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DEFECTS IN THE CONCEPT OF REGIONALISM

TO SOLVE TRADING PROBLEMS

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of the Joint Committee on the Economic Report

Multilateralism, Nondiscrimination  
and the Most-Favored-Nations Clause

American foreign economic policy has always favored the principle of multilateral trade and nondiscrimination. Under the principles of multilateral trade, each country will buy its imports in the cheapest market and send its exports where it can get more for them. This evidently will maximize gains from trade for all participants.

This is closely related to the principle of nondiscrimination. In the area of tariff policy, nondiscrimination means that imports of any commodity should be taxed irrespective of where it comes from. These principles have been implemented by inserting so-called most-favored-nation clauses into all American trade agreements before and after the inception of the Reciprocal Trade Agreement policy in 1934. Under this clause no country can treat imports from the United States less favorable than imports from any other country.

Most-Favored-Nation Principle and Regional Blocs

Regional trading blocs violate the most-favored-nation principle because they do precisely what the most-favored nation clause forbids: under a regional trade arrangement imports into any member country from any other member country are treated more favorably than imports from the outsiders. Outsiders are discriminated in favor of insiders. The United States always

looked with disfavor upon any such discriminatory arrangements--for example, upon the British Reciprocal Preferences, a regime under which members of the British Commonwealth accord each other lower duties than are charged on imports from non-British countries.

#### Exceptions to the Rule of Nondiscrimination

Apart from such exceptions which were only suffered, there have always been others which were not only accepted as perfectly legitimate, but were even applauded or encouraged. The most important exception of this kind is the customs union.

#### Customs Unions vs. Preferential Tariff Arrangements

By a complete customs union we mean an arrangement whereby two or more countries eliminate tariff and other trade barriers between themselves entirely, and agree on a common tariff against the outside. A customs union constitutes a higher degree of discrimination against outsiders than a preferential tariff regime, because under the customs union imports from other members are entirely duty free as compared with imports from the outside; while under the preferential tariff regime, imports from other members pay only less (usually 20 or 30 per cent less) than imports from outside.

(Incomplete customs unions are customs unions under which imports from other members are not entirely duty free, but pay substantially reduced duties. Hence the difference between an incomplete customs union and a preferential regime is only one of degree.)

American official policy has been often criticized or even ridiculed for (a) approving and encouraging customs unions and (b) condemning tariff preferences. If tariff preferences are bad because they imply discrimination,

then a customs union should be worse because it implies a higher degree of discrimination. A 10 per cent preference is bad, a 50 per cent preference is worse, a 90 per cent preference still worse, but once it reaches 100 per cent as in the case of the customs union, the vice turns into a supreme virtue. Many economists and foreign negotiators at international conferences found it difficult to resist the temptation to point out this apparent contradiction. It can be shown, however, that a good case can be made on economic and political grounds for differentiating between customs unions and preferential tariff regimes.

Advantages of Customs Unions  
over Preferential Tariff Regimes

A customs union does away with all customs red tape, simplifies customs procedures, and creates a large free trade area between the members of the union. It is a general, once-for-all, across-the-board elimination of barriers, and therefore likely to be definitive and stable. On the other hand, a preferential tariff regime, as for example the one existing between the members of the British Commonwealth, is in its nature selective. It does not do away with red tape, but rather makes it worse, because differential tariff treatment makes it necessary to ascertain the origin of imports. (Suppose country A imports raw materials and semi-finished goods from B, and sells the finished product to C where it enjoys preferential treatment. How large must the value added in A be in order to be treated preferentially?)

Because preferences are not across-the-board, but selective, there is a strong tendency in each country to grant preferences only for those commodities, and to such an extent that the larger imports from the preferred area shut out cheaper imports from the outside and do not result in a net increase in total imports. In other words, preferences divert trade from cheaper to

more expensive sources of supply, but do not create a larger volume of trade. They are likely to be trade diverting, while a customs union will always be to some extent, possibly to a large extent, trade creating. To give an example, under such a regime European wheat importing countries will import less cheap wheat from the United States or Canada and more expensive wheat from France or Turkey. Such trade diversions are in the interest of light cost producers in preferred areas, but they do not benefit the consumer in the importing area, and they reduce government revenue in the importing country. Moreover, they do not hurt the competing producers in the importing country. This is, of course, the reason why selective duty reductions under preferential tariff regimes are rarely allowed to be trade creating. They are in most cases not steps in the direction of freer trade, but on the contrary are steps away from it; they make for a less favorable allocation of the world's productive resources because imports do not come from the cheapest sources available.

To summarize, the traditional American policy of favoring customs unions while objecting to preferential tariff arrangements is perfectly justified on economic grounds.

#### Customs Unions Rare and Unlikely

Customs unions are very rare occurrences. The only modern example is Benelux, the union between Belgium, the Netherlands and Luxembourg. It might also be mentioned that for those countries that have rigid exchange control, import quotas, state trading monopolies, and generally highly regimented and planned economies, a mere customs union would not accomplish very much. In order really to achieve the benefits of a larger economic area they would have

to modify not only their tariffs but also do away with exchange control (payments restrictions) and quotas. In that case, we may speak of economic unions and economic modification or integration.

