21st Century Regionalism

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Regionalism Has Changed

The nature of regionalism has changed radically over the past two decades, but economists' and governments' thinking about regionalism has not. The change in regionalism reflects the change in trade itself.

- 20th century trade was conceptually simple – it meant goods crossing borders; trade agreements were correspondingly simple.

For example, the mainstay of global trade governance – the General Agreement on Tariffs and Trade (GATT) – is less than 100 pages long. Regional trade agreements at the time were also simple and dealt mainly with preferential tariff reductions.

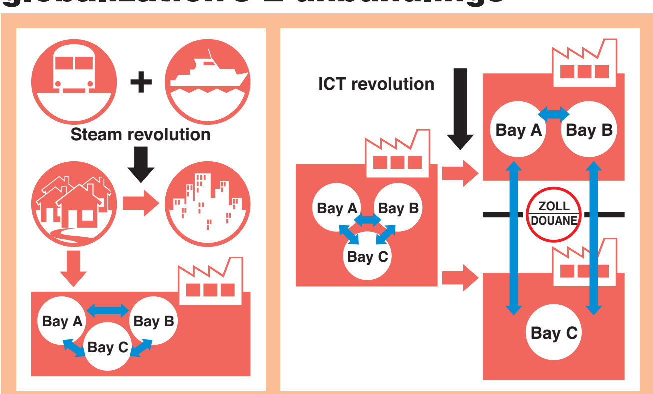
- 21st century trade is radically more complex; trade agreements underpinning this trade must be correspondingly complex.

As the WTO was otherwise occupied with the Doha Round, the newly needed trade disciplines arose outside the WTO. The main elements were "deep" regional trade agreements (such as Japan's Economic Partnership Agreements), bilateral investment treaties, and unilateral reforms by emerging economies. The resulting package of deeper disciplines – what could be called "21st century regionalism" – requires new thinking.

In a nutshell, 21st century regionalism is not primarily about preferential market access as was the case for 20th century regionalism; it is about disciplines that underpin the trade-investment-service nexus. This means that 21st century regionalism is driven by a different set of political economy forces; the basic bargain is "foreign factories for domestic reforms" – not "exchange of market access." As 21st century regionalism is largely about regulation rather than tariffs, regulatory economics is needed rather than Vinerian tax economics. Finally, 21st century regionalism is a serious threat to the WTO's centrality in global trade governance, but not for the reason suggested by the old building-stumbling-block thinking. 21st century regionalism is a threat to the WTO's role as a rule writer, not as a tariff cutter.

Before fleshing out each of these points it is important to get to the bottom of the story: "What fundamental changes led to 21st century trade and 21st century regionalism?"

CHART 1
Schematic illustration of globalization's 2 unbundlings



Source: Baldwin, Richard (2011). "21st Century Regionalism: Filling the gap between 21st century trade and 20th century trade rules", CEPR Policy Insight No. 56

Globalization as 2 Unbundlings

Globalization is often viewed as driven by the gradual lowering of natural and man-made trade costs. This is a serious misunderstanding. Globalization leaped forward in the 19th century when steam power slashed shipping costs and it progressed gradually with the postwar reductions in trade barriers and transportation costs. Globalization made a second leap at the end of the 20th century when ICT decimated coordination costs. The implications of the two leaps can be dramatically different, but understanding why requires a bit of background.

1st Unbundling: Steam Made it Possible, Scale Economies Made it Profitable

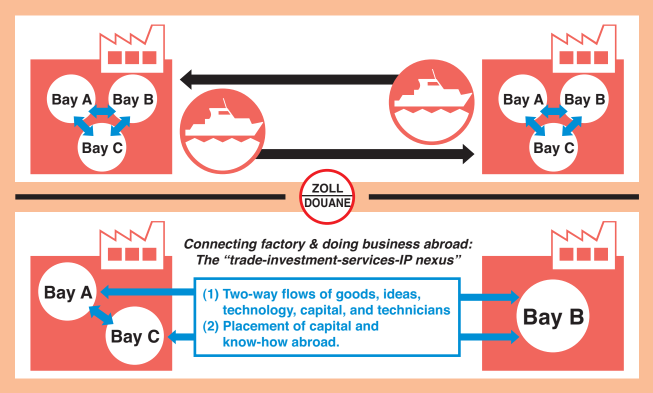
When sailing ships and stage coaches were high-tech, few items could be profitability shipped over anything but the shortest distance. Production and consumption were forcibly bundled geographically; each village made most of what it consumed *(Chart 1)*. The steam revolution changed this. Railroads and steamships radically lowered transport costs. It became feasible to spatially separate production and consumption; scale economies and comparative advantage made it profitable to do so. Nations specialized along comparative advantage lines and international trade boomed. This was globalization's 1st great unbundling.

