Introduction

The North American Free Trade Agreement (NAFTA) between Canada, Mexico and the United States is but the latest of a plethora of minilateral trade agreements that co-exist with the GATT rules-based multilateral trading system. Why, then, does it and the widening and deepening of the European Union (EU) — formerly the European Community (EC) — cause so much concern in smaller non-included economies, especially those on the Western Pacific rim (East Asia and Australasia)?

North Americans seem genuinely surprised by that concern: they will admit that some outsiders may be adversely affected by trade and investment diversion associated with the implementation of the Canada–US Free Trade Agreement and its expansion to include Mexico; but because the US and Canadian economies were already highly integrated, and because the Mexican economy is relatively small, they expect those effects to be insignificant. The same type of point is often made by West Europeans over the likely entry of some European Free Trade Association (EFTA) countries into the EU in the mid-1990s.

Such direct effects, however, are only part of the concern of outsiders. The much more important parts have to do with fears of:

- external trade barriers being raised by these blocs;
- preferential access to West European markets being extended to more products from Europe’s former communist countries (potentially expanding the bloc from 370 million to more than 500 million people);
- NAFTA admitting other members from Latin America and perhaps elsewhere;
- more-confident US and EU leaders being more aggressive unilaterally in their relations with other countries (especially those in East Asia, which could lead the larger of them to retaliate); and
- the cumulative effects of these developments, in addition to those associated with other recent and prospective regional integration agreements (RIAs) (for example, in Latin America), in eroding the GATT rules-based multilateral trading system on which the prosperity of open economies depends.

This paper, rather than giving a blow-by-blow account of the features of NAFTA and the EC’s Single Market Act and its initiatives to deepen and expand further (about which scores of papers have been written already), addresses several questions raised by the above more general
concerns. First, is there evidence from the past that suggests the direct and indirect effects of RIAs on trade and investment have been income-reducing for excluded economies? Many would answer ‘yes’, and some cite the increasing regionalisation of world trade to support that view. The next section of this paper suggests that this conclusion is probably unwarranted. It is true that the share of world trade that is intra-regional has been increasing. But it is also true that the proportion of GDP traded has been increasing sufficiently rapidly for there to be growth also not just in trade with other regions but also in the share of GDP traded extra-regionally. Whether that extra-regional trade volume would have been larger in the absence of the RIAs’ formation depends on how restrictive the counterfactual trade policy would have been — about which we are able to say little.

The third section considers whether enlarging NAFTA and EU membership is likely to contribute to or slow this past trend for increasing economic integration across regions as well as within regions. Not all the signs are positive and the net effect may indeed be negative, but the paper argues that on balance the concerns of excluded economies relating to trade and investment diversion probably are exaggerated. The fourth section focuses on the broader systemic question that is more worrying for excluded small open economies — namely, will the proliferation of RIAs erode the GATT rules-based multilateral trading system, a system that has served them moderately well in the past? It concludes that there is indeed cause for this systemic concern. The final section of the paper looks at how Asian and other excluded economies might respond to the economic integration initiatives in North America, Europe and elsewhere.

**Effects of existing RIAs on the trade and income of economies not included**

The recent proliferation of regional integration agreements and proposals, and the difficulties experienced in concluding the Uruguay Round, have fuelled fears that international trade is becoming more of a regional affair in ways that will reduce global welfare. Evidence often cited to support these fears includes the increase in the shares of industrial countries’ trade that is intra-regional. During the postwar period, for example, Western Europe’s intra-regional trade share has risen from a half to almost three quarters. But what is the picture in North America and elsewhere in the world, and do increased intra-regional trade shares mean that economies outside these regions are worse off?