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Diana Brand*

Regional Bloc Formation and World Trade

The grouping together of neighbouring countries to form free trade areas or economic and monetary unions currently constitutes a phenomenon occurring in all regions around the world. How far has the bloc-building process progressed? How will the development of world trade be affected by this process during the 1990s? How can companies respond to the developments in the global marketplace?

In recent years there has been a pronounced increase in the number of agreements among neighbouring countries to remove mutual trade barriers (cf. Table 1). This tendency towards regional bloc formation needs to be viewed against the background of the past trend in overall world trade. Since 1983, world trade has developed dramatically. During the decade as a whole, it grew in volume by 50%, with annual rates of increase running in the 6% to 9% range at times. Simultaneously, there has been an increase in international economic interdependence, for world trade has grown considerably more strongly than world production. As a consequence, competition on world markets has intensified.

Individual governments have a number of economic policy options available to respond to the internationalization of markets:[1]

Option 1: The government can accept the challenge presented by open markets.

Option 2: Economic policy can take refuge in protectionist practices.

Option 3: "National champions" can be specially nurtured by subsidizing individual companies or industries.

Option 4: Free trade areas can be formed which, because of the existence of a large internal market, respond to the intensification of competition by sealing themselves off, or which at least represent a potential threat to trade.

Although all four options are combined in practice, during the 1980s the bulk of the emphasis in economic policy tended to be placed on the second and third options. For a good example of intensified protectionism, one needs to look no further than the substantial increase in non-tariff trade barriers and in agricultural subsidies.[2] According to a GATT investigation, use of protectionist policies has continued to increase in the early 1990s. For example, the number of (officially recorded) antidumping measures almost doubled from 1990 to 1991; at the same time trading nations – especially the major trading powers – are showing less and less willingness to allow matters to be determined by the GATT arbitration tribunal.[3]

Bloc Formation Growing in Importance

During the 1990s, "Option 4", i.e. the formation of regional trading blocs, can be expected to join worldwide protectionism as an increasingly significant scenario in foreign trade policy. On the one hand, the GATT rules only allow members to group together into regional free trade zones if they pledge that the trade barriers facing third countries will not be increased. In practice, however, a check is not even made in most cases to see that the trade liberalization conforms to GATT regulations.[4]

The advantages one hopes to gain from trade areas consist firstly in the increased economic power flowing from the fact that a large internal market allows market potential to be more fully exploited and better use to be made of the benefits of specialization. Secondly, large

* Ifo-Institute for Economic Research, Munich, Germany.

[1] Cf. Wolfgang Kartte, in: Frankfurter Allgemeine Zeitung, 15th Feb. 1992, p. 13.

[2] The proportion of imports subject to non-tariff barriers increased by more than 20% between 1966 and 1986, but by almost 40% in Japan and by 160% in the EC. Agricultural subsidies rose by 80% in the USA in the 1980-85 period, by 60% in Canada and by 21% in Japan (cf. World Bank: World Development Report 1991).

[3] Cf. Financial Times, 18th March 1992.

[4] Cf. ibid.

blocs are more likely than individual countries to be able to assert their economic interests by using political means, one of the reasons for this being that gaining access to large blocs carries the promise of substantial profits. As long as the GATT rules are incapable of guaranteeing multilateral free trade, political power represents a crucial lever for trading partners wishing to assert their economic interests.

As far as the distribution of economic and political power is concerned, the European industrial countries were some way ahead for many years having acted as pioneers in establishing the EC as their economic bloc. If they wished to improve their own power positions in the struggle for market shares in world trade, the other trading regions had no choice in the longer run but to also join together to form blocs. In view of the trends now beginning to develop, it would appear appropriate to compare the situation with the process of corporate concentration. If two or more firms merge, they are initially able to gain a competitive advantage over their rivals. The latter, however, will increasingly respond by entering into their own mergers or other forms of collusion in a bid not to get left behind in the competitive struggle. The eventual outcome is a new form of competitive equilibrium in which only large corporations negotiate with one another.

From a purely economic point of view, there is no doubt that multilateral free trade is the best alternative of all. However, as long as this is unrealizable in political terms it might be a "second best" solution to at least remove trade barriers within regionally delineated economic zones. The economic criterion to determine whether the formation of such an economic bloc is ultimately positive or negative in its effect is whether the predominant role is played by trade creation or by trade diversion.

