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The new minilateralism and developing countries

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Nº 208

"THE NEW MINILATERALISM AND
DEVELOPING COUNTRIES"¹

Winston Fritsch

¹ Paper presented at the meeting "More Free Trade Areas? A Conference on the Outlook for World Trade Policy", organized by the Institute for International Economics, Washington, D.C., October 31 - November 1, 1988. The author would like to thank Marcelo de P. Abreu, Sam Laird, Jeffrey Schott and John Whalley for their comments on an early outline of this paper as well as the research assistance provided by Eduardo Pimentel Serra. The usual caveats apply. The reader is reminded that this is a preliminary draft, not to be quoted.

After decades consistently following the outright defense of the MFN clause and the multilateral approach defined under the influence of Cordell Hull as a reaction to the disintegration of the world trade system in the mid-thirties and strengthened under the GATT, the US has over the past few years progressively drifted to a more aggressive bilateral stand in trade policy². Examples such as the negotiations relating to temperate agriculture, competition in global oligopolies and VERs, the new GSP reciprocity and so on could be multiplied to illustrate this point.

An important aspect of this recent drift has been the fading away of the strong American skepticism about her gains with the proliferation of preferential arrangements and regional trading groups, which had been a crucial motive to American

² For a brief scholarly presentation of the history of the US position on these issues, see Diebold, Jr. (1988). A good review of recent trends is to be found in Jackson (1987), pp 377-384.

conversion to multilateralism during the Depression and strongly held until well into the seventies. This eventually culminated with the implementation by the US of discriminatory free trade areas for the Caribbean basin and Israel, the FTA provision of the 1984 Trade Act and, more recently, the conclusion of a far reaching free trade agreement with Canada. While the initiatives towards the smaller trading partners were clearly motivated by restricted geopolitical reasons, the latter has more profound global implications.

Generally stated, the motivation for this recent move of the trade policy of the two North American industrial countries towards a bilateral deal stemmed from a combination of a pair of common feelings. On the one hand, there were discontent and frustration with inherent features of the GATT trade liberalization process - especially the free-rider and the least-common-denominator or "convoy" problems². On the other hand, there was the perception that there were advantages in escaping the constraints imposed on the scope and depth of the negotiations by the MFN clause and a multilaterally negotiated agenda⁴.

In the case of Canada - which was, in fact, the demandeur of the agreement - this move was basically an isolated initiative justified by the overwhelming importance of her Southern neighbour in Canadian trade. In the case of the US, however, it also

² These are discussed in the paper prepared by Paul Wonnacott and Mark Lutz for the conference.

⁴ Whalley (1988), p 175.

reflects the broader trend towards bi or minilateralism in American trade policy referred to above. Thus, it should come as no surprise that the political momentum generated by the very success of the FTA negotiation with Canada would prompt US government officials to rescue the old notion that the enlargement of an US-centered FTA could provide an alternative - though admittedly second best and non exclusive - to the GATT liberalization process⁵. As recently stated by James Baker: "If possible, we hope...liberalization will occur in the Uruguay Round. If not we might be willing to explore a 'market liberalization club' approach, through minilateral arrangements or a series of bilateral agreements. In this fashion, North America can build steady momentum for more open and efficient markets."⁶. More specifically, the US government has initiated informal follow on contacts in this direction with East Asian countries, including Japan⁷.

The consequences of these recent trends to developing countries - both in terms of the opportunities open as well as through the systemic impact of an outright US support to minilateralism - have not yet been fully analysed and this piece is a very preliminary and exploratory attempt in this direction. The paper is to be divided in three sections besides this introduction. The first briefly discusses the trade and welfare gains accruing to small countries when forming a FTA with a large

⁵ For the classic presentation of this view, see Camps & Diebold, Jr. (1983).

⁶ Baker (1988), p 41.

⁷ Idem.

trade partner and whether comprehensive agreements covering a substantial portion of trade between the US and individual developing countries are likely to occur. The second addresses the systemic consequences of the new minilateral initiative in US policy from a developing country perspective. Finally, a third section summarizes the main conclusions.

Developing country gains from free trade with the US

It is almost forty years since the fallacy of the notion that there were sure trade and welfare gains to be reaped even in the restricted liberalization implied by the formation of minilateral free trade arrangements was challenged independently by Viner and Byé by noting that the relevant effects should consider the impact on trade flows with all partners^a. In more general terms, this is simply a corollary of the general theorem of the second best in the sense that in a world in which free trade is restricted, the elimination of one or a subset of trade constraints does not necessarily leads to a superior situation.