Most economists and policymakers continue to view globalization through the prism of trade theory that was designed to understand the effects of lower trade costs, i.e. the 1st unbundling. This has led to many policy mistakes – one being that governments and most economists continue to think about the costs and benefits of regionalism from a 20th century perspective.

2nd Unbundling: ICT Made it Possible, Wage Differences Made it Profitable

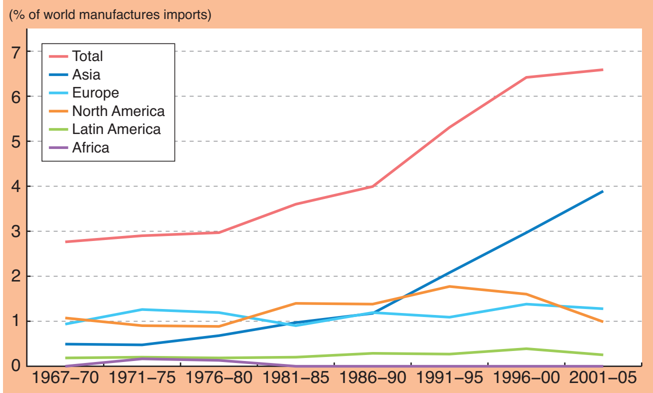
The 1st unbundling did not make the world flat. Indeed, as production dispersed internationally, it clustered locally (dispersed workshops became clustered into large-scale factories). The seeming paradox is solved with three points: i) cheap transport favoured large-scale production, ii) such production is complex, and iii) proximity lowers the cost of coordinating the complexity. In short, by removing one constraint (transport costs), the

CHART 2
Schematic illustration of 20th and 21st century trade



Source: Author's work

CHART 3
Outward processing trade, 1967-2005: Mostly North-North until 1985



Source: Amador, João and Sónia Cabral (2008). "Vertical specialization across the World: A Relative Measure", Bank of Portugal working paper, No. 10-2008

1st unbundling brought forward another constraint – coordination costs.

Consider a stylized factory with three production bays as schematically illustrated on the right side of *Chart 1*. Coordinating the stages requires continuous, two-way flows among the stages of things, technology, people, training, investment, and information (double-headed arrows). Productivity-enhancing changes keep the process in flux, so the flows never die down. Clustering production in factories reduced coordination costs.

Some of the coordination costs are related to communications. As telecommunications became cheaper, more reliable, and more widespread from the mid-1980s, the "coordination glue" began to loosen – with the biggest changes happening between high-wage and low-wage nations. Telecom advances united with soaring computing and transmission capacities to create the ICT revolution.

The ICT revolution made it technically possible to coordinate complexity at distance. The vast wage differences between advanced and developing nations made separation profitable. This was globalisation's 2nd unbundling – production stages previously performed in close proximity were dispersed geographically. The result was 21st century trade (even though it started in the 1980s in East Asia, where it is called "Factory Asia" and across the US-Mexico border where it is called Maquiladora trade).

Trade-Investment-Services Nexus: 21st Century Trade

The 2nd unbundling made international commerce far more complex. The point is that internationalizing supply chains did not end the need to coordinate production stages – it internationalized it.

The heart of 21st century trade is an intertwining of 1) trade in goods, 2) international investment in production facilities, training, technology and long-term business relationships, and 3) the use of infrastructure services to coordinate the dispersed production, especially services such as telecoms, internet, express parcel delivery, air cargo, trade-related finance, customs clearance services, etc. This could be called the trade-investment-services-intellectual-property nexus.