Assessment in Economic Terms

The danger that trade diversionary effects will be greater than those of trade creation is especially acute if trading blocs exploit their strong negotiating positions vis-à-vis third countries. The relatively strong power position of a trading bloc, both economically and politically, is based upon the following factors:

- ☐ the loss of efficiency resulting from an orientation to the domestic or internal market is considerably less for a trading bloc than it would be for a single country;
- ☐ a trading bloc is less reliant on imports from third countries and thus less vulnerable to retaliatory measures;
- ☐ a bloc can also influence the terms of trade in its own favour more easily than can individual countries.

Given this background situation in which the exploitation of power positions plays a major part, the fear is that the various blocs will increasingly try to fence themselves off from one another, with "Fortress Europe" being followed by "Fortress America" and "Fortress Asia".

As against that, proponents of trading blocs argue that regionalization is a necessary intermediate step along the road to expansion in world trade. In reality, however, that is

Table 1
Regional Bloc Formation on the Increase

America		Europe		Asia/Pacific	
1989:	US-Canadian free trade agreement	1985:	By 1992: Completion of the Common Market	1983:	CER (Australia, New Zealand)
1991:	NAFTA (USA, Canada, Mexico)	1991:	"European Economic Zone" (EC, EFTA)	1991:	By 2008: AFTA (ASEAN countries)
	By 1992: MCCA (Central American Common Market)		By 1999: EMU (Economic and Monetary Union)		Under discussion:
	By 1994: MERCOSUR customs union (Argentina, Brazil, Paraguay, Uruguay)		Associate agreements (Czechoslovakia, Hungary, Poland)		EAEC (ASEAN, China, Japan, Hong Kong, Indochina, Myanmar, North and South Korea, Taiwan, Vietnam)
	By 1994: Andes countries' customs union (Bolivia, Ecuador, Colombia, Peru, Venezuela)		Later new entrants (Austria, Finland, Sweden)		APEC (ASEAN, China, Japan, Hong Kong, South Korea, Taiwan, Australia, New Zealand, Canada, USA)
	By 1994: Free trade among the "group of three" (Mexico, Colombia, Venezuela)				
	By 1996: Mexico-Central America free trade area				

only the case if the formation of the trading blocs does not simultaneously involve discrimination against third countries. In the words of the world trade expert Jagdish Bhagwati, regional trade agreements "... are only (a) good and welcome (development) as long as a stable set of rules exists for world trade and third countries are effectively protected against discrimination" – a condition which might be cast in doubt in the light of the current crisis in the GATT negotiations.[5] Whenever any such discrimination does occur, it leads to a distortion in the structure of international trade and hence to inefficiency, as trade is no longer able to conform to the principle of comparative advantage. The proponents maintain that one reason why such discrimination would not develop is that industry lobbies would exert a sufficient degree of pressure to ensure that they will not have to give up the cost-saving opportunities offered to them by "global sourcing", or alternatively because they will demand that their respective domestic governments should press for greater opening of markets in third countries.[6] However, this line of argument fails to recognize that governments of the world trading powers in the past have been much less subject to the influence of industrial lobbies than to that of agricultural lobbies. As is generally known, the EC's agricultural protectionism has bound up too many productive resources in the agricultural sector, while Europe's industry has had to accept losses in its competitiveness relative to the USA and Japan.

The best way of determining whether there is justification in the fears that the formation of new trading blocs will cause trade diversion to predominate over trade creation is to make a comparison of the economic potential of the three main regions involved and then try to draw conclusions from the EC's experience for the future development of regions elsewhere in the world.

Comparison between Regions

The first feature which becomes apparent when comparing the three regions[7] is that Europe is in first place in terms both of per capita income and of foreign trade volume. Europe alone accounts for 48% of world trade. It is followed by the American continent and the Asian-Pacific Basin which account for 21% each. The volume of foreign trade accounts for almost 50% of the European gross domestic product, whereas in America the proportion is only 23%, and in the Asia/Pacific region 40%.

However, it would be a premature conclusion to interpret these figures as suggesting that Europe had not shut itself off from the rest of the world to any appreciable extent. One simple reason why Europe's proportion of foreign trade turns out so high is that the European countries are relatively small, making them naturally more dependent on foreign trade than others such as the USA or the People's Republic of China.