As shown by Viner, the formation of the FTA, besides allowing the substitution of cheaper imports from the preferential trade partner for the output of inefficient domestic producers (trade creation effect), can also displace previously cheaper

^a See Viner (1950) and Byé (1950).

imports from sources outside the FTA (trade diversion effects). Since then, although the Vinerian analytical framework has been extended to cover consumption and other effects, the basic policy proposition has not been proven false on purely economic grounds, except under abstract and wholly unrealistic situations⁹. In fact, the multilateralist policy conclusions were strengthened by the proof that the formation of preferential free trade areas is certainly a second-best alternative when compared to a non-preferential, multilateral, tariff cut¹⁰.

Of course, this is not the place for even a selective review of the theory of free trade areas¹¹. Suffice it to say here that difficulties in making unambiguous a priori statements in the normative analysis of free trade areas immensely increases with the variety of assumptions made about such features as the size, complementarity, production and transportation costs and the degree of protection in the relevant countries. Thus, given the great heterogeneity of the very large group of developing countries, to assess the consequence of joining a FTA with the US for "LDCs" is no mean task. Some basic insights could, nevertheless, be provided by bringing into the analysis some stylized facts concerning relative size, the commodity and country

⁹ See, for instance, Kemp & Wan (1976). Analyses introducing non-economic objectives are discussed in the following section.

¹⁰ Cooper & Massel (1965).

¹¹ For the full classical conventional partial equilibrium analysis of static effects, including those on consumption and the terms of trade, accompanying commercial integration the reader is referred to Johnson (1962), Chapter 3. An updated discussion of the economics of free trade areas is provided in the paper prepared by Wonnacott and Lutz for the conference.

patterns of trade and the height and structure of protection in a representative LDC and in the US.

Let us start with a first approximation stemming from the very general proposition derived from the conventional analysis of commercial integration. Ignoring terms of trade changes following integration stemming from differences in size, from the standpoint of a particular country considering to form a FTA with the US, the net static trade effect is likely to be greater:

(i) the greater the degree of protection in the US against her before the formation of the FTA (i.e., the more competitive she is with the US), and the greater the importance of the US as a market for her exports;

(ii) the more efficient the US is as compared with third suppliers. This is very important for, as the height of protection in developing countries is generally substantial, US relative inefficiency can be the source of non-negligible trade diversion effects.

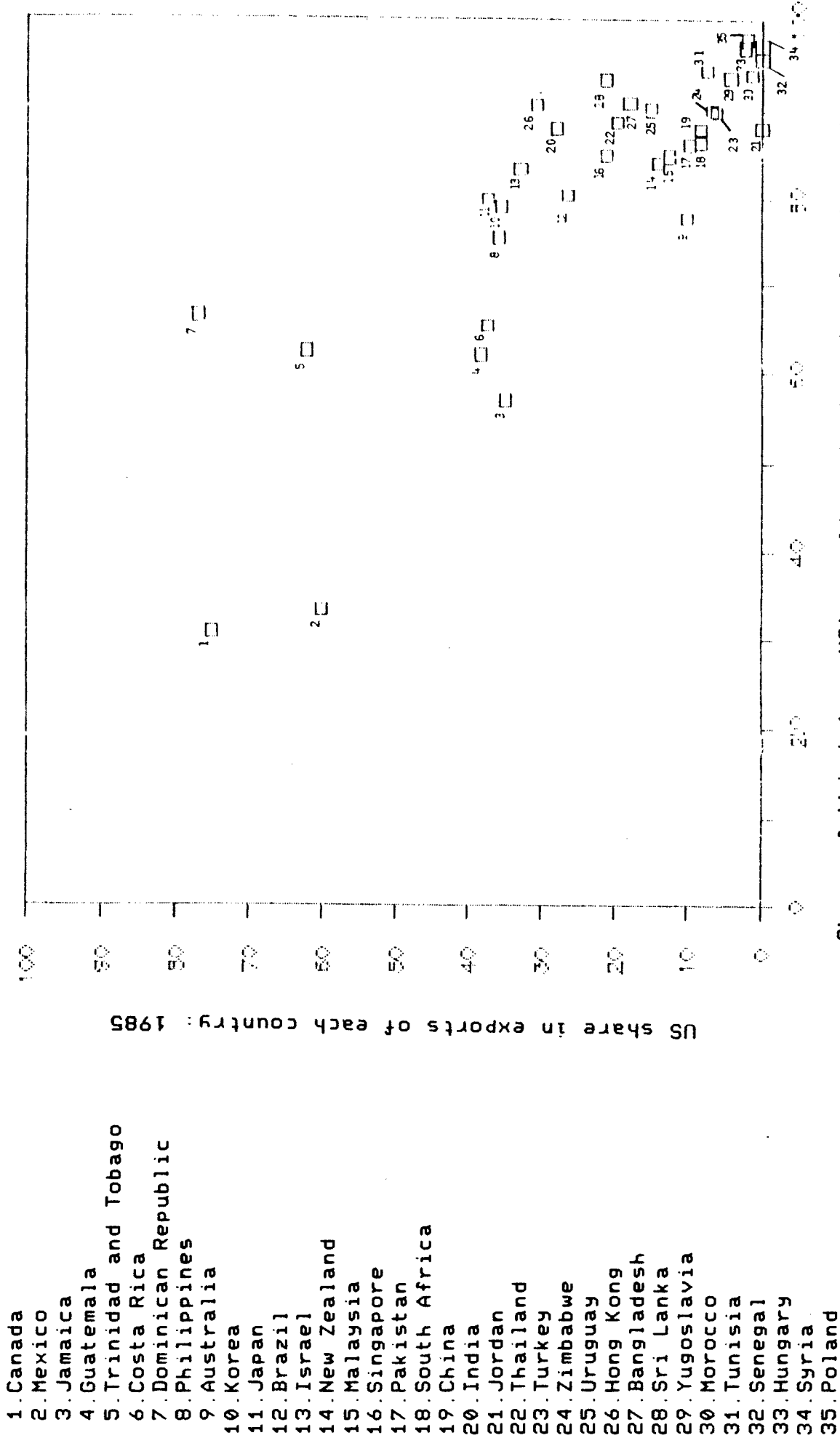
On the basis of this a priori reasoning - and with a strong but provisional caveat for ignoring complications stemming from differences in relative country sizes, the existence of selective non-tariff barriers in the US, the domestic distributive effects of liberalization in highly protected developing countries as well as other possible determinants of gains from integration, whose practical importance will be discussed below - a rough rule to assess which developing countries are likely to be attracted to