The differences between 20th and 21st century trade are illustrated schematically in *Chart 2*. The top panel illustrates 20th century trade; trade is dominated by goods made in factories in one nation and sold to customers in another. Inside factories, there are complex two-way flows of goods, people, and ideas (the double-headed arrows). The lower panel illustrates 21st century trade. Here factories and offices have been unbundled internationally, so the complex flows are now part of international commerce. The complex two-way flows that used to take place within factories and offices now take place across international borders. This revolutionized the nature of trade – even though this revolution has not been thoroughly recognized in most economists' thinking.

It is useful to think of the trade-investment-services nexus as being created by two distinct sets necessities: connecting factories, and doing business abroad.

Indicators of 2nd Unbundling

Trade in parts and components, trade in infrastructure services, and foreign direct investment are the most easily measured aspects of this multifaceted, multi-directional commerce, but they are only the tip of the proverbial iceberg.

The 2nd unbundling happened first among developed nations. Examples include US-Canada or French-German trade in autos and auto parts in the 1970s. The big change, however, came when the 2nd unbundling accelerated between developed and developing nations. The dominant factor here was the juxtaposition of the ICT revolution and colossal wage discrepancies. *Chart 3* shows that this trade was more important among European and North American nations up until the early to mid-1980s. After that, it boomed North-South, but especially in Asia *(Chart 3)*.

Heighten Mobility of Technology

A less obvious implication of the 2nd unbundling was the amplified international mobility of technology. This is important since the economics that applies to trade in goods does not apply automatically to international technology movements.

The contrast between free trade in goods and free trade in technology can be illustrated with an analogy. Allowing trade in goods is like allowing baseball teams to exchange players – a reform that will almost surely make both teams better if each freely agrees to the deal. Transferring technology, however, is like the better team training their opponents' batters. The resulting game will surely be at a higher level, but it is not clear that both teams benefit.

21st Century Regionalism

The rise of 21st century regionalism was a global phenomenon. International commerce was transformed by the production networks that created Factory Asia, Factory North American and Factory Europe. (Latin American and Africa are too far from the US, Germany and Japan to have benefitted from this so far.) The most natural policy response should therefore have been at the multilateral level. As history would have it, this was not to be.

As mentioned, the WTO was focused on the Doha Round and its very 20th century focus on tariffs and the narrow slice of world trade that takes place in the agriculture sector. Moreover, as many of the production chains were regional, rather than local, the governance gap between 20th century trade rules (the WTO) and 21st century trade was filled by uncoordinated developments elsewhere – primarily in deep regional trade agreements (RTAs), bilateral investment treaties (BITs), and autonomous reforms in emerging economies.

Bilateral investment assurances – known as Bilateral Investment Treaties – exploded along production share and the trade-investment-services-IP nexus *(Chart 4)*.

The world also saw an explosion of “deep” RTAs *(Table 1)*. Here “deep” agreements mean those that contain provisions that go far beyond the traditional trade liberalization measures such as tariff removal.

The WTO was not the locus of liberalization for another reason as well. 21st century trade is driven by a different set of political economy forces than 20th century trade liberalization. The old logic of trade agreements was an exchange of market access, or “my market in exchange for yours”. The basic bargain in 21st century regionalism, however, is quite different. It is “advanced economy factories for emerging market domestic reforms”. In essence, the possibility of industrializing by joining a supply chain instead of building a supply chain completely overturned the politics behind emerging market protectionism. Instead of providing a respite to competition from foreign goods, tariffs on any intermediate good became a hindrance to joining the global value chain. Tariffs switched from helping domestic industry to hurting it. And the same applied to business-unfriendly investment climates. Of course, market access is still important, but the deep provisions are not really about market access – they are about helping foreign companies connect production facilities internationally, and do business locally.

An important implication of this recasting of the basic political deal is that not all nations can drive such a bargain. Only nations that possess technology that they are willing to offshore have the leverage to demand the massive domestic reforms that are so common in 21st century RTAs. To date, that basically boils down to the US, the EU and Japan although South Korea and Taiwan may also fall in this category. South-South FDI flows are rising, and South-South BITs along with them, so this feature many change.

