarkable trend in the world economy. But he states that when one asks whether a yen bloc is forming in East Asia, one is presumably asking something more than whether trade and financial flows among these countries are increasing in absolute terms. The share of intra-regional trade and finance must be higher, or increasing more rapidly, than would be predicted based only on such factors as the GDP or growth rates of the countries involved.

Frankel finds that most claims that an Asian trading bloc is forming are based on somewhat misleading figures. For example, he reports that the share of intra-regional trade for East Asia has increased from 33 per cent in 1980 to 37 per cent in 1989, and that this could be seen as an indication of a growing trading bloc. However, Frankel points out that the share of intra-regional trade in East Asia has not been increasing appreciably faster than that in North America, and has been increasing more slowly than that in Europe. So Frankel concludes that Asia, even though its output is growing at a pace outstripping both North America and Europe, is not becoming a bloc more rapidly.

In a more substantial examination of the statistics, Frankel finds that, if one allows for the rapid growth of East Asian economies in the 1980s, then it is likely that there has been no movement toward intra-regional bias. The author demonstrates that, even if there were no intra-regional trade bias, the observed intra-regional trade

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[36]Agriculture, however, was found to be the notable exception.

[37]This section derives from J. Frankel, *Is Japan Creating a Yen Bloc in East Asia and the Pacific?*, (preliminary draft November 1991) and J. Frankel, "Is a Yen Bloc Forming in Pacific Asia?" in *Finance and the International Economy: The AMEX Bank Review Prize Essays,* 1991.

would increase due only to the greater weight of the Asian countries in the world economy because of their greater than average economic growth.[38] Using a "gravity" model to determine the significance of regional bias in trading relations, separate from other factors such as geographic proximity and economic growth, Frankel finds that at least some of the Asian countries' trade with each other is not explained by these economic factors. However, changes in the coefficient between the years in the sample were not found to be significant and no overall trend of rising regional bias was found.[39]

In summary, the general conclusion of the study is that "beyond the evident facts that countries near each other trade with each other, and that Japan and other Asian countries are growing rapidly, there is no evidence that Japan is concentrating its trade with other Asian countries in any special way nor that they are moving toward a trade bloc as rapidly (or as deliberately) as in Western Europe."[40]

[38]For example, consider that there is no intra-regional bias in 1980, i.e., that each East Asian country conducted trade with other East Asian countries in the same proportion as the latter's weight in world trade (e.g.,15 per cent). Total trade by Asian countries increased by 108 per cent in dollar terms over 1980 to 1989, while total world-wide trade increased only 53 per cent. Therefore, even if there continued to be no regional bias in 1989, the observed intra-regional share would have increased by one third (to about 20 percent) due only to the greater weight of the Asian countries in the world economy. Frankel goes further to state that the "clubbishness" that might be indicative of a trading bloc for East Asia does not exist. If it is assumed that a regional bias term explains the difference between the actual share of intra-regional trade in 1980, 33 per cent, and the share that would occur if East Asian countries traded with other countries in the same proportion as their weight in world trade (15 per cent), this term would be 2.18 (.33/.15). If this regional bias term were unchanged in 1989 and multiplied by the East Asians' 1989 weight in world trade, the prediction would be that the intra-regional trade share would be 44 per cent in 1989. Instead, it is only 37 percent. Frankel indicates that the implicit intra-regional bias actually fell during the 1980s; it did not rise as a cursory examination of the numbers would lead one to believe.

[39]Frankel found that the coefficient of the dummy for European Community regional integration was also significant, with a higher result for membership in the EEC rather than for just being a country located in Europe. The North American regional integration coefficient was found to be insignificant, and had a very high standard error, which is attributable to the small sample size of three.

[40]On the financial side, Frankel found that there was only weak evidence of a special role for Tokyo as a financial centre exerting influence in its part of the world. New York was found to have a dominant effect for Hong Kong and Singapore, for example. These results, however, were influenced by the fact that during the sample period most Asian countries had not yet opened their financial markets to external influence by any foreign centre.

- *Globalization and Regionalization in the Asia-Pacific Region*[41]

In this 1993 study, Urata investigates the effects and causes of regionalization in the Asia-Pacific region. Urata examines the difference between intra-regional trade and inter-regional trade for the triad of East Asia, North America and the EC. The author finds that, although intra-regional trade for the three regions did increase between 1980 and 1990, so too did inter-regional trade among the three regions. This indicates that intra-regional trade increased at the expense of trade with the rest of the world, largely developing countries outside East Asia. Urata points out that there are some common and uncommon factors that could be responsible for the increase in intra-regional trade. Favourable economic performance and geographic and cultural proximity within each region are contributing factors common to all three regions. However, the government-driven regional integration agreements found in Western Europe and in North America are not shared by Asia, which is nevertheless witnessing increased intra-regional trade.

In contrast to this "state led" regional integration in Europe and North America, Urata notes that the impetus for integration in Asia has mainly come from the private sector. It is interesting to note that the non-discriminatory liberalization of foreign trade and foreign direct investment policies has accelerated regionalization in East Asia, whereas preferential trading arrangements appear to have promoted regionalization in Europe and North America. An attempt to create a regional trading group in East Asia, known as the East Asian Economic Group, failed because it was realized that East Asia needed to maintain an open trading system for the region, which depends significantly on extra-regional contacts.[42]

Urata also examines the foreign direct investment (FDI) facet of regional integration, stressing that world FDI since the mid-1980s has grown even more rapidly than world trade. One of the most striking features of the growth in FDI in the late 1980s was the rise of the Asian NICs as host countries, especially at a time when investments in other developing countries were falling. The NICs also became active FDI suppliers to the ASEAN, whose suppliers of FDI had been almost exclusively the U.S. and Japan.

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[41]This section examines S. Urata, "Globalization and Regionalization in the Asia-Pacific Region" in *Business and the Contemporary World,* Autumn 1993.

[42]*Ibid.*, p. 36

Although conventional thinking used to be that trade leads investment, it is now recognized that FDI can influence the pattern of trade of the host economies through such factors as the sales and procurement practices of the foreign affiliates, i.e., investment can lead to trade. In Asia, the share of exports to local sales for Asian Japanese affiliates is higher than for the rest of the world, whereas the share of local sales in total sales is lower than for the rest of the world.[43] These figures are a result of the Japanese strategy to set up affiliates in East Asia as an export base, contributing to the export expansion of the host economy. By contrast, affiliates of Japanese firms in developed economies are set up to maintain their market share in the host countries or regions, and do not contribute as much to export expansion of the host economy. Other observations indicate that, although Japanese affiliates promote Asian integration, they also appear to contribute to an increasing *inter-dependence* between North America and Asia, and Europe and Asia.

- *World Investment Report 1991: The Triad in Foreign Direct Investment*[44]

In its annual investment report, the United Nations Centre on Transnational Corporations (UNCTC) focuses on the emergence of the triad (defined as the U.S., EC and Japan) as the dominant world force in global foreign direct investment. They state that, since 1983, total world FDI outflows have increased at an unprecedented rate of 29 per cent per year, three times faster than the growth in global exports and four times faster than world output. During the 1980s, around 80 per cent of outward stocks and flows were accounted for by the triad members alone.[45] The UNCTC believed that, at the time of the report, FDI was in its "take-off" phase, and would become an increasingly important factor in international economic integration.

The report notes that a significant change occurred in the patten of global FDI during the 1980s. At the beginning of the decade, it would have been difficult to characterize the U.S., EC and Japan as forming a triad which together dominated world investment stocks and flows. The role of Japan, even in outflows, was then relatively small and the EC was still too fragmented. The U.S. was the single most important home and host country for FDI in the world economy. By the start of the 1990s, however, Japan had emerged as an important FDI power, at least in terms of

[43] Urata remarks that the share of export sales in total sales for Asian affiliates was about 40 per cent in 1990, compared to only 4 to 8 per cent for the United States and the EC.

[44] UNCTC, *World Investment Report 1991: The Triad in Foreign Direct Investment*, ST/CTC/118, 1991.

[45] UNCTC, *op. cit*, pp. 2-3.

outward investment flows, and regional integration in the EC enhanced its already-strong FDI activity. As a result, the UNCTC re-characterized global FDI patterns as *tri-polar* for the 1990s. In recent years, the UNCTC finds that the U.S. has lost its dominant position to Japan in terms of outward flows, although it would take some years for Japan to build a rival DIA stock.[46] The report finds that the role of the triad in the world economy, as measured by FDI stock and flows, is dominant and that its role as a recipient of FDI increased during the 1980s.[47]

The UNCTC also finds that there was growth in intra-triad FDI that could, in part, be explained by heightened competition among increasingly global transnational corporations (TNCs), particularly in R&D-intensive industries. There was also evidence of TNCs building "regional core networks" around the triad. For example, in order to best serve strategic interests in both the EC and the U.S., as well as in Asia, Japanese TNCs were found to be building regionally-integrated, independently sustainable networks of overseas investments centred around a triad member.