form a FTA with the US can be devised based on purely static economic gains according to conventional trade theory. Countries likely to benefit should (i) export a reasonably large proportion of manufactures, (ii) have the US as an important market for its exports, and (iii) buy a relatively large share of its imports in the US, thus indicating a high American competitiveness among her suppliers.

Selecting a sample of developing exporters of manufactures and calculating the weight of the US in the trade of each of the members of the sample can provide, therefore, a neat way of identifying likely gainers from commercial integration with the US based on the rough criteria presented above. The result of such an exercise is shown in Chart 1, below, a scatter diagram of ordered pairs of the share of the US in the exports of each country from a sample of LDCs, and the share of third, i.e. non-US, suppliers in the imports of each of these countries. The sample includes all World Bank developing members with over US\$ 500 million of exports and at least 20% of manufactures in total exports in 1985¹². It can be seen that the number of developing countries having both a reasonable degree of competitiveness and substantial trade with the US is very limited, being restricted to a group including Mexico and a few Caribbean countries.

¹² Australia, Canada, Japan and New Zealand are also shown as references.

CHART 1



Share of third (non-US) suppliers in imports of each country: 1985

Note: For sampling criteria, see text.

Source: IMF, Direction of Trade Statistics.

The notion that incentives for commercial integration are likely to be low, as suggested by the rough general analysis made above, is reinforced by bringing into the analysis some basic stylized facts relating to trade regimes in the US and in the South, considerations relating to the irrelevance of the American tariff relative to the recent wild fluctuations of dollar real effective exchange rates and, last but not least, the implications of the huge difference in size between the US and the representative LDC for adjustment costs in the latter.

Consider first the complications posed by some specific features of the American structure of protection to the creation of incentives for developing countries to join in a FTA. A first and fundamental problem will be how to discriminate in favour of partners which are already entitled to some preferential margins by virtue either of the US GSP, which grants duty free treatment to eligible products or of special and more comprehensive agreements in terms of product coverage as the CBI. This could be done either by withdrawing the GSP offer from all non-participating LDCs, or by selectively enlarging it to the participating countries, increasing the number of eligible products so as to include products of export interest to them. However, while the former alternative seems unthinkable in terms of foreign policy, the latter is bound to face great domestic political resistance as GSP exclusion not unfrequently reflects the opposition of US producers to duty free treatment. In fact, the enlargement of the GSP offer towards import sensitive products is likely to be limited even in the case of very small LDCs as the

experience of the CBI - which excludes, among other products, MFA products and shoes - clearly demonstrates. This difficulty would also apply to the abolition or reduction of VER quotas and insurance against arbitrary and protectionist LFV actions, issues which - as the greatest single source of bilateral trade conflicts between the US and the larger, semi-industrialized, developing countries - could otherwise provide an important additional inducement for these countries to negotiate bilateral liberalization arrangements.