There are two sets of reasons why customs unions and economic unions are so difficult to achieve. First, they face the same difficulties as free trade or freer trade. Since customs unions like free trade (although to a lesser extent) create trade and lead to a greater volume of international exchange of goods and services, they cannot help but hurt special interests. After formulation of a customs union in each country, export industries will have to expand while those industries in which other members of the group have a large comparative advantage will suffer. (There will always be a third group where larger imports from other members of the union will only shut out imports from the outside without increasing the total volume of trade. This trade diversion will not hurt any special interests, but by the same token, not benefit the community.) To the extent thus that a customs union creates trade, it runs into exactly the same kind of difficulties and may in the short-run be exactly as painful to special interests as freer trade in general.

Secondly, however, a customs union, economic union, or any regional trading bloc runs into a second type of difficulty over and above those which it shares with generally freer trade: it requires agreement on a common tariff, and in the case of economic unions, agreement on a common policy with respect to payments restrictions and possibly other phases of monetary and economic policy.

It follows from this that usually a customs union or economic union, or a regional trading arrangement that really does any good and constitutes a step towards freer trade between the countries concerned (and is not confined to useless and uneconomic trade diversion) is even harder to achieve than a general

nondiscriminatory reduction of trade barriers through the operation of the most-favored-nation clause. This is so because the regional solution, to the extent that it does any good at all, while stepping on as many toes of special interests as the nondiscriminatory, multilateral solution, requires in addition agreement on a common tariff and common economic policies which the multilateral solution does not.

There are, of course, occasionally special political forces powerful enough to overcome these difficulties. The German Follverein is a case in point. Another one is Benelux. When the time comes for reunification of East and West Germany we may be sure that economic difficulties will be swept away by national enthusiasm. But I doubt whether there is anywhere in the world a comparable situation.

#### What Should Be American Policy?

In view of all this, what should be the attitude of American policy? If any two or more countries really want to create a large free trade area in order to enjoy the same economic advantages which the United States derives from its large market, the United States could not, in good grace, object, although the creation of such a large trading bloc may--but by no means necessarily will--imply damage to American interests (not only damage to some special interests offset by benefits to others, but net damage to the United States as a whole).

On the other hand, it would be unwise for us to press other countries into discriminatory trading blocs. They are likely to be trade diverting instead of being trade creating. And let us not forget one thing: if, for example, we encourage Europe to adopt such policies, it will not only hurt us (without doing the Europeans much good except in the unlikely case that

they really proceed close to complete unification), but will also hurt other countries which can afford it much less than we because foreign trade for them is more important for them than for the United States. Japan, other Asian countries, and Latin American countries, for example, would be hurt by an exclusive regional trading bloc in Europe.

It will be much better for all concerned if we follow our traditional policy of general nondiscrimination and general lowering of tariffs and other trade barriers. Similarly, in the area of international payments the principle of general free convertibility as laid down in the charter for the International Monetary Fund should continue to guide U.S. Foreign Economic Policy. In the trade area, as well as in the payments area, great progress has been made. It would be a pity to give up or to de-emphasize the multi-lateral approach now when final success is near.

I would not deny that in Europe the policy of regional trade liberalization (implying though it does discrimination against the United States, Canada, Latin America, Japan, and others) has had some success, and has gone beyond trade diversion, creating additional trade between the European countries. Fortunately, however, the discrimination against the United States, Canada, Latin America, has become progressively less severe because restrictions on imports from dollar countries have been reduced and currencies have become more freely convertible. (Discrimination against Japan is, however, still strong in many parts of the world.) This is to be welcomed not only from our point of view, but also from the European standpoint.

Since the Europeans seem to be eager, on the whole, to go forward in this direction, it would be a mistake on our part to try to put the clock back. We should not induce them to increase discrimination against us, Latin America, Japan, etc., by making exclusive regional trade arrangements among themselves. What we should do is to encourage them to go forward on the way

towards nondiscriminatory freer trade. Tariff concessions under the extended reciprocal trade agreement policy would be a suitable measure of encouragement. Since European countries have reduced discrimination against us on their own initiative, with little or not encouragement on our part, they surely would move faster in that direction if they did receive some encouragement.

In other parts of the world where there has been some talk of regional trade groupings, conditions are much less favorable than in Europe. This is true of the Far East, of Latin America, and the Middle East. Compared with Europe, countries in those regions are much less homogeneous, less disciplined financially, and there exist sharper political cleavages than in Europe. All this makes regional trade arrangements practically unworkable.

Economic Problem of Japan  
Not Amenable to Regional Solution

To make the Japanese economy viable and stable is one of the most pressing problems. Japanese trade interests are world-wide. They do not fit into any regional arrangement. The problem must be solved on a global basis. Fortunately, progress has already been made. Japanese exports to this country as well as to other parts of the world have increased sharply. This creates difficulties to American as well as British competitors of Japanese products. But that cannot be helped unless we want her to seek trade outlets in China and Russia, and to cease buying cotton and coal from us. We should continue to try to induce other countries to accord most-favored-nation treatment to Japan. But the Asian regional bloc is politically unworkable, economically unsound, and would not solve the Japanese economic problem.



Regional Approach to  
Other Than Trade and Payments Problems

While I thus reach the conclusion that the regional approach to the problem of world trade and payments is economically and politically unsound, it does by no means follow that every economic problem must be solved on a literally global basis or by means of monster conferences. On the contrary, it is the supreme virtue of the most-favored-nation principle that trade negotiations can be bilateral or restricted to manageable groups without giving up the benefits of multilateral exchange.

Moreover, there are many special problems--fisheries, transportation, exchange of electric power, nuclear research, etc.--which can best be solved by a small group of interested countries. But the groups will usually not be the same; they will vary and overlap according to the nature of the problem.