The report examines the theoretical inter-linkages between trade and FDI, finding no obvious answer to the question of whether FDI is a substitute for, or a complement to, trade. For example, to the extent that FDI is a response to actual or expected trade barriers, it can be seen as a substitute for trade. At the same time, international production undertaken via FDI was considered to complement international trade to the extent that trade was either a component or an outgrowth of the international production strategies of TNCs. For example, there is substantial intra-firm trade within TNCs and, increasingly, the establishment of successful international operations involves trade by affiliates of TNCs operating in host countries and selling to third-country markets.[48] The report also finds that TNCs were responsible for a substantial share of world exports and imports. In the U.S., at least 80 per cent of the country's trade was undertaken by TNCs in 1988.[49]

The report cites several important policy implications of the emergence of a triad in FDI, the increasing importance of FDI as an engine of international economic

[46]Also, inward FDI stock in Japan is very small.

[47]UNCTC, *op. cit.*, p. 35.

[48]For the case of intra-firm trade, for example, more than a third of U.S. trade represented intra-firm transactions between foreign affiliates and their parent corporations.

[49]This measure includes parent companies in the U.S., foreign affiliates of home-country TNCs, and U.S. affiliates of foreign TNCs.

integration and the inter-linkages between trade and FDI. The UNCTC finds that, despite the trend towards economic integration, the individual country remained the most important arena for policy-making in investment. The opening of regional borders to economic competition, however, puts competitive pressure on the national policy systems that regulate economic activity. The report cautions that a wide range of policies, including environmental and social policies, may face increasing pressures to change as a result of integration with countries with different policy frameworks. Over the long-term, measures taken in the areas of trade and technology, which can significantly affect the competitiveness of a country, were considered likely to have as much, if not more, impact on the behaviour of TNCs than policies that directly encourage or discourage investment. The general conclusion is that integration might lead not only to competition among firms, but also to competition among *policy systems*.[50]

- *OECD Study on Regional Integration*[51]

This 1993 OECD document examines the extent of total regional integration, an important part of which is economic integration. It finds that regional integration appears to have contributed to a steady increase in intra-EC trade from 51 per cent in 1963 to 61 per cent in 1973, followed by stagnation and decline to 58 per cent in 1983 and a subsequent resurgence to 62 per cent in 1990. The study concludes that the EC has resulted in a progressive increase in the importance of intra-regional trade, but this has not prevented the growth in imports from third countries, with the important exception of agriculture. When integration is looked at for the whole of Europe, i.e., including the EFTA, the central and East European countries and other neighbouring countries, the study concludes that there have been no major changes in the share of intra-regional trade over a ten-year period.

Investigating FDI, the study finds that faster growth in intra-regional investment has gone hand-in-hand with faster growth in investment between regions. Intra-regional investment quadrupled within the EC over the period 1985-89, in response to the credibility of the single market programme. But European investment in North America also quadrupled over the same period and grew dramatically in Asia, though from a lower base. Intra-regional investment increased for North America in recent years, but North America has also become a net recipient of FDI as a result of massive

[50]UNCTC, *op. cit.*, p. 85.

[51]This section outlines the relevant parts of OECD, *Study on Regional Integration*, TD/TC(93)15, November 1993.

inflows into the U.S.. Some concern was expressed that NAFTA could divert U.S. outward investment from East Asia towards Mexico. The study also finds rapid growth in intra-regional investment within East Asia, with Japan and to a lesser extent the Asian NICs being the main sources. As with intra-regional trade, intra-regional investment in East Asia has grown much faster than in Europe. This has been both a cause and a result of rapid economic growth in the region and has taken place without any formal trade or integration agreement.

In general, the study finds that it is not possible to conclude from the evidence of changes in trade and investment flows that regionalization of the world economy is occurring. There has been a significant increase in intra-regional trade and investment, but this has been accompanied by increases in international (extra-regional) trade and investment. It is also impossible to determine whether the growth in regional trade and investment would not have taken place even if there had been no regional integration agreements. There has clearly been growth in regional trade in Asia, despite the lack of any formal trade agreement. This appears to be attributable to rapid economic growth, which would probably have played a similar role in promoting intra-regional trade and investment in Europe and North America even if there had been no new formal regional initiatives in these areas. Growth in regional trade was also attributed to shifting competitive positions and the evolving transfer of production from high to low cost countries in the regions. Natural economic factors seem to have played an important part in regional integration for the three regions.

3.3 Summing up

In general, the literature achieves the broad consensus that the world is not rapidly becoming tri-polarized and closed to inter-regional economic relations, although the members of the triad do possess an unrivalled amount of economic power, both individually and collectively. It seems, however, that the extent of regionalization is not as pervasive, particularly in Asia and North America, as is popularly believed. Although substantial regionalization cannot be ignored, especially in Europe, so far the benefits have been found to outweigh the costs, i.e., globalization and multilateral trade liberalization have not been significantly hampered, and may even have been boosted, by regionalization. The conclusion that regionalization is, in fact, a natural economic process stemming from the pursuit of maximum efficiency, separate from *de jure* political agreements, is also important. The concern that various authors express over the trade and welfare effects of the potential formation of three large, powerful economic blocs, is mostly related to regional integration that is not efficient, i.e., a *de jure* process undertaken to the excessive and inefficient exclusion of other countries. In fact, globalization and regionalization are found to be co-existent, parallel reactions to similar economic stimuli.

4. Are There Trading Blocs?

4.1 Methodology and scope

The studies reviewed in the literature survey examine a variety of measures of regionalization, but few actually examine whether trading blocs, measured solely by trade and investment patterns, are forming around North America, Europe and Asia. The methodologies of the studies are specific to the questions that the authors proposed to investigate and the conclusions cannot be extrapolated beyond the original intent of their work. It is also important to note that it was recognized as very difficult to separate pure economic motivations from regional bias when investigating the reasons behind regionalization. Even the studies that attempted to do so were careful about qualifying their statements.

This Paper now attempts to assess whether regional trading blocs are indeed forming around the triad of North America, Europe and Asia in a straight-forward way. This section does not attempt to determine what effects, if any, regional trade agreements or other legal and policy arrangements have had on trade flows. The question of *why* trading blocs may be forming is different from the question of *whether* trading blocs are forming. This section addresses the latter question, since it must first be answered in order for the former question to be of relevance. So the main aim of this analysis is also its main limitation; the empirical investigation is geared toward determining whether strong *de facto* trading blocs are emerging, but does not answer the question of why they are, or are not, doing so.[52]

Like the studies in the literature survey, the methodology of this work is specific to addressing the focussed question of whether regional trading blocs are forming around the triad. The first measure used in this section investigates the regionalization of trade within the triad. The question to be answered is whether there is any clear trend in the trading activities of the three regions and whether any broad conclusions about tri-polarization can be drawn from evidence of intra-regional trade flows. For example, if the intra-regional trading relationships of the regions

[52]This section does not examine whether regionalism has caused regionalization of trade flows, but rather attempts to determine whether regionalization of trade flows is in fact occurring with the vigour that popular reports claim.

were found to be becoming consistently stronger over time, it would be possible to conclude that trade was becoming more regionalized around these three poles; i.e., trading blocs are forming. A trend of decreasing strength in regional trading relationships or mixed evidence would obviously yield different conclusions. The second measure used in this section examines the "strength" of the three regions in global international trade transactions. It examines the share of world trade that the three regions account for, individually and collectively. This shows how important the regions are in world trade and, more importantly, whether they account for a growing proportion of world trade over time; i.e., is the "power" increasing?

- Data limitations

No data are perfect. Imports, measured in U.S. dollars, are used as a measure of overall trade flows because of their relative reliability and comparability vis-à-vis other indicators. No adjustments are made for price or exchange rate fluctuations that occur during the period studied. Gross domestic product data are also valued in U.S. dollars, which causes some measurement problems related to exchange rate fluctuation. Implications of these complications are noted in the analysis when warranted. Some observations, particularly for smaller Asia countries, were missing from the data set. Where this occurred, the observations were derived using the previous year's data, or dropped if the information gap was too great for any extrapolation to be appropriate. The three regions investigated in this study are North America, Europe and Asia. *North America* consists of Canada, the U.S. and Mexico. *Europe* consists of OECD Europe.[53] *Asia* consists of the ASEAN-6, with the exception of Brunei for which no data were available, plus Japan, Korea and Hong Kong.[54] China was rejected as part of the sample for Asia because of poor data quality. The sample years for Europe and North America are 1960 to 1993, inclusive. For Asia, the sample period extends only to 1992. The source of all trade data is the IMF and the source of GDP data is DRI.

[53]OECD Europe comprises Austria, Belgium and Luxembourg, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey and the U.K..

[54]The ASEAN-6 consists of Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand.

4.2 Regionalization[55]

The degree of regionalization is measured by the share of intra-regional imports in total imports of the region from the world. It is important to note that, since imports are measured in value terms, price fluctuations can affect import shares.[56] The ratio measures what proportion of the region's trade is with itself, rather than with the rest of the world. *A high and increasing ratio of intra-regional trade would be indicative of strong and growing intra-regional trade transactions.* Since the denominator of the ratio is total imports of the region from the world, an increasing ratio implies that extra-regional imports are decreasing, *as a share of total imports.* This does not mean that the values or volumes of extra-regional and intra-regional imports cannot be growing at the same time. However, their shares of the total cannot both be growing. Therefore, if the intra-regional share is growing, the extra-regional share must be decreasing.