A second aspect to be considered is that in a world of wildly fluctuating real exchange rates between key currencies and very low tariffs in the OECD countries small economies, enjoying greater independence in the choice of their exchange rate regimes, may reap far greater positive trade effects by belonging to a depreciating-currency area than by joining its issuing nation's customs area through a FTA. Thus, while the current US external disequilibrium and recurrent pressures on the dollar persist, developing countries can look at pegging its exchange rate to the dollar as an unilateral way of having the benefits of trade diversion against non-dollar area competitors in US markets without any of the reciprocal ties imposed by a FTA agreement. This alternative course of action has, of course, different domestic macroeconomic consequences from creating a FTA with the US, but for countries traditionally tied to the dollar and which are likely to remain so - such as, for instance, those of Latin America - this is an irrelevant consideration.

The crucial point about both the limited gains developing countries are likely to derive from forming a FTA with the US and the sub-optimality of this policy alternative relates, however, to the size difference between the trade partners and the former's willingness to liberalize. The essence of this basic point is that, from the standpoint of a small developing country, entering into a FTA with a large and open country as the US which is comprehensive in terms of product coverage - as demanded by GATT's Article XXIV - is tantamount to trade liberalization¹². If we also make the reasonable assumptions that large differences in resource endowments exist between the US and the developing country and that there are high trade barriers in the latter, it is natural to conclude that, according to orthodox theory, free trade with the US will lead to a large reallocation of resources in the small partner and, therefore, give it an opportunity to reap substantial static gains.

The political answer to that opportunity in each case will, of course, depend on beliefs held by the relevant domestic actors in the developing country as to the benefits of trade liberalization and their assessment of the political costs of the sizeable adjustment involved in the change in the trade regime. The interesting point to note, however, is that (i) if they tend to favour the maintenance of a restrictive trade regime the proposal of a FTA is, ex-hypothesi, a non-starter, while (ii) if,

¹² Given the huge difference in size between the US and the representative LDC, when tariff barriers fall, the latter's relative prices are likely to adjust fully to those of the US.

on the other hand, they are willing to liberalize they should in fact do so on an MFN basis so as to avoid the negative trade diversion effects of the formation of a FTA with the US, a conclusion which can be reached much on the lines of the arguments presented in Cooper and Massel's classic paper referred to above against the alleged second-best properties of a customs union. Thus, in none of these two possible assumptions as to the domestic propensity to liberalize is the formation of a FTA with the US to be considered an optimum policy choice. One should also note that fears of retaliation from third partners are obviously likely to loom large in the decision of whether to form a FTA in those small countries which, besides imposing high trade barriers, do not buy an extremely high proportion of their imports in the US, as the vast majority of developing countries¹⁴.

The preceding analysis of the benefits and costs of adjustment to developing countries in forming a FTA with the US leads to the conclusion that because economic incentives are likely to be small, the number of such agreements is bound to be very limited. Nevertheless, two objections could still be levied against such conclusion.

The first is the usual point that static benefits or losses implied in conventional analysis are low in relation to possible "dynamic" gains¹⁵. Among these, the most often quoted in

¹⁴ This last point could also be seen as a strong additional disincentive to the formation of an FTA with the US for countries lying too far to the right in the diagram shown in Chart 1.

¹⁵ The term is attributed to Balassa (1962) and usually implied to cover gains resulting from the impact of commercial integration on growth rates of participating countries through the operation of a large variety of rather unrelated effects on efficiency at

the discussion of free trade between partners of widely different size are the scale economies allowed to firms located in the smaller partner by the increased size of the common market after integration occurs. It should be stressed, however, that for the great majority of developing countries such gains are purely notional. Not only scale economies do not usually prevail in a large number of labour intensive industries but, more importantly, supply constraints and/or uncertainty as to the stability of the preferential arrangement are likely to more than outweigh the positive effects of potential economies of scale, as the fiasco of the GSP as an instrument for industrialization abundantly shows.