Implications for World Trade System

21st century regionalism is good news and bad news for the world trade system. The good-news part is easy to explain. Trade liberalization has progressed with historically unprecedented speed in the 21st century, even when measured by a 20th-century-trade yardstick like average tariffs. As a result, trade volumes have boomed, lifting billions out of dire poverty. Twenty years ago, one could wonder whether regionalism would be a building or stumbling block; now we know there were no stumbling blocks on the road to zero tariffs. The road remained open and the world is driving down it as fast as ever. This building-stumbling-block thinking, however, focuses attention on the wrong issues.

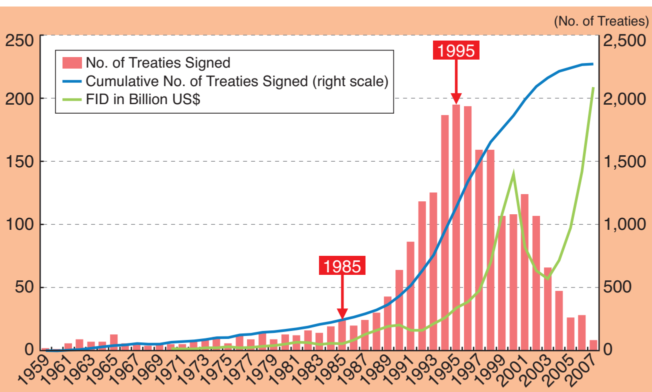
21st century regionalism is a threat to the world trade system, but the nature of the threat is subtle. It has little to do with the stumbling-block versus building-block analysis that Jagdish Bhagwati introduced two decades ago.

21st century regionalism has three parts: deep RTAs, BITs, and unilateralism. Unilateralism is not a systemic threat to the WTO – although it does make finishing Doha harder. Likewise, BITs have co-existed with the WTO for decades without any apparent harmful spillovers.

The real threat is that deep RTAs may undermine the WTO’s central place in world trade governance. But the threat to WTO centricity does not come on the tariff-cutting front; it comes on the rule-writing front. As was shown above, the tariffs have come down a great deal already, although they are still important in some sectors, especially agriculture.

CHART 4

Explosion of bilateral investment treaties



Source: UNCTAD’s World Investment Report, various issues

TABLE 1

Deeper-than-WTO provisions in RTAs

	Pre-WTO	1995-2000	DDA era, post 2001
Customs cooperation	13	11	56
Anti-dumping cooperation	12	8	53
Anti-subsidy cooperation	4	5	52
Export taxes restrictions	8	8	41
State aid restrictions	10	9	34
Beyond WTO intellectual property rights	6	4	41
Beyond WTO service liberalization	7	2	39
State-owned enterprise disciplines	5	3	35
Standards cooperation	2	2	36
Food standards cooperation	2	1	35
Public procurement	5	0	32
Investment disciplines	6	2	31
Competition policy	11	9	39
Movement of capital	6	5	38
Investment	4	1	35

Source: World Trade Report, WTO (2011)

More specifically, deep RTAs may undermine the WTO as the forum for agreeing new rules – specifically the rules necessary to foster the trade-investment-services nexus that is the core of today's international commerce. But why is the choice of forum a problem for global trade governance? There are three main reasons to worry about the WTO being sidelined on the rule-writing front.

First, the basic WTO trade norms are almost universally accepted and respected – a very rare thing (think of climate change, nuclear proliferation, or human rights). These norms are a global public good of enormous, if unquantifiable, benefit. The universality of the norms stems in large part from the way they were promulgated – in multilateral negotiations where the GATT/WTO consensus principle held sway. The new trade disciplines are being promulgated in settings of massive power asymmetries – the deep RTAs signed by the US, EU and Japan with small to medium-sized developing nations. Lacking the legitimacy that comes from multilateralism and consensus, it is not at all clear that the new norms will be universally respected.

For example, some emerging markets – China, India and Brazil – are large enough to attract foreign investment and technology without signing deep RTAs, and they have so far shunned them. (The EU-India agreement, for example, excludes many of the deeper disciplines in the EU's other RTAs.) China, in particular, might decide to reject the rules – creating something like a "Cold War of deeper trade disciplines". This sort of distrust could spread beyond the new rules, especially if China, India and Brazil feel that the US is practicing "competitive liberalisation" – trying to encircle them in a way that eventually confronts them with what might be seen as an ultimatum. This outcome would be made more likely if the US reverts to its aggressive unilateralism of the 1980s (the Plaza Accord and the Structural Impediments Initiative that forced Japan to revalue and remove behind-the-border barriers) and 1970s (Nixon's 10% surcharge that forced Germany to revalue).