Table 2
Disproportionately Faster Growth in Internal Market Trade in Western Europe, 1980 - 1989
(average annual rates in %)

Trading region	GNP growth	Internal market trade	Trade with rest of the world
Western Europe (EC + EFTA)	2.3	8.3	5.0
North, Central and Latin America	2.7	6.1	5.7
South/East Asia (incl. Japan)	5.6	12.4	15.0

Sources: World Bank: World Development Report 1991; GATT: International Trade 89-90, Vol. II; own calculations.

If one looks rather more closely at foreign trade interdependence, it will also become clear that a far greater proportion of the trade carried out by European countries is intra-regional trade than is the case in America or the Asia/Pacific region. Over 70% of Western European trade takes place within the EC and EFTA zone. In America, on the other hand, only 47% of total foreign trade is intra-regional, and in the Asia/Pacific region only just under 43%. Although this approach to figures does not take account of the regions' different politico-geographical structures,[8] that ought at most to have a certain effect on the quantities involved while leaving the essence of these relative differences unaltered.[9]

It is economically quite plausible that intra-bloc trade should constitute the predominant part of world trade as a whole. The relatively low transport and communication costs between neighbouring countries mean that intra-regional trade tends to be more profitable than overseas

[5] Cf. Wirtschaftswoche, No. 13, 20th March 1992, p. 95.

[6] Cf., e.g., H. G. Hilpert: Wirtschaftliche Integration und Kooperation im asiatisch-pazifischen Raum, ifo Studien zur Japanforschung, No. 5, Munich 1992.

[7] The comparison between the three regions not only took account of existing free trade areas or customs unions, but also of the countries which appear likely in the short or medium term to join those blocs. The regions considered were: America (North, Central and Latin America), Europe (EC, EFTA, Czechoslovakia, Hungary, Poland), and the Asia/Pacific region (ASEAN, Japan, China, Hong Kong, South Korea, Taiwan, Australia, New Zealand).

[8] The USA's 50 states are counted as one single country for trade purposes.

[9] If every state in the USA were to be treated as a separate unit, it would then also be only correct to count China's provinces or Germany's *Länder* on the same basis.

trade. The removal of trade barriers within the EC undoubtedly goes a long way to explaining the relative significance of internal trade within Europe. However, the fact that three-quarters of all foreign trade is actually intra-regional also points to the conclusion that third countries are being discriminated against as the single market is perfected.

The suspicion is confirmed by a comparison of the trends in foreign trade in Western Europe (EC and EFTA) with those in the other trading regions (cf. Table 2). Economic growth, which also has a positive effect on the demand for imports from third countries and is thus one of the main advantages pointed out by proponents of bloc formation, was 2.3% per annum in Western Europe during the 1980s, or in other words was not higher than in competing regions at all. Trade within Western Europe, which grew at 8.3% per annum during the same period, expanded considerably more strongly than trade with the rest of the world. The latter grew by an annual rate of only 5%, which is a less rapid rate than for the growth of world trade in general (5.8%). In contrast, trade within the Americas grew at 6.1% per annum between 1980 and 1989 – a rate which was hardly any higher than that for the region's trade with other parts of the world. In South and East Asia (including Japan) the growth in trade with the rest of the world was actually almost 3 percentage points higher than that in intra-regional trade.

Apart from the large share taken up by trade within the common market, trends in the structure of foreign trade also suggest that trade diversion has been occurring as the EC's internal market has been built. During the last 30 years, the significance of raw materials and agricultural produce as part of world trade has been in decline while trade in industrial goods and especially in technologically highly sophisticated manufactured products has grown continuously.[10] Yet the structure of the EC's shares of world exports has been shifting in precisely the opposite direction. In the 1980s, EC countries increased their share of world exports (including exports to other EC countries and to third countries) in agricultural produce[11] by almost 10%, and in raw materials (excluding fuels)[12] by almost 6%. Both the USA and Japan were able to reduce those proportions during the same period. On the other hand, the EC's market share in the world trade in machinery and vehicles, which almost doubled in total during the 1980s, declined by 4%. These figures clearly show that the EC's protectionist foreign trade and agricultural market policies have prevented its export structure from keeping up with trends in world trade. The support given to the agricultural sector[13] and the artificial propping up of the raw materials, iron and steel sector – i. e. the measures taken to protect sectors which undoubtedly are not those where the European industrial countries have their comparative advantages – have obviously led to the creation of artificial comparative advantages. By revaluing EC countries' currencies and by creating allocative effects within the EC itself, these distortions of market forces have accelerated the loss of world market shares for industrial products.