The second and more substantial argument draws on effects stemming from the consideration of intra-industry trade and direct investment flows, not captured by conventional theoretical analysis. The basic point about intra-industry trade is that, if strong product differentiation and economies of scale at the firm level prevail, the distributive losses arising from trade liberalization are likely to be dampened by positive consumption effects generated by the availability of a wider range of products the greater the existing degree of trade overlap, given trade partners' factor endowments¹⁴. Although the net effect is likely to become negative the greater the difference in trade partners' factor endowments, this result seems to provide a strong rationale for attempts at integration on a single industry basis or across a limited range of products.

the firm or industry level. For a review of these effects, see El-Agraa (1988, pp 26 ff).

¹⁴ See Krugman (1981).

Of course, agreements which do not cover "substantially all trade" between the contracting parties are not allowed under GATT's Article XXIV. However, deals patterned on the old US-Canada "auto-pact" - which provides a clear example of the kind of agreement referred to above - can be replicated in certain instances. Such restricted agreements may happen not only because, as suggested above, they seem more attractive to the representative developing country than comprehensive deals, but also because in the context of the present trend in US trade policy towards bilateralism and "new reciprocity"¹⁷ they should look natural from the American standpoint, even if not entirely in conformity with Article XXIV.

This tendency for integration within a limited range of products also seems to be reinforced - though not necessarily on a strict intra-industry basis - by the consequences of worldwide sourcing and the globalization of industrial activity within multinational firms. Examples of special provisions in US and host countries' trade laws to facilitate sectoral or vertical integration in processing abound and their ad-hoc amplification in the context of bilateral agreements - such as the so-called "super 807s" (free access beyond quotas for products manufactured with US materials) allowed in the CBI - has occurred. Indeed, there is evidence that the importance of intra-firm trade in FTAs is growing¹⁸. Thus, in predicting the reactions of small countries to

¹⁷ Cline (1982).

¹⁸ Dunning (1982, p 430).

the offer of a FTA with the US account should be taken of the perceived effects of free trade on their locational advantages as recipients of FDI flows.

The preceding few paragraphs clearly show that the complexity of the analysis increases sharply as the focus is narrowed to take into account existing institutional realities. This suggests that to make any organised discussion about the likely response of "LDCs" to the present US drive towards the formation of FTAs one should try and divide the large number of developing countries into relatively homogeneous groups according to certain key features. A first aspect to be noted is that, given current trade patterns, the regions of greatest interest from the US perspective are the Pacific rim and Latin America and the Caribbean. It would seem that the 50-odd ACP countries - with the exception of a few Caribbean countries - as well as the so-called Mediterranean countries have such wild options in trade policy as a FTA with the US entirely blocked by their traditional dependence on the EEC preferential umbrella, while specialised oil exporters have very little to gain from free trade under the present structure of protection in the US. As the developing countries in the Pacific basin are the object of detailed treatment in other papers to be presented at the conference, it may be useful to briefly discuss the Latin American and Caribbean case so as to illustrate some of the general points made above.