The ratio of intra-regional imports to total imports of the region from the world indicates whether trading blocs are emerging or growing by measuring whether countries within the region are forming closer trade ties and becoming increasingly integrated. The ratio does not measure what factors caused these blocs to form, but captures the results of all effects, economic, legal, political, etc.. Causation cannot be extrapolated from high ratios. For example, if the ratio for Europe is particularly high and growing, this may be the result of the strong *de jure* integration that has taken place since the 1950s. But the ratio itself does not determine this. The same high ratio might have been present in the absence of any regional integration

[55]This measure of regionalization applies to trade-related regional integration only. It ignores international investment-led integration. This can be an important omission, particularly as trade and investment become increasingly linked. International direct investment data are analyzed separately in section 5 of this Paper.

[56]Large swings in oil prices are the most problematic of the price effects. As the price of oil increased drastically in 1972 and 1979, so too would the value of imports from oil-producing countries. As Europe is heavily reliant on extra-regional oil imports, the effect of these price increases was to decrease the intra-regional import shares. The reverse is true when a substantial decrease in oil prices occurs, as was the case in 1986. Since North America is not nearly as reliant on oil imported from outside the region, its import shares are not as affected by large swings in oil prices as those of Europe and Asia.

agreements; it is not possible to form concrete causal conclusions based only on numerical observations.[57]

Chart 1 shows that the ratio of intra-regional imports to total imports for Europe has trended upwards over time. The two deep troughs that occur in 1973 and 1980 are partially attributable to the two oil crises which would have had a distorting effect on import values (see footnote 56 for an explanation). These shocks, however, were temporary. The intra-European import share displays a definite upward trend since the 1960s, despite the dips. In 1993, over 65 per cent of OECD European imports came from other OECD European countries, in comparison to 1960 when this ratio was 52 per cent. It is evident that, by this measure, a high proportion of European trade is intra-regional and that this proportion has been steadily growing.

Chart 2, however, tells a different story for North America. The share of intra-regional imports to total imports has been falling from its peak of 43 per cent reached in 1969. The decreasing ratio over the long term indicates that a regional trading bloc has not been forming in North America. However, the intra-regional import ratio has been increasing since 1987 and much attention has been given to this phenomenon owing to the negotiation of trade agreements between Canada, the U.S. and later Mexico. Although the current trend may continue, it has not yet pushed the intra-regional share back to its 1969 peak. Also, it should be recognized that the level of the intra-regional import ratio in the 1980s and 1990s has vacillated between 30 and 35 per cent, far from the 60 to 70 per cent range for Europe. Although there is a definite recent trend of increasing intra-regional imports as a proportion of total imports, North America does not yet constitute a strong regional trading bloc, based on this indicator.

The data for North America is, of course, dominated by the U.S.. Charts 3 and 4 illustrate that it is the fall in the U.S.'s intra-regional imports ratio since 1969 that has caused the North American ratio to fall. Canada's trade integration with the U.S., as measured by the ratio of imports from the U.S. to imports from the world, has been relatively stable and high for the sample period shown in Chart 4, with the decline evident in the late 1980s showing signs of recovery by the early 1990s. Chart 4 shows that Mexico has experienced increased trade integration with the U.S,

[57]In order to determine causation, a detailed econometric study would be required. Much work in the area of determining why regionalization is emerging has been based on observation and anecdote. For an example of an econometric study which attempts to separate different factors concerning the causation of regional integration, see Frankel, *op. cit.,* or the Group on Asia-Pacific Economic Integration Towards the 21st Century, *Economic Integration in the Asia-Pacific Region and the Options for Japan,* 1993.

measured by the import ratio, since the early 1970s. These high and/or increasing ratios are offset by the low and falling U.S. ratio over the sample period, shown in Chart 3. The rising U.S. ratio evident since 1987 also drives the North American increase seen in Chart 2. It is important to note that both Canada's and Mexico's level of trade integration with the U.S. is high, as indicated by the high import shares of over 60 percent. This level more closely resembles the European ratios than the North American average. The low level of U.S. intra-regional import shares, shown in Chart 3, indicates that extra-regional trade makes up the majority of U.S. trade and, because of its size, the U.S. dominates the North American data.

Chart 5 reflects Asia's dynamic growth in the world economy, but tells a more moderate story than might have been expected.[58] The share of intra-regional imports to total world imports increased dramatically since the 1960s, almost doubling from 18 per cent in 1960 to 31 per cent in 1992. However, the Asian ratio for 1992 remained below the North American ratio of 35 per cent and well below the European ratio of 70 per cent, and the increase in the Asian ratio from 1960 to 1992 was 13 per cent, compared to an increase of 18 per cent for Europe, over the same period. Asian integration, although dynamic, did not outpace that of Europe, even though it started from a lower base. However, Asia does exhibit a consistently growing trend towards intra-regional trade, with no sign of diminishing. If this trend continues, Asia could be on its way to becoming a regional trading bloc similar to Europe. Nonetheless, currently, Asia still engages heavily in extra-regional trade.

The evidence presented above leads to the conclusion that, *with the exception of Europe, regional trading blocs are not, at present, prevalent. Over the long term, North America has experienced a declining trend in regionalization of trade and Asia's share of intra-regional trade, although growing consistently, remains low.* Europe, on the other hand, exhibits intra-regional trade shares which would be indicative of a regional trading bloc. Its intra-regional trade share is not only high, but also has been growing steadily, indicating that the European regional trading bloc not only exists, but is strengthening. A trading bloc might be emerging in Asia, but the intra-regional trade share would need to continue to grow at its past pace for a further thirty years before it reached levels equivalent to Europe's. The actions of the potential economic powerhouse of China could also substantially influence the path of future Asian economic integration. North America's recent increase in intra-regional trade ratios is still too new to predict consistent long-term growth.

[58]Data limitations for Asia necessitated considerable manipulation and assumptions in order to create a full series for all the countries included in the Asia sample. Missing data were sometimes omitted or estimated, depending on the relative importance of the observation.