It will be crucial to the future development of world trade whether the free trade areas which are currently under formation in America and Asia develop according to a similar pattern to what has already been seen in the EC. Another vital factor will be how the overall world economic framework is constituted during the 1990s.

Scenarios for the World Economy

The World Bank has developed two possible scenarios for the development of the world economy until the year 2000: the "baseline" scenario makes rather positive assumptions regarding external conditions (which chiefly include rapid economic recovery in the industrial countries), while those of the "downside" scenario include such negative factors as the failure of the Uruguay Round. If the baseline scenario is fulfilled, the real growth in world GDP will be just under 4% per annum averaged across the 1990s, and that in world trade will be 6%. The downside scenario, on the other hand, forecasts growth in world GDP of only 3.2% per annum and an annual increase in world trade of 4.5%. Thus if the GATT talks do come to a positive conclusion in all sectors, i. e. including agriculture, there could be an annual increase of just under $200 billion in the value of world trade up to the year 2000.[14] However, as the GATT negotiations drag their feet the more pessimistic of the two scenarios would currently appear to be the more likely to come about. The World Bank estimates that the welfare losses which a trade war among the three "triad powers" in the wake of a final breakdown in the GATT talks would trigger off would amount to 3-4% of the world GDP which could have been achieved if trade had been liberalized.

[10] The share of world trade (with services excluded) taken by industrial goods increased from 54% in 1965 to 73% in 1989. On the other hand, the share of agricultural goods fell by half from almost 20% in 1965 to 10% during the 1980s.

[11] Foodstuffs, drinks and tobacco (SITC 0, 1). Source: UN: 1988 International Trade Statistics Yearbook, Vol. 1, 1990; author's own calculations.

[12] SITC 2, 4.

[13] At just under DM 82 billion, the EC's agricultural subsidies in 1990 were higher than those of the USA (DM 36 bn) and Japan (DM 31 bn) put together.

[14] Cf. I. Goldin and D. van der Mensbrugghe: Trade Liberalisation: What's at Stake, OECD Development Centre 1992.

One problem with the World Bank's forecasts is that they do not take account of developments in Eastern Europe. In volume terms, however, Eastern Europe has not yet become particularly significant for world trade, as only 2.6% of the OECD countries' exports went to former members of the CMEA in 1989. Nor is there expected to be any rapid progress in integrating the Eastern European economies into the world economy within the next five years. It will take until the second half of this decade, at the earliest, before products from the former CMEA countries have reached a stage where they are competitive on the world market, and before significant extra demand comes from Eastern Europe.

The length of this process is also crucially dependent on the amount of progress made by the GATT negotiations, particularly with regard to key sectors such as textiles, coal, steel and agriculture. Another critical factor will be the future trade policy pursued by the EC towards the former CMEA countries. The agreements of association the EC entered into with Poland, Hungary and Czechoslovakia at the end of last year are unlikely to do much to alter the fact that these countries will continue to be adversely affected by EC protectionist policies for the next five to ten years.[15] The existing member countries of the EC made the completion of these agreements conditional upon adopting a slower pace of trade liberalization for certain "import-sensitive" items such as textiles and clothing, iron and steel, and on excluding agricultural trade completely from the liberalization.

Crowding Out of Interregional Trade

To summarize these considerations on the development of the world economy in one general forecast, it is appropriate to make the rather pessimistic basic assumptions that no substantial progress will be made by the Uruguay Round, that economic recovery in the industrial countries will be modest and that interest rates will remain high around the world as a result of financial uncertainty coupled with the tremendous requirement for capital in Eastern Europe.

As far as the consequences of bloc formation are concerned, our forecast assumes that the free trade blocs now planned in America and Asia will develop along similar lines to the EC.[16] The European example shows a continual increase in the share of the member countries' total exports taken up by intra-Community trade since the EC was established more than thirty years ago. If that same trend is extrapolated until the year 2000, only 30% of the EC's trade will then be left over for third countries. If one considers that the current share of intra-bloc trade in Asia (including the Pacific region) is something over 40% while in America it is almost 50%, that places the Asian region at an equivalent stage down the path to an internal market to that of the EC in 1960, and the American continent at that of the EC in 1970. During the 1960s and 1970s, the growth in world trade ran at an annual rate of just over 4%, which corresponds to the World Bank's downside scenario for the 1990s. Thus there is indeed some common ground in the overall economic conditions. If it is assumed that the internal markets in the American and Asian free trade areas in the 1990s will develop at a similar pace once trade barriers have been removed to that of the European bloc in the 1960s and 1970s, the share of total exports taken up by intra-bloc trade can be expected to have risen substantially to just under 50% in Asia and approximately 60% in America by the year 2000. Once all three trading

[15] Cf. Patrick Messerlin: Restrictions on OECD Imports from Eastern Europe, Institut d'Etudes Politiques de Paris, March 1992.