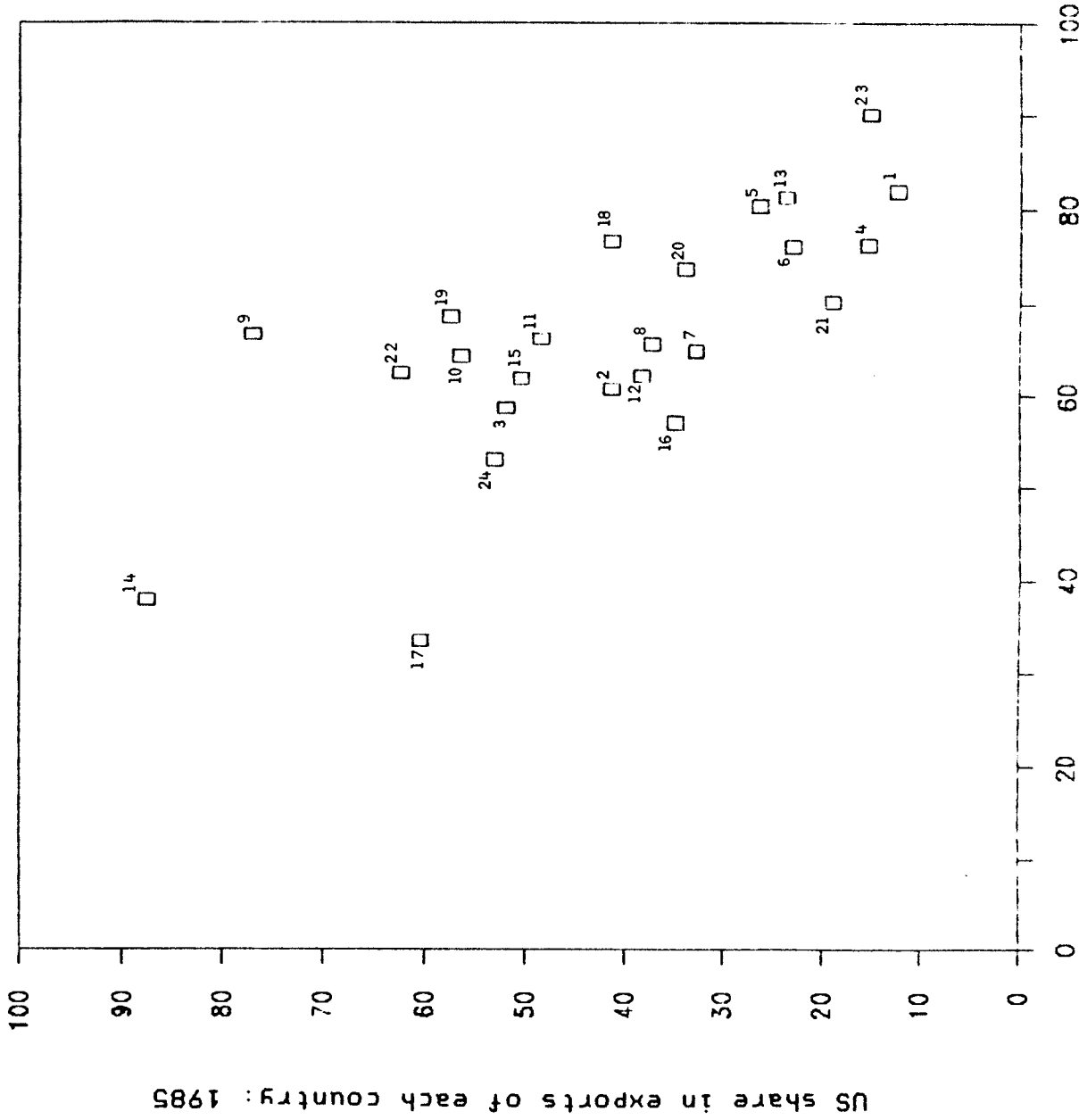
This large group of countries could be divided for analytical purposes into four main subgroups, namely: (i) the

countries of South America, (ii) Mexico, (iii) the CBI economies and (iv) the other small countries in Central America and the Caribbean with the obvious exception of Cuba and Nicaragua.

Although a reasonably heterogeneous group themselves, the South American countries have in common a smaller dependence on US markets and supplies than the rest of Western Hemisphere countries. This greater geographical diversification of South America's trade pattern can be easily glanced in Chart 2 below where, except for oil producing Ecuador and Venezuela, all the countries of the continent cluster in the southeastern corner.

Together with the high level of protection usually prevailing in South America, its diversified trade pattern would seem to indicate, as suggested above, reduced incentives to free trade with the US. Moreover, the severe balance of payments difficulties presently faced by the larger semi-industrialized countries in the region as a consequence of their high levels of foreign debt mean that, given the bleak current prospects for capital inflows, far reaching liberalization attempts as implied by free trade with the US are almost certain to backslide, thus creating severe problems of credibility from the US standpoint.

CHART 2



Share of third (non-US) suppliers in imports of each country: 1985

Note: The sample includes all Western Hemisphere countries (IMF definition) with exports to the US valued at over US\$ 100 million in 1985.

The case of Mexico - to be discussed in greater depth in another paper at the conference - has great similarities with that of the other semi-industrialized Latin American economies. Its peculiarity stems from the fact that the country's trade flows are much more heavily geared to the US than in the case of the latter, as can be seen in Chart 2. In this sense, the Mexican case provides a graphic illustration of the quasi equivalence of forming a FTA with the US and fully fledged trade liberalization. Predicting the chances of a comprehensive Mexico-US free trade agreement depends, therefore, on predicting the result of the inevitable political confrontation over the design of trade policy between the traditionally cautious Mexican stance regarding liberalization¹⁹ and the views of the apparently more liberal technocracy emerging within the ranks of the Partido Revolucionario Institucional.