Chart 1
Intra-Regional/Total European Imports

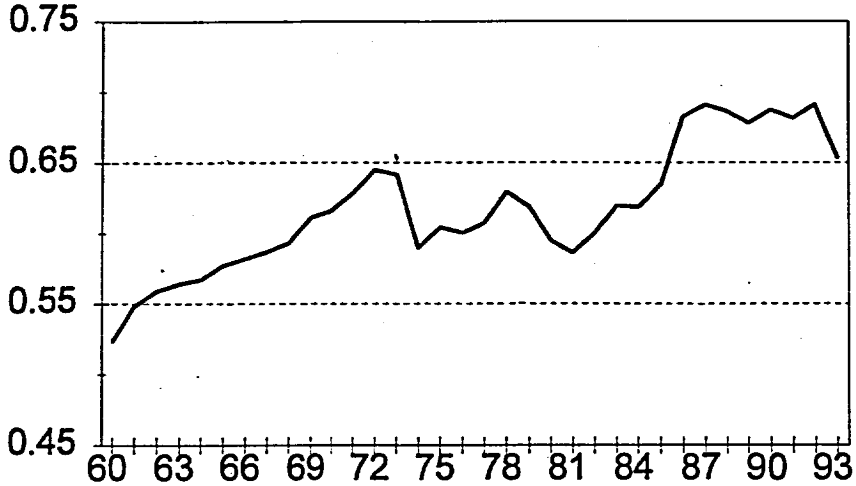


Chart 2
Intra-Regional/Total North American Imports

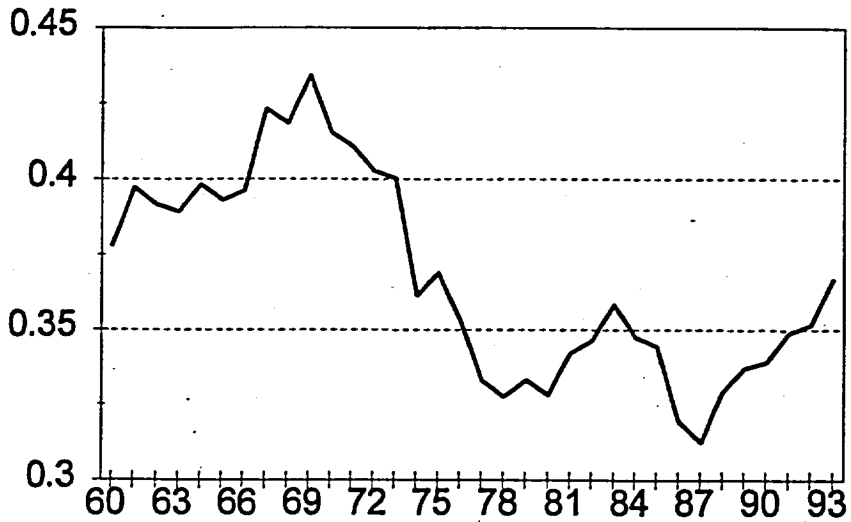


Chart 3

U.S. Imports from North America/U.S. Imports from the World

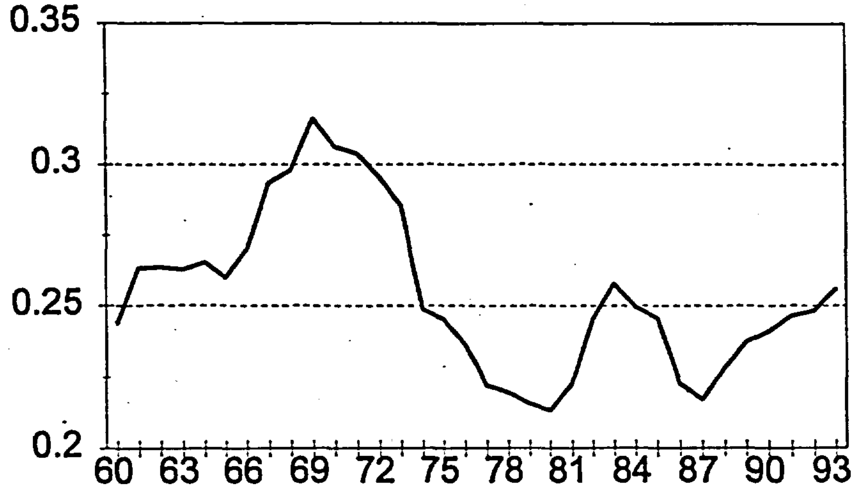


Chart 4

Imports from U.S./Imports from World

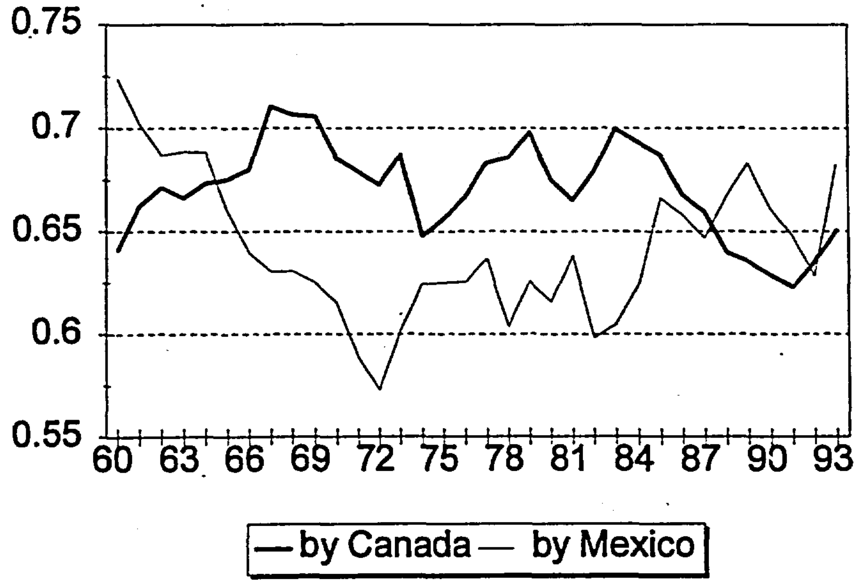


Chart 5

Intra-Regional/Total Asian Imports

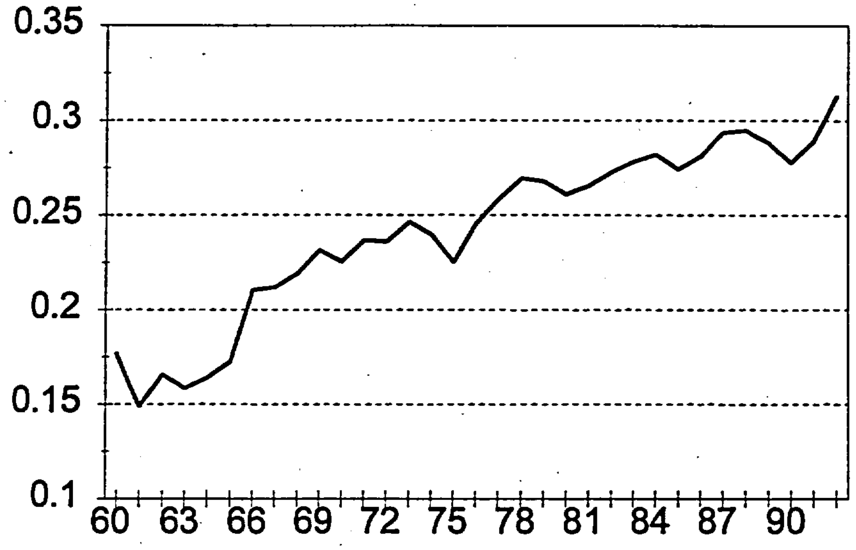
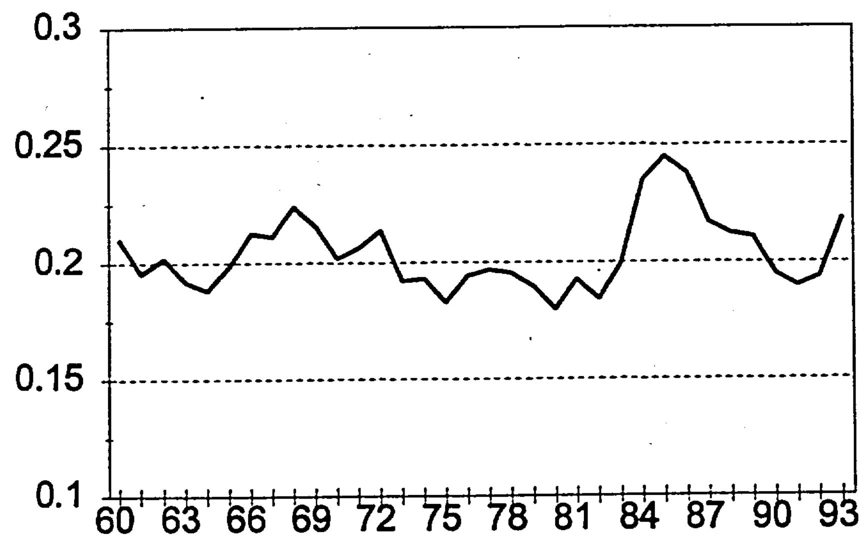


Chart 6

Total North American/Total World Imports



It is important to remember that formerly strong regional trading blocs, such as the COMECON and the British Commonwealth, have weakened and collapsed over time, resulting in a substantial decrease in economic polarization. It was not long ago when the United States and the USSR were considered to be two superpowers which dominated a *bi-polar* world. The degree of polarization of international economic relationships between these two superpowers was great, as the USSR traded very little with non-Communist nations. The collapse of the COMECON opens trade between formerly communist countries and the West to a degree that was not thought possible even ten years ago. These events illustrate that international integration is a fluid and dynamic process that must be examined in a historical economic context, and that current trends should not be considered immutable over the longer term.

4.3 The importance of the regions[59]

In this section, the importance of the three regions to total world trade is investigated. One indicator that measures the importance of the three regions is their share of world imports. The ratio of total imports of a region to total world imports measures the amount of trade the region accounts for in world trade. It is important to note that the level of the ratios of regional imports to world imports is not technically correct. These ratios have been calculated as a percentage of *available* world total, from which some countries are missing. Comparisons to the other study results, however, indicate that the data are sufficiently complete to be used to formulate clear conclusions.[60]

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[59]It is important to distinguish between the concept of "importance" and the concept of "power". In this section, "importance" in trade is simply defined as the amount of total trade the region in question accounts for. For example, if a country, say the U.S., used to account for a high proportion of total world trade, say 40 per cent, in the 1960 but now accounts for only 20 per cent of world trade, it can be said that their importance as a trading nation has decreased. Power, however, has a deeper meaning. Power may not be lost if importance decreases; indeed it can be gained. For example, increased intra-regional trade in Europe might come at the expense of extra-regional trade. If, over time, Europe accounts for a smaller proportion of total trade, because the decrease in extra-regional trade has not been offset by the increase in intra-regional trade, then it has lost "importance" as a trading region. But, its "power" could have actually increased, i.e., it could be in a stronger negotiating position because it can act more like a single entity. As defined here, "power" is a political and policy-oriented concept, whereas "importance" relates a factual economic relationship.

[60]This "available world total" comprised 46 countries. The results, however, compare favourably to a similar study by Lloyd, *op. cit.*, p.33.

Chart 6 illustrates that the amount of total world imports accounted for by North America has remained fairly constant at around 20 per cent over the sample period. The share of world imports accounted for by Europe is much higher than that of North America, ranging between 40 and 50 per cent (Chart 7). However, this ratio shows a decreasing trend over the whole sample period and has vacillated around 45 per cent since the mid-1970s. Only Asia's share of total world imports has been growing consistently over the sample period, from 7 per cent in 1960 to 16 per cent in 1992 (Chart 8). This increase is related to the area's rapid growth and its increase in the share of world GDP from just under 10 per cent in 1971 to over 20 per cent in 1992 (Chart 9). Although the three regions, particularly Europe, account for a significant proportion of total world trade, it is clear that that proportion has not been increasing for Europe or North America, leaving Asia, whose ratio in 1990 still remains below those of Europe and North America, as the only region that has experienced consistent growth in its share of total world imports.