Second, a world where the WTO's importance starts to resemble that of UNCTAD – with all the action going on in RTAs – is not a world that fosters multilateral cooperation on other issues, such as trade-related policies that help with climate mitigation and adaption, or food shortages linked to drought or floods. US, EU and Japanese interests will be served in the short term, and the interests of small to medium emerging markets will likewise be served (if not evenly), but where do Brazil, India and China fit in?

These nations are not in a position to set up their own systems of deeper disciplines for the trade-investment-services nexus because they do not have advanced technology factories to offshore in exchange for host-nation reforms (on the political economy of 21st century regionalism). By the time their multinationals are ready to make major outward pushes, the rules-of-the-road written by the US, EU and Japan will have been firmly embedded into international commerce. More precisely, they will be embedded in the domestic laws and regulations of all the host-nations that the Chinese, Indian and Brazilian companies will be looking at. Like it or not, Chinese, Indian and Brazilian companies will have to play by the rules that are now being written by the US, EU, and Japan in agreements that involve massive power asymmetries.

If Brazil, India and China play their assigned roles in this storyline, it may all work out peacefully. But that is not the only outcome observed when such tactics were applied historically. This is a world that starts to resemble the 19th century "Great Powers" situation. That episode of globalization did not end well.

This is not the only scenario, of course. A whole system of trade and investment disciplines has developed in the form of BITs. Up to now, BITs and their system of jurisprudence, negotiations and politics does not seem to have undermined the WTO's authority on the issues covered in the 1995 Marrakesh Agreement. But as international commerce becomes ever more dominated by the trade-investment-services nexus, the WTO may be increasingly sidelined when it comes to trade governance.

Third, the WTO's adjudication function is still working well, but any dispute settlement system must walk on two legs. The judges can connect the dots for particular cases, but the basic rules must be updated occasionally to match evolving realities. For example, the Appellate Body finds itself ruling on issues like "zeroing" where the negotiated consensus is disputed. If the basic rules applied by the Appellate Body are not updated, there is a serious danger that the judges will overreach themselves, basing decisions on previous decisions that were based on previous decisions. Similar challenges may arise when members ask the Appellate Body to rule on 21st century climate subsidies and taxes based on rules negotiated in the 1940s and last updated in 1994. The larger members may be tempted to take matters into their own hands, applying sanctions based on unilateral law, not multilateral law.

Finally, if the WTO becomes sufficiently sidelined, it may prove very difficult to successfully negotiate rule updates. Hereto, the GATT/WTO has always packaged rule-updating in Rounds that were driven primarily by trade-liberalization politics (juggernaut). If all the trade liberalizing action moves to the RTAs, WTO members will have to find a new way to negotiate rule updates.

Concluding Remarks

The rise of 21st century regionalism is not yet a disaster for the world trade system. It has kept trade liberalization and trade booming despite the WTO's slow progress. But the present course of events seems certain to undermine the WTO's centricity – RTAs will take over as the main *loci* of global trade governance. Without a reform that brings existing RTA disciplines under the WTO's aegis and makes it easier to develop new disciplines inside the WTO system, the RTA trend will continue, further eroding WTO centricity and possibly taking it beyond the tipping point where nations ignore WTO rules. This scenario runs the risk that global trade governance will drift back towards a 19th century Great Powers world. If the RTAs and their power asymmetries take over, there is a risk that the GATT/WTO would go down in future history books as a 70-year experiment in which world trade was rules-based instead of power-based. This trend should worry all world leaders. In the first half of the 19th century, attempts by incumbent Great Powers to impose rules on emerging powers smoothed the path to humanity's greatest follies – the two world wars. JS

Richard Baldwin has been professor of International Economics at the Graduate Institute, Geneva since 1991, policy director of CEPR since 2006, and editor-in-chief of Vox since he founded it in June 2007. He is advisor to many governments and international organizations, and author of numerous books and articles on trade, globalization and regionalism.