[16] There is nevertheless a difference in that these free trade areas will still have differing external tariffs from one country to another whereas the EC is a customs union with a common external tariff.

[17] Cf. H. G. Hilpert, op. cit.

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blocs are in a situation in which at least 50% of their trade is internal, trade between the three regions will be restricted to a minimum. In other words, the development can now be envisaged in which intra-regional trade will gradually crowd out world trade, though that does not necessarily mean that world trade would decline in absolute terms. What it does mean is that trade growth is likely to be concentrated chiefly within the major blocs. This scenario does not depend on the assumption that trade wars will necessarily break out between the regions, but any exacerbation of protectionism would of course accelerate the trend in this direction.

It is not at all a bold prediction to assume that the EC's internal trade within the single market will account for 70% of its total trade in 2000, for after all, that 70% proportion has already been attained today by the combined economic zone of the EC and EFTA. Apart from that, the EC 1992 programme is still not yet complete, and it will be followed by the effects of the Maastricht Treaty. The gradual move towards a common European currency will undoubtedly generate tremendous positive effects in respect of the development of intra-Community trade.

Economic Integration in Asia

There are also good reasons for the forecast increase in internal trade in the Asian region. Though it is relatively unlikely that political and economic antagonisms will allow Asian integration to proceed on the basis of the sort of political agreements which have shaped the EC or NAFTA,[17] the Asian countries can nevertheless be expected to make gradual progress on an informal but consensual basis towards integration. *De facto* integration will also take place in the course of time thanks to the increasing competitiveness of these countries relative to America and Europe.

Developments in recent years confirm the trend for a continual increase in trade within the Japan/South-East Asia region. Japan's exports to Malaysia, for example, rose by more than 38% last year, those to Taiwan by 18%, to South Korea by 15% and to Singapore by 14%, whereas the overall increase in Japanese exports was only 5%. Japan's trade with the rest of Asia exceeded that with the USA for the first time in 1991. Americans and Europeans are also playing a declining part in direct investment in South-East Asia. The four "tiger" countries of Hong Kong, South Korea, Taiwan and Singapore have already dislodged Europe and the USA from the top positions in the direct investment table in the ASEAN region, and in some cases Japan, too; there is every sign that this trend will continue during the 1990s.

A further indicator of the trend towards Asian economic integration is the development of foreign trade in those countries with a dominant Chinese population. Taken together, the trading conglomeration of the People's Republic of China, Hong Kong, Macao, Taiwan and Singapore – which might be defined as a "Greater Chinese trading bloc" – has a foreign trade volume comparable with that of Japan; its share of world trade in 1991 lay between 7% and 8%.[18] What might be termed Greater Chinese internal trade expanded strongly during the 1980s, and is much more substantial in volume than the internal trade among the "four little dragons" (Hong Kong, Taiwan, Singapore, South Korea) or among the ASEAN countries. In addition, there are clear signs of increasing interrelationships between the Chinese bloc and its "outer circle".[19]

Another factor which can be expected to be decisive in the development of intra-Asian trade is the fact that Japan is constantly expanding the division of labour between itself and its neighbouring countries. This process of interlinking trade in the Pacific Basin is described in Japan as the "flying wild geese" model.[20] This model places Japan at the head of a formation of imitating countries which, one after another, take up the world market positions which have first been given up by Japan. This development proceeds in conjunction with the product cycle, in which the leading economy always operates with the most modern technology, leaving those products which are already "played out" in technological terms to its less developed counterparts. The interrelationships the imitating countries now have with Japan in terms of trade, capital and technology mean that they are plugged into a development process which is allowing them to gradually close the gap between themselves and Japan at the head of the flock.