It is unlikely that something as radical as a FTA with the US shall be sought by the Mexican government in the foreseeable future. However, as in all indebted countries, the feasibility - and, thus, the likelihood - of any liberalization attempt is crucially dependent upon the availability of financial accommodation, a variable entirely outside the Mexican

¹⁹ The following statement by Victor Urquidi, the former president of the International Economic Association, on the possible consequences of a comprehensive FTA between the three North American economies upon Mexican industry can be taken as representative of the view held by large sectors of Mexican opinion: "the mere notion that Mexico, from a weaker economic position than the other two, should open its tariff border, would mean the rapid demise of most of Mexican manufacturing industry, before it even had a chance to start making inroads - if it could - into the US and Canadian markets.". Urquidi (1986).

authorities' control. In any event, the momentum provided for the current American government drive towards integration, the crucial dependence of Mexican economic performance on export growth and, last but not least, the strategic importance Mexico holds for the US, may be instrumental in helping to shape additional, sectorally limited, forms of commercial as well as industrial integration which could serve as a nucleus for more ambitious initiatives in the future.

Finally, it remains to consider groups (iii) and (iv) formed by the small Central American and Caribbean primary exporters, with few exceptions heavily dependent on the US market as can be gauged by looking at the position of the subset of countries belonging to this group in Chart 2. The position of CBI countries - among which the main suppliers of non-oil exports are the Dominican Republic, Costa Rica, Guatemala, Honduras and El Salvador - is rather unique, and it is very unlikely that they could be enticed to give something for nothing and form a FTA with the US before the CBERA expires in 1996. In relation to group (iv) an important change in the export outlook of a number of ACP countries in the Caribbean is likely to take place in 1992 with the end of the substantial benefits now derived by these countries from export subsidies and guaranteed quotas in sugar and bananas granted by the EEC^{R*}. As combined current exports of these two staples are 50% above manufactured exports in those countries^{R¹}

^{R*} I thank Paul Meo for a note drawing my attention to this point.

^{R¹} World Bank (1988, p 18).

this may turn the management of US sugar quotas and guaranteed access to banana exports from these countries to the American market into an important element in bilateral trade negotiations. Together with the generalization of some concessions now granted to the CBI in trade in manufactures, they could prove important bargaining chips in reciprocal liberalization deals if the US were at all interested in investing in such negotiations with this large number of very small economies. The inevitable consequence, of course, would be the erosion of preferences now enjoyed by the CBI.

Systemic effects of minilateralism and the developing countries

Although the systemic consequences of the new US drive towards the formation of FTAs is certainly to be addressed at greater length by other papers presented at this conference it may nevertheless be apt to consider some of these from the specific developing country perspective.

A first point to note regarding the new US alternative strategy towards trade negotiations is that the negotiating procedures implicit in the sequential process of widening the group of free trading nations around the US have a fundamental difference with those of the GATT in terms of the incentives to negotiate: minilateral enlargement through FTAs avoids the free rider problem^{RR}. This has crucial implications for LDCs, since

^{RR} See Cooper (1985) for a discussion.

joining the club implies de facto abandonment of S&D - whose legal umbrella provides perhaps the single most important incentive for the vast majority of developing countries to be in the GATT - in dealings with fellow members.

A second aspect of general importance to developing countries is that it is very unlikely that agreements of the scope of US-Canada FTA could be negotiated with any significant number of them. If they occur at all, they should most likely, as suggested in the preceding section, be restricted to non-comprehensive, sectorally selective agreements tailored to the characteristics of individual US developing trade partners²². In any case, the number of prospective developing partners will be small both because the US will have to offer selective treatment in NTBs so as to make the agreements attractive, as well as because negotiating problems would increase exponentially with the number of countries. Of course, even a small number of such arrangements may prove to be a strong irritant in US foreign economic relations with those being discriminated against especially if individual beneficiaries are relatively large developing countries. However, the very existence of these restrictions upon the number of likely developing club members would seem to indicate that, as far as LDC membership is concerned, systemic implications of the new bilateral US approach will be small and certainly not strong enough as to erode MFN or jeopardize the GATT as a relevant forum.

²² For a similar view, see Katz (1988, p 178).

It should be stressed though, that there are strong asymmetries in the global trade impact of the creation of an US FTA with large and small countries. Indeed, the analysis of systemic effects should take into account that the formation of US FTAs with large third parties affects the prospective gains to be reaped by a particular developing country in forming FTAs with the members of the new free trading club. This change may be considerable in the event of the US forming a free trade bloc with a third party which is also an important trade partner of the developing country in question. Such "domino effect" can be easily illustrated with the help of the diagrams used in the preceding section. In the situation just described, the developing country would move substantially "northwestwards" in the charts if a US-third party bloc is substituted for the US as the developing country partner, thus indicating increased potential gains from joining the larger FTA.