Chart 10, which shows the total of the three regions' imports as a share of total world imports, yields an interesting observation. Although the share is high, it has been *relatively constant* at around 80 per cent over the entire sample period. There has been, however, an increase in the ratio over the 1980s and 1990s, leaving the 1993 ratio, 80 per cent, 6 per cent higher than that of the trough in 1981. As Chart 11 illustrates, most of the increase over the 1980s was fuelled by Asia's growth in imports, reinforced by an upswing in European imports over the mid- and late-1980s. It should be noted that the three regions' share of total world imports is high, but so too is their share of total world GDP.

Although the share of total world trade that the three regions account for is high, and there has been increased concentration of trade for the regions of Europe and Asia (shown in section 4.2), the constancy of the total regions' share in world imports over the entire sample period shows that *the "importance" of the three regions, or the proportion of world trade that they account for, has not been increasingly rapidly, as popular reports might indicate.* For example, although European trade has been becoming more concentrated, Europe is not accounting for an increasing amount of total world trade.[61]

[61]It should again be noted that Asia, which has been the fastest growing of the three regions, exhibits a consistent tendency to account for an increasing share of world imports, although the absolute level remains low.

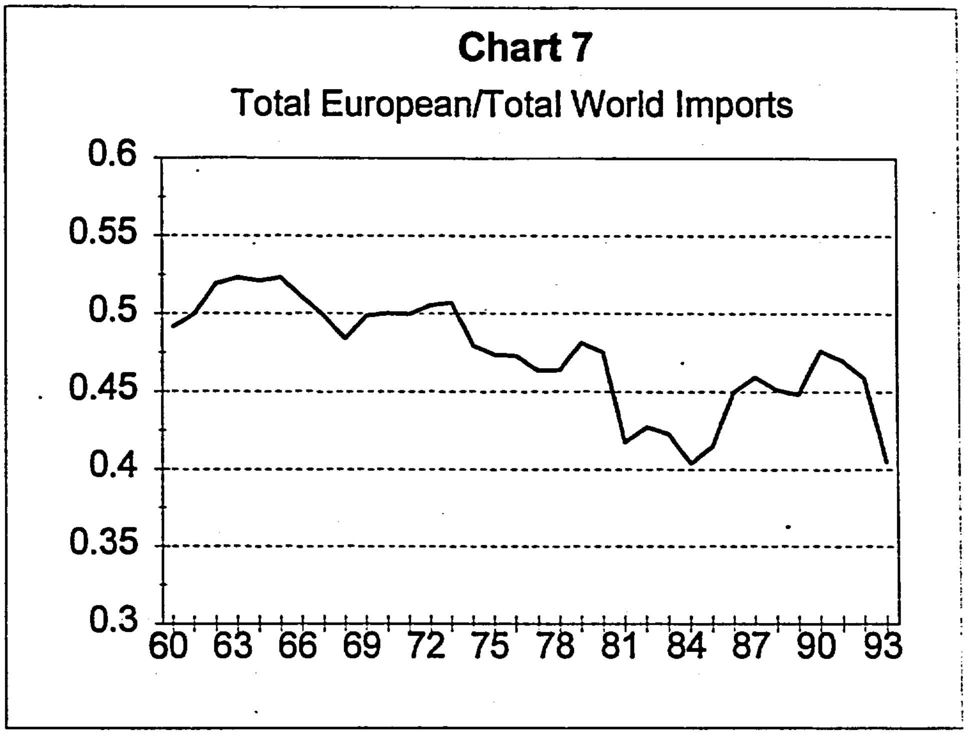


Chart 7
Total European/Total World Imports
0.6
0.55
0.5
0.45
0.4
0.35
0.3
60 63 66 69 72 75 78 81 84 87 90 93

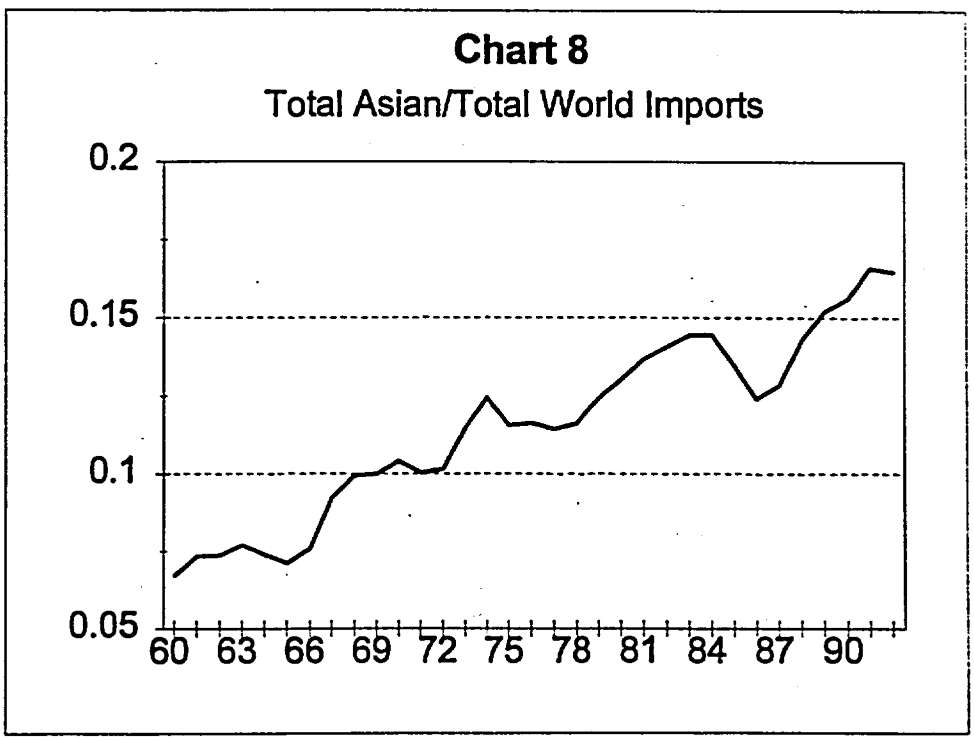


Chart 8
Total Asian/Total World Imports
0.2
0.15
0.1
0.05
60 63 66 69 72 75 78 81 84 87 90

Chart 9

Asian GDP/World GDP

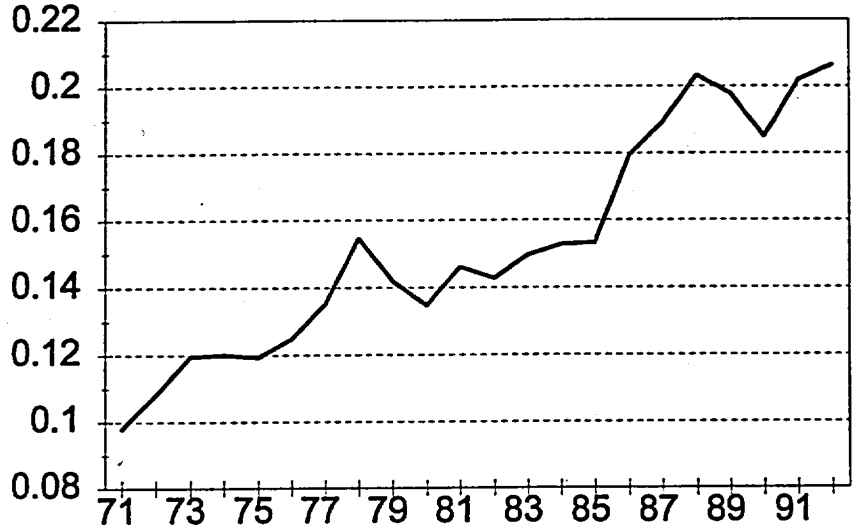
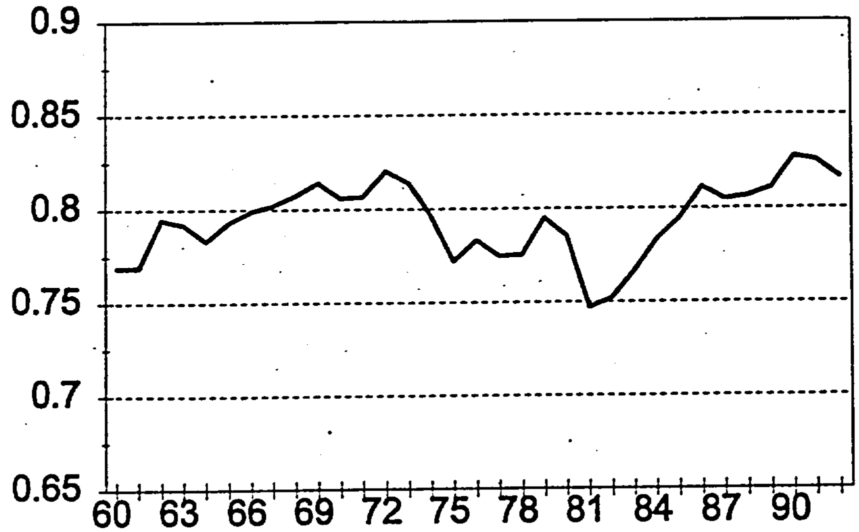