The "flying wild geese" model does not, of course, operate without friction, for the more developed countries only normally cede market positions to their imitators under the pressure of competition. However, a crucial element in the development of intra-regional trade is the fact that an awareness of this type of "horizontal division of labour" has now developed in South-East Asia which acts

[18] Cf. A. Gälli: Konturen eines großchinesischen Handelsblocks, in: ifo Schnelldienst, No. 8, 1992. According to Gälli's analysis, this "Greater Chinese" trading bloc is so significant that one even ought to count it as the fourth centre of gravity in the world economy besides Europe/EC, the USA and Japan.

[19] North and South Korea, the ASEAN countries, Vietnam, Mongolia (cf. A. Gälli, op. cit.).

[20] Cf. A. Ernst: Ursachen der Dynamik der asiatischen Pazifikstaaten, in: Japan-Analysen/Prognosen, No. 60/61, ifo-Institut, July 1991; see also H. G. Hilpert, op. cit.

to maintain the momentum of the development process in the region. However, a system of this kind harbours the danger of increasing discrimination against outsiders. That in turn further reinforces the probability that intra-Asian trade will become more significant than the region's trade with the rest of the world during the 1990s. If one takes into account that the combined purchasing power of the Asian countries on the western shores of the Pacific will exceed that of the USA some time in the 1990s, the dimensions of the intra-Asian trade which will by then have been built up become rather more clear.

Intra-bloc Trade on the American Continent

The main spur to growth in intra-bloc trade on the American continent is likely to be the implementation of the free trade agreement incorporating Canada, the USA and Mexico. Although it is true that intensive trading relations already exist within the NAFTA zone,[21] the exchange of goods and services among the three countries will continue to expand once trade barriers have been eliminated. Because of its wage cost advantage, Mexico's industry will specialize more in exports of relatively labour-intensive products. It is also likely that Mexico will be able to export more textiles and agricultural produce to North America in future. The USA will be able to increase its exports of relatively capital-intensive goods to Mexico, the main beneficiaries being the machine tool and engineering, chemical and plastics industries. According to a recent study, the net gain from NAFTA during the 1989-1995 period is likely to be a growth in exports of $16.7 billion for the USA and of $7.7 billion for Mexico.[22]

The free trade agreements which have been drawn up among countries south of Mexico will make an additional contribution to the increase in intra-bloc trade in the Americas during the 1990s. It is true that efforts to introduce free trade in Latin America have been underway for about 20 years, and that all such efforts to date have failed. Some degree of scepticism is also therefore called for with regard to the present-day free trade agreements such as MERCOSUR or the Andes Pact, especially in view of the differing levels of development among their member states.[23] Nevertheless, a factor making increasing Latin American integration more likely is the development, as in Asia, of an awareness that increased regional cooperation is just as essential as economic reform. All Latin American countries except Cuba have introduced market economic reforms for the 1990s, which include such measures as combating inflation, privatizing government enterprises and liberalizing foreign trade. According to the forecasts made in the Ifo Institute's "Economic Survey International" in October 1991, Latin America can be expected to develop into the second most dynamic growth region of the 1990s after the Asia/Pacific region. That trend will have a correspondingly stimulatory effect on intra-Latin American trade.

Bloc Expansion

One may summarize by making the following forecast for the development of world trade: As a result of economically determined mechanisms, intra-regional trade can be expected to expand during the 1990s within the three blocs consisting of Europe, America and the Asia/Pacific region. The laws of economics also imply that any free trade area which already exists will successively incorporate more and more neighbouring countries until such time as further expansion of the economic bloc is resisted by geographical constraints. Free trade blocs need this successive expansion to ensure that the horizontal division of labour within their own zones remains as effective as possible. For once the existing trading partners have all attained similar levels of development, they will no longer be able to specialize at different stages of the product cycle. Hence it is in the interest of the member countries of a free trade zone or customs union to seek new members and thus avoid unduly intense competition amongst themselves.

Once the three free trade blocs have grown to a large size they will not only have displaced inter-bloc by intra-bloc trade, but will also have tremendously increased their political power. That in turn will imply an ever-increasing likelihood of trade wars taking place between the three blocs.

Relevance for Business Strategies

The recommended action for companies in the light of these developments is an obvious one: particularly those which manufacture internationally tradable goods must endeavour to establish a presence in all three trading blocs, and not simply with trading agents but with manufacturing facilities of their own. The need to do this remains the same whether or not the trading blocs erect trade barriers against each other. For once the countries in such groupings join together in a single economic system

[21] No less then one third of the USA's exports already go to Canada and Mexico, and in Mexico's case over 70% of its total exports go to North America.