Chart 10

Total Three Regions/Total World Imports



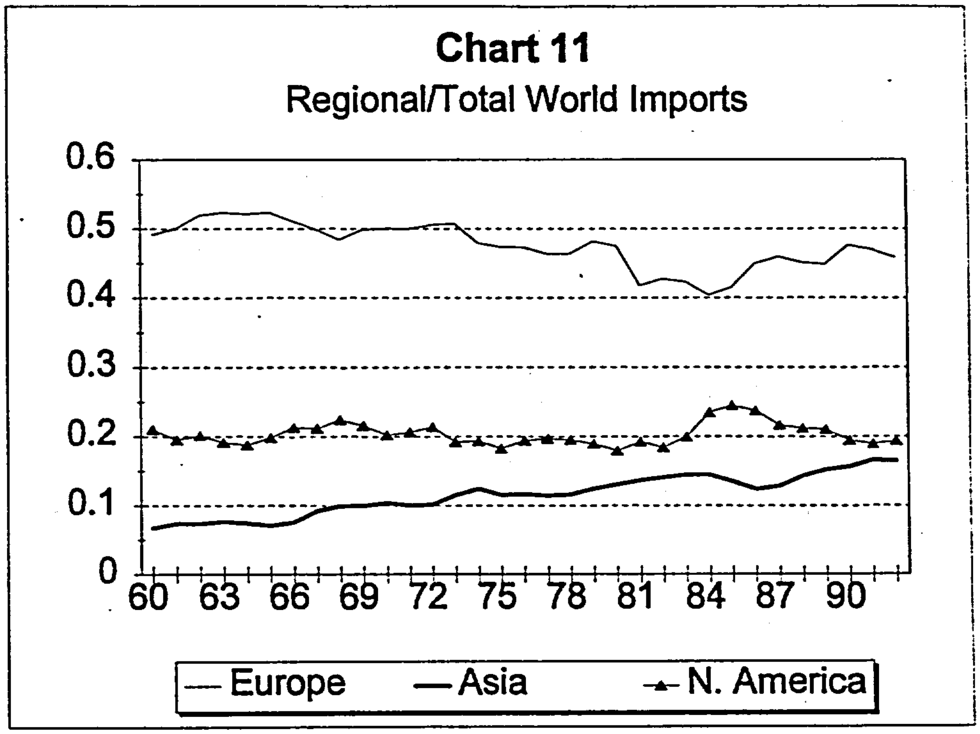


Chart 11
Regional/Total World Imports
0.6
0.5
0.4
0.3
0.2
0.1
0
60 63 66 69 72 75 78 81 84 87 90
Europe
Asia
N. America

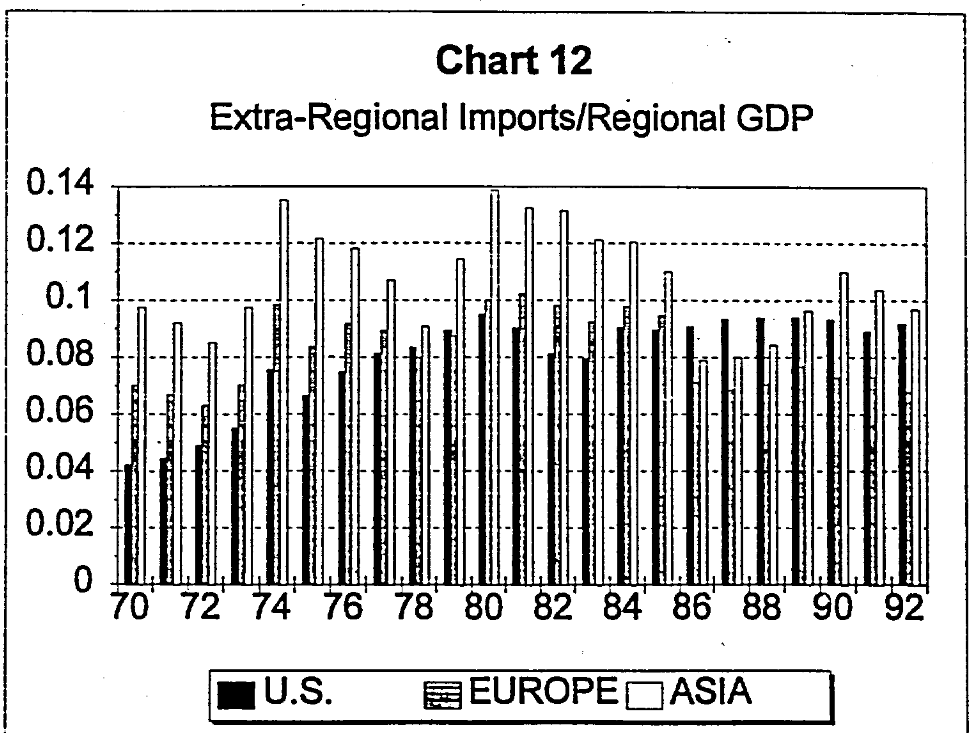


Chart 12
Extra-Regional Imports/Regional GDP
0.14
0.12
0.1
0.08
0.06
0.04
0.02
0
70 72 74 76 78 80 82 84 86 88 90 92
U.S.
EUROPE
ASIA

4.4 A note on trade and GDP

When discussing the definition of a trading bloc in section 2.1, the apparent inconsistency of considering a bloc to be a threat to multilateral liberalization if it involves regional integration, while simultaneously disregarding that countries themselves are blocs, was pointed out. The point is that the distinction is arbitrary and becomes increasingly blurred as Europe moves closer to complete economic union. In a sense, the U.S. has achieved complete economic union *with itself* and, as a bloc, is the largest economy in the world.

In this light, it is interesting to note that U.S. imports from the rest of the world as a percentage of its GDP have consistently fallen below extra-regional European imports, until 1986 (Chart 12).[62] This implies that Europe, taken as a trading bloc, and until the mid-1980s, was a more open economy to international trade that of the U.S., if the latter is considered to be a trading bloc.[63] Asia also shows a consistently higher extra-regional imports-to-GDP ratio than the United States. If Europe trades more extra-regionally than the U.S., then the concern over "Fortress Europe" should be qualified. If Europe became one country, it would have traded a greater proportion of its GDP, on average, over the sample period, than the U.S.. Asia, too, is a more active trader than the U.S., according to this measure. Although this measure is not an indicator of the existence of trading blocs, it does serve to illustrate the arbitrary

[62]The break in the series that occurs in 1986 can be explained by two separate effects which work simultaneously on GDP and imports to bring the ratio down for Europe, relative to the U.S.. The first effect results from a fall in the U.S. dollar vis-à-vis the European currencies related to the implementation of the 1985 Plaza Agreement. The currency effect implies that the value of intra-European imports, which are priced in European currencies, will increase when converted into U.S. dollars (i.e., 10,000 Austrian shillings worth of imports would have been converted into $U.S. 4,830 in 1985, but the same value in shillings would have been worth $U.S. 6,550 in 1986.) This implies that the intra-European share, which is subtracted from total world imports to obtain the numerator of the ratio, is larger, leaving the numerator, and the ratio, smaller than would have otherwise been the case. Also, the GDP of European countries, when converted into U.S. dollars, is higher in 1986 than in 1985 because of the change in exchange rates. Even if nominal GDP evaluated in the domestic currency did not change, GDP denominated in U.S. dollars would increase, making the denominator of the ratio larger, and the ratio smaller, than it otherwise would have been. To complicate matters further, these exchange rate effects were accompanied by a large change in petroleum prices. In 1986, petroleum prices decreased to half of their 1985 levels (U.S.$26.98 to U.S.$13.82.). As the price of oil falls, so too would extra-regional imports, in value terms. Since Europe is particularly dependent on oil imports from non-European countries such as Saudi Arabia, the result is that the ratio of extra-regional imports to GDP falls for Europe.

[63]Note that, although "Fortress Europe" is the main interest, Asia too follows this pattern of greater "openness".

nature of the definition of a "bloc" and the implications of defining blocs by looking only at trade flows which cross *international* borders.

5. Regional Economic Integration Measured by International Direct Investment

5.1 Is regional direct investment indicative of regional integration?

International direct investment, like international trade, can be seen as a measure of integration of the involved countries, called the home and host economies. A home and host are integrated through international investment in direct and indirect ways. The home country experiences the implications of the outflow of investment through several channels, although employment and trade are of primary importance. The host country also experiences the effects of the investment through employment and trade. If there is a high degree of intra-regional investment, and foreign direct investment (FDI) is significant relative the host country's size, it is possible to say that the host country is integrated with the home country. If the direct investment that is occurring is within one region, and is two-way (i.e., there is a significant amount of direct investment abroad (DIA) and FDI between the same home and host countries) then it can be said that the regional economies are integrated, although the term "investment bloc" is not usually used. The home and host countries would also be integrated in that economic conditions that affected the parent in the home country would have implications for the subsidiary in the host, and vice versa. This linkage between home and host country has a parallel in the relationship between importing and exporting countries. Income levels based on economic conditions in the importing country partially determine the demand for exports from the exporting country.