[22] G. Hufbauer and J. Schott: North American Free Trade: Issues and Recommendations, Institute for International Economics, Washington, D. C. 1992.

[23] Cf. Diana Brand: Freihandel in Lateinamerika – Ein erfolgversprechender Weg aus der Krise?, in: ifo Schnelldienst 20/91.

it will be profitable to undertake direct investment within the region in order to obtain a share of the benefits of a common market (such as the transport and data communications networks, technology transfer interdependencies, or common norms and standards). That is one of the reasons why the USA und Japan have given preference to direct investment in the EC rather than to increasing exports to the Community. For example, while the share of the USA's total exports of manufactures directed to Europe has remained steady at around 20% in recent years, direct investment in the EC has increased to such an extent that it accounted for 50% of the USA's total foreign direct investment in 1990.

The present decade holds the prospect of being one in which direct investment will have a crucial influence on the development and structure of the world economy. There has been a continuous increase in the flow of direct investment during the past ten years, with growth rates since the mid-1980s far in excess of those for world trade. Out of a world capital stock from foreign investment estimated at $1,500 billion, $200 billion was invested worldwide in 1989 alone. The growth in direct investment is particularly concentrated among the triad powers of the EC, USA and Japan, which between them are responsible for 80% of foreign direct investment around the world.[24]

As regards the structure of direct investment, readers will be aware of the asymmetrical relationship between Japan and the other two regions. To illustrate, direct investment in Japan from the EC amounts to less than one tenth of Japanese direct investment in the EC.

On the other hand, European industry is relatively well represented in North and Latin America. Particularly direct investment in Mexico has a major strategic significance now that the North American Free Trade Area is in the offing. This has been recognized by Japanese and South Korean automobile manufacturers, which plan to use Mexico as a base for producing the smaller models they wish to sell into the North American market. However, because the USA plans to counter these proposals by issuing local content requirements, the importance of having a presence in the North American market will grow ever greater in future.

Japan is regarded as a good example of how an export-oriented strategy is being replaced by one in which direct investment plays a central part. The aim of Japanese producers is to build up networks of regional, self-sustaining production centres in Europe, America and elsewhere in Asia. On the one hand, this is intended to secure access to all three regional markets while it will also provide Japanese multinationals with protection against the risk of losing sales due to greater protectionism in the EC or the USA. The network of production facilities being established by Japanese companies in neighbouring Asian countries serves three complementary purposes: firstly, it is intended to gain market shares in the countries concerned; secondly, more finished products are to be exported from them to the USA and Europe; and thirdly, they are to be used to supply cheap components to Japanese subsidiaries in Europe and America.

Thus Japan's example shows how a regional strategy can be most effectively combined with a global strategy. In view of the competitive advantage Japanese producers have established for themselves by means of this strategy, European and American producers can be expected to be forced to adopt a similar approach. That would entail North American business having to invest a greater amount of capital in the low-wage countries of South America while EC countries would have to establish production facilities in Eastern Europe and North Africa; following the principle of horizontal division of labour, the plants in outlying countries would be used to supply cheap components to the parent companies at home. Recent trends in direct investment show that regional networks of this type are indeed now being established.[25] However, such supranational division of labour oriented to different contributions to value-added harbours the danger that outsiders which are not integrated into the regional system will be closed out by high market barriers. That will accelerate the tendency for world trade to be displaced by regional trade.

Strategic Alliances

In addition to devoting resources to direct investment, European companies can also be recommended to enter into more alliances with foreign companies in the competing regions, whether in the form of agreements, shareholdings or mergers. One of the main advantages of these forms of cooperation with local companies is that they make it easier to gain access to the local market or reduce the risks involved in developing and manufacturing new products.[26] An increase in the number of such alliances between companies belonging to different trading blocs would also have the advantage of reducing the likelihood of protectionist action being taken. For the more international ties exist between different companies, the more difficult it becomes to identify any particular product's country of origin, and hence to enforce local content regulations.

[24] Cf. United Nations: World Investment Report 1991.

[25] Cf. ibid.

[26] Cf. A. Jaquemin: Stratégies d'entreprise et politique de la concurrence dans le Marché Unique Européen, in: Revue d'Economie Industrielle, No. 57, 3/1991.