5.2 Methodology, data and scope

Foreign direct investment is concentrated among the OECD countries, with the triad of the U.S., EU and Japan alone accounting for some 80 per cent of global stocks and flows. This section investigates intra-regional FDI and attempts to evaluate to what extent FDI undertaken by the triad is intra- versus inter-regional. The source used for this analysis is the OECD's compilation of domestic statistics, the *International Direct Investment Statistics Yearbook*.[64] The *Yearbook's* definition of North America, Europe and Asia are slightly different than those used in section 4 of this Paper. For the present section, North America is still considered to include the U.S., Canada and Mexico. Europe consists of the EU (Belgium-Luxembourg, Denmark,

[64] OECD, *International Direct Investment Statistics Yearbook*, 1993 and 1994.

France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain and the U.K.) and Austria, Finland, Iceland, Norway, Sweden, Switzerland and a small category called "other" by the OECD. Asia consists of Japan plus South and East Asia (Hong Kong, Korea, Malaysia, Singapore, Taiwan, Thailand, China, India, Indonesia, Philippines and "other"). Investment stocks were chosen as the measure of regionalization because they are indicative of the total-to-date involvement by the home and in the host countries. Stocks are "sticky" by nature; once an investment is undertaken in one year this forms a stock that will remain in future years even if there is no further investment. Flows, on the other hand, measure the yearly stream of investment into or out of a country. They can be negative one year and positive the next. Since a snapshot of three different years is chosen to represent the trend in foreign direct investment, the volatility of the flows rendered them unsuitable for this type of comparison. Stocks are also a relevant variable when determining the total FDI interest in a region, although flows would better measure turning points and pattern changes.

Data on FDI are thin, unreliable and not generally comparable across countries. Recognizing these limiting factors, this section attempts to extrapolate trends from sample years of 1982, 1987 and 1992.[65] It examines the U.S., Japan, Canada, France, Germany, the Netherlands and the U.K. and tries to establish whether there are regional trends to the pattern of foreign investment of these countries, both as homes and hosts. To do this, these countries' stock of FDI and direct investment abroad (DIA) with the three regions of Europe, North America and Asia are given as a percentage of their total FDI or DIA stocks. It is important to note that, even if a country has a high proportion of its DIA stock in one region and a low proportion in another, this does not mean that the country's economic integration within the region that has a large amount of DIA is greater. For example, 44 per cent of Japan's DIA stock in 1992 was in North America, mostly the U.S., while only 15 per cent was in Central and East Asia. However, considering the size of the Asian economies compared to the U.S. economy, Japan's degree of economic influence in Asia is not considered lower than that in the U.S..

5.3 International direct investment patterns

Table 1 shows the international investment patterns of the U.S.. It is evident that, over the past decade, the stock of FDI in the U.S. held by Asia (mostly Japan) has increased significantly from only 8 per cent in 1982 to 24 per cent in 1992. However, it is still Europe, at just under 60 per cent, that overwhelmingly dominates

[65]Sample years can vary, however, because of data limitations for specific countries.

the stock of FDI in the U.S.. The increase of the proportion owned by Asia has come at the expense of Europe's portion and not that of Canada and Mexico, whose share has remained flat over the ten year period. This shows the relative lack of importance of North American FDI for the U.S..

Table 1
U.S.: Shares of Total FDI and DIA Stock, By Geographic Region

FDI	1982 (%)	1987 (%)	1992 (%)
Europe	66.45	68.66	59.17
North America	9.60	9.48	9.58
Asia	8.15	13.83	23.95
DIA			
Europe	44.50	47.86	48.86
North America	23.36	19.95	16.80
Asia	8.93	10.40	12.01

Looking at direct investment abroad undertaken by the U.S., North America's share of the U.S.'s total stock abroad has been declining, losing to increases in U.S. stock in Europe and in Asia. However, it must be considered that even a small amount of investment in the North American economies of Canada and Mexico can be indicative of more economic integration than the same amount would in the larger 18 economies of Europe. Also, although Asia is more important to the U.S. as a source of FDI than is North America, the same is not yet true for DIA, although the trend seems to be pushing the U.S. in this direction.

What we see for the case of the U.S. is evidence of strong inter-regional investment linkages between Europe and North America, with investment going to and coming from Japan, and the rest of Asia, playing catch-up. The evidence of strong intra-North American linkages comes only with regard to the DIA stock of the U.S.; although at 17 per cent of the total in 1992, it is still significant (i.e., North America is Canada's largest investor by far, see Table 2). However, to say that international direct investment is not inter-regional, on the part of the U.S., would be inaccurate.

It is evident from Table 2 that Canada is highly integrated with the U.S., both as a home and host country, although decreasingly so. The highest percentage of both outward and inward direct investment stocks of Canada is with the other North American countries, with Europe second and Asia a distant third. Although Canada has been increasing its outward stock in Europe and Asia, as a percentage of the total, North America still holds almost 60 per cent of all Canadian direct investment abroad. Europe and the dynamic new markets of Asia, however, are becoming an increasingly important new location and source of international investment for Canada, as the share of U.S. FDI declines.

It is evident from the cases of the U.S. and Canada that inter-regional investment is prevalent and is a growing trend. Although for the case of Canada, the size and proximity of the U.S. ensures strong economic integration both in investment and trade, the reverse is not true for the U.S., the bulk of whose investment is in Europe and whose stock of investment in North America as a percentage of the total has shrunk over the 10 year period considered in this section. Although it is not accurate to say that this means there has been decreased relative economic integration, because the size of the Canadian and Mexican economies are small relative to the collective size of the economies of Europe and Asia, *U.S. direct investment strategies have not excluded extra-regional partners.*

Japan, although the single largest investor in South and East Asia, only had 15 per cent of its total outward stock in Asia in 1992 (Table 3). A full 44 per cent was in North America, mostly the U.S.. Japan has held an increasing proportion of its investment stock in North America and Europe since 1982 and a decreasing proportion in Asia. This, however, does not indicate that Japan is not closely tied to Asia through investment and does not hold a significant amount of economic influence in the area. It simply does not require the same amount of direct investment stock in the smaller Asian economies to achieve a considerable amount of economic integration. A much larger stock would need to be held in the larger economies of the U.S. and the EU in order for Japan to hold a significant amount of their total investment stock or for this stock to be significant relative to GDP. As far as the small level of FDI stock held by foreign countries in Japan is concerned, North America is the leader. It is interesting that, in both the cases of the U.S. and Japan, one geographic region is both the largest recipient and source of international direct investment. For the U.S., that region was Europe; for Japan it was North America. Again, *for Japan, as for the U.S., extra-regional investment is a prominent part of Japanese economic activities.*

Table 2
Canada: Shares of Total FDI and DIA Stock, By Geographic Region

FDI	1982 (%)	1987 (%)	1992 (%)
Europe	21.10	22.81	27.23
North America	74.80	69.83	63.73
Asia	2.13	5.21	6.97
DIA			
Europe	14.57	16.59	20.76
North America	67.49	65.71	58.09
Asia	3.81	5.83	7.12

Table 3
Japan: Shares of Total FDI and DIA Stock, By Geographic Region

FDI	1982 (%)	1987 (%)	1992 (%)
Europe	22.39	22.99	29.03
North America	50.14	48.39	46.26
Asia	1.99	3.39	2.81
DIA			
Europe	11.02	14.89	19.32
North America	30.33	38.85	44.42
Asia	27.13	19.05	15.49

Because of the difficulty in amalgamating data from different domestic sources, France, Germany, the Netherlands and the UK were chosen to represent separately the European region. Tables 4-7 report the results for these countries. Overall, it is evident that Europe itself is the largest home and host of these European countries' international investment, with the exception of the UK partially due to its strong historical ties with North America. It is noted that the proportion of the stock of direct investment abroad held in Asia by the European countries has remained relatively constant between 1987 and 1992, weaker than even the slight growth seen in the proportion of the stocks held by the U.S. in Asia. North America seems to have been losing its proportion of European DIA, while Europe's proportion has been growing substantially. Examining FDI leads to much the same results. The highest proportion of FDI in the sample countries, with the exception of the UK, comes from Europe, and this proportion has been increasing. Increased FDI from Japan has pushed the proportion of the stock held by Asia in Europe up, but it is still small. *In general, it can be concluded that Europe's intra-regional investment patterns match its intra-regional trade patterns and that there is significant intra-regional investment within the European region.*

5.4 Measuring integration: Some limits

Like trade, international investment is only one measure of international economic integration. Also, like trade, although the intra-regional shares in FDI and DIA stocks can show what amount of investment undertaken is intra-regional, they do not really measure the extent of economic integration. For example, a country may have a high percentage of its FDI coming from one source, e.g., from the U.S., but FDI is relatively unimportant compared to the size of the host country's economy. In this case, although the one home economy accounts for a high percentage of all FDI in the host economy, the amount of FDI in the host economy, measured as a percentage of its GDP for example, is so low that there is no substantive economic integration. If total FDI is large relative to the size of the economy, then the country could be said to be more internationally integrated with the source country. Therefore, it is possible to have little economic integration with countries with which DIA stock is high and, on the other hand, to be highly integrated with countries in which DIA stock is low. In order for international direct investment to signal economic integration, the countries must have a significant percentage of their FDI stock from the source with which they are supposedly integrated *and a high ratio of FDI to GDP.*

Table 4
France: Shares of Total FDI and DIA Stock, by Geographic Region

FDI	1987[66] (%)	1991 (%)
Europe	n.a.	73.17
North America	n.a.	19.99
Asia	n.a.	5.40
DIA		
Europe	58.41	69.59
North America	26.35	21.91
Asia	1.91	1.99

Table 5
Germany: Shares of Total FDI and DIA Stocks, by Geographic Region

FDI	1983[67] (%)	1987 (%)	1992 (%)
Europe	47.71	52.90	59.63
North America	42.84	36.00	28.69
Asia	4.54	6.67	8.46
DIA			
Europe	40.65	49.25	59.43
North America	32.24	30.62	26.75
Asia	3.45	4.03	4.38

[66] Data prior to 1987 are not available.

[67] Data for 1982 are not available.

Table 6
Netherlands: Shares of Total FDI and DIA Stock, by Geographic Region

FDI	1984[68] (%)	1987 (%)	1992 (%)
Europe	47.77	51.23	60.11
North America	35.99	30.30	23.22
Asia	2.68	3.19	5.06
DIA			
Europe	36.41	49.90	53.00
North America	46.98	36.73	29.88
Asia	3.68	3.56	4.69

Table 7
UK: Shares of Total FDI and DIA Stock, by Geographic Region

FDI	1987[69] (%)	1992 (%)
Europe	35.99	41.00
North America	49.59	43.93
Asia	5.06	5.97
DIA		
Europe	27.84	29.38
North America	42.98	42.12
Asia	7.36	7.51

[68] Data prior to 1984 are not available.

[69] Data prior to 1987 are not available.

Although it is evident that, in general, intra-European direct investment plays an important part in strong European economic inter-linkages, Table 8 shows that the proportion of FDI to GDP for our sample countries varies widely. In the Netherlands, it is close to 30 per cent. In Canada and the UK, it is 20 per cent. Germany, the U.S. and France show significantly lower ratios of around 7 per cent and Japan's ratio is virtually zero. Therefore, even though it can be seen in Table 3 above that 44 per cent of Japan's FDI stock comes from the U.S., it cannot be considered that Japan and the U.S. are economically integrated, based on this measure. FDI simply is not a large enough part of the Japanese economy. For the U.S. also, FDI is a small proportion of GDP. Table 9 shows the ratio of FDI to GDP for several Asian countries. Although there is again a variance, the ratio is generally higher than those for the above OECD countries, indicating the FDI is a more important factor in the Asian countries, relative to the overall size of these countries' economies. FDI as a measure of economic integration, therefore, can more realistically be applied to countries such as Canada and the smaller Asian and European economies, whose FDI to GDP ratios are higher, signalling the more internationally dependent nature of these economies.

Table 8
Foreign Direct Investment as a Percentage of GDP[70]

	1987		1992[71]	
	FDI/GDP	DIA/GDP	FDI/GDP	DIA/GDP
Canada	19.32	12.75	20.18	15.48
France	n.a.	5.17	7.49	9.99
Germany	5.14	7.88	6.90	10.32
Japan	0.40	5.80	0.75	10.85
Netherlands	18.39	29.12	27.20	41.19
UK	13.80	91.26	19.25	24.58
U.S.	5.80	6.92	7.33	8.50

[70]Sources: IMF, *International Financial Statistics Yearbook 1994* and UNCTC, *World Investment Report 1994.*

[71]Data for France is for 1991.

Table 9
Foreign Direct Investment as Percentage of GDP

	1990	1992
Indonesia	36.63	33.35
Malaysia	33.04	39.20
Philippines	4.75	5.44
Singapore	87.77	86.67
Thailand	9.95	n.a.

6. Policy Implications

The three fundamental conclusions to be drawn from the literature survey and the results of the empirical analysis in this Paper are:

- regional economic blocs, if measured by actual trade and investment patterns, are not as easily defined as is sometimes suggested by more visible concepts based on legal or policy arrangements;
- globalization and regionalization are not mutually exclusive concepts or polar opposites and regionalization does not necessarily imply net world welfare losses; and
- although there is evidence indicating the existence and possible emergence of powerful regional trading centres, rapid tri-polarization of the global economy is not yet evident to the extent that is popularly reported.

The empirical study and literature review reveal that trade integration in North America has not experienced consistent growth as it has in Europe and Asia, although 1987 may, in future, be seen as a turning point towards a steady increase in regional integration. Although this Paper points out that there seems to be little to fear from the threat of an increasingly tri-polarized world, it is nevertheless true that the North American experience with tri-polarization is different from those of the other two poles. There are two distinct Canadian policy options with respect to the North American experience.

- Canada could exclusively pursue North American, or even hemispheric, trade integration, since North America has not been consistently expanding its intra-regional trade shares, as have Europe and Asia.

- Canada could avoid specific policies that promote North American integration, since there is little threat of Europe or Asia closing off trade and investment. Our interests would be best served in a global context.

A third, and much more likely, option would mix the two extremes. For example, this might involve expanding regional trade agreements such as the NAFTA, without limiting membership to the Western Hemisphere. This third option would involve a balancing act between pursuing the expansion of regional trade agreements, while at the same time remaining committed to multilateral negotiations. For example, regional agreements could be use as "test beds" for multilateral agreements. These test beds might liberalize faster and further and could push towards global free trade.

The literature survey highlights the current thinking that regionalization and globalization need not be viewed as divergent and competing processes. Also, regionalization, in the form of natural trading bloc formation as well as some *de jure* regional trade agreements, can actually enhance multilateral liberalization, particularly if a regional trade agreement goes further in liberalizing than what could have been obtained in multilateral fora. Traditional fears about the effects of regionalism, such as trade diversion, ignore such dynamic benefits as increased income within the region spilling over to the rest of the world in the form of increased demand for extra-regional imports. The policy implication is that regional trade agreements should not be as feared by smaller, non-member countries as much as traditional thinking might suggest. Although multilateralism is still preferable to regionalism in trade negotiations as far as total welfare effects are concerned, regional trade agreements that do not hinder multilateral agreements and follow natural economic development may, in reality, contribute more to the global freeing of trade than to the polarization of the world economy. However, it should be remembered that it is this global, multilateral freeing of trade that remains the ideal.

Although it is a reality that the members of the triad possess unrivalled economic power, a country's (including Canada's) trade and investment policies should not be defensive, but should be determined by the tenets of economic efficiency and welfare maximization. Even though the proximity to the economic powerhouse of the United States benefits Canada tremendously and our southern neighbour will remain a priority for policy makers, *exclusionary* regional policies should not be pursued. Promoting trade with several different geographic areas based on their economic merits should remain the aim of competitive and liberal Canadian policies.

Looking at investment, this Paper found that the stock of foreign direct investment in Canada has been increasingly accounted for by sources outside the U.S., although the U.S. retains the highest proportion of the total stock. Europe and Asia both possess an increasing proportion of the total stock of FDI in Canada. Encouraging potential future investment from Europe and Asia, as well as other regions, should continue to be the aim of Canadian investment policies that are not exclusionary or confined to one specific region. Tax polices and those that affect the more general macroeconomic environment, such as social and labour policies, also need to be competitive in order to continue to attract FDI in an inter-regionally competitive environment. These policies will become increasingly important to attracting and maintaining FDI the more globalization advances.

One qualifier is that the benefits of regional integration must come from increased international competition, not protected markets. During the initial phases of economic integration, a longer "phasing-in" period or some alternate form of industry protection may be necessary politically to ease the structural adjustment process, particularly for the more vulnerable economic partner. But it is very important to ensure that such programs are decidedly temporary. Otherwise, certain groups with political clout could lobby for this special treatment to become permanent, undermining potential benefits of integration.

It is also important that extra-regional trade, at least as a percentage of GDP, remains a significant part of total trade for the three regions reviewed in this Paper. Averting a potential "trade war" between the members of the triad is necessary for welfare gains to be realized. This cautionary note is particularly relevant at a time when pressures for protection, particularly in the U.S., are developing.[72]

Finally, there is a simple, but important, lesson to be drawn from economic history. At this time, when the world is still feeling the effects of the dissolution of one of the most insular trading blocs in modern history, the Soviet Union and the COMECON, it is important to remember that economic systems are not static. The fall in importance of other "trading blocs", such as the British Commonwealth, exemplifies the fluidity of global economic relations. Although it might appear evident that tri-polarization is emerging today, the long-term evidence indicates that the trend is neither so robust nor so exceptional as is popularly reported. It is interesting to note that few would have predicted fifty years ago that Japan would rival the U.S. for global economic dominance today. Although tri-polarization might indeed be the way of the future, policies should be flexible enough to respond to unforeseen changes.

[72]Urata, *op. cit.,* pp. 44-5.

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