A scenario like this is not an abstract possibility. It could well materialise in the event of the formation of a US-Japan FTA as recently hinted as a possible objective by American government officials in the highest authority^{e4}. In that case, a priori prospective gains of countries such as ASEAN members or Korea, which are also substantial trade partners of Japan, are

^{e4} As declared by the Treasury Secretary in connection to the possibility of follow-up agreements to the US-Canada FTA, "Ambassador Yeutter has reported that there are voices in other nations - including Japan, South Korea, Taiwan and some of the nations of the ASEAN - that have indicated that they do not wish to be left behind". Baker (1988), p 41.

likely to rise. In a situation in which the high expectations in relation to the benefits of GSP have clearly given way to worries as to long run market access for manufactures in the US among the relatively more advanced developing economies of East Asia, the inducements to join such FTA should become dominant.

The formation of a discriminatory Pacific free trading club around an US-Japan FTA (which could eventually include Australia and New Zealand) may have a not negligible impact on ways different groups of developing countries fit into and behave towards the trading system. A crucial determinant of this impact will be the way the European Communities react to the weakening of multilateral discipline against discrimination implicit in such a scenario. One should keep in mind that from the creation of the present system and throughout the post-war era it was the US which most consistently and actively (although not always successfully) countervailed the atavic tendencies of former European colonial powers to rebuild her network of preferential ties²⁵. In this sense, an active shift in US policy towards granting discriminatory preferences to a relatively large number of developing countries in the Pacific rim, which could be possibly enlarged as to include Mexico and further Central American and Caribbean countries, would represent a marked departure from America's traditional stance on a crucial aspect of multilateral trade policy which may weaken the European restraint to discriminate.

²⁵ For a brief but enlightening analysis of these developments, see Murray (1977).

This latter possibility has worrying implications for the position of many developing countries in the system. In a situation in which protectionist feelings in Europe seem to be on the increase under the pressure from adjustments to a weaker dollar and 1992 superimposed on high structural unemployment, they could lead to pressures for the widening of existing preferential margins in the EC with particularly damaging consequences to the European exports of non-ACP and non-Mediterranean developing countries. In this still unlikely but notionally possible scenario, the larger South American and Asian countries not belonging to the ACP group, with their more diversified geographical trade patterns, could have to face the worst of both worlds being discriminated against other LDCs in the two larger OECD free trade areas. If, on the other hand, current US actions in the Pacific materialize without bringing about these negative European spillovers, the result may be an increasing isolation of the East Asians joining the US from the long standing G-77 coalition, a prospect which - especially for those primary commodity exporters in ASEAN - may entail some political costs.

A crucial systemic question from the developing country perspective is, therefore, what is going to result from the Pacific Round of multilateral trade negotiations the US is presently engaged in parallel to the GATT talks. Unfortunately, this question begs another old and still rather open question in the positive theory of economic integration, viz. the fact that some argument alien to conventional trade theory must be put in

place to explain the occurrence of FTAs and, as Krauss(1972) nicely puts it, to falsify the proposition that "there is ... precious little that a country cannot do for itself that it can do better with the aid of some other country"²⁶. Economists' attempts at modelling this puzzle - which, as noted by the late Harry Johnson with amazing actuality over twenty years ago, puts the profession "in opposition to the dominant strands in the actual formulation of international economic policy"²⁷ - through footnotes to received theory²⁸ may provide only formal answers for the simple reason that for a particular strand of policy to be dominant there must not be a valid economic reason for it²⁹. Indeed, as has been noted in a similar context, policy was formulated in the past on the basis of the belief that the earth was flat³⁰. To make a long story short, there is always the possibility that the perception of the existence of a source of large gains - either not captured by conventional economic analysis or simply irrational from the latter's standpoint - may determine the decision of individual countries to join a FTA with the US (as opposed to going for multilateral liberalization) and this enormously complicates any attempt at making general - and economically rational - predictions.

²⁶ Krauss (1972, p 424).

²⁷ Johnson (1965, p 257)

²⁸ As, for instance, done by Johnson himself by redefining economic welfare in terms of public goods. Johnson (1965).

²⁹ In fact in his classic analysis of discriminatory arrangements Patterson argues that in the move towards integration in the sixties in all of the schemes except the EFTA "it was repeatedly emphasized that the political aspects were as important, or much more important, than the economic". Patterson (1965, p 146).

³⁰ Krueger (1986, p 285).

This apparent demise of the possibility of a rational prediction of the outcome of the present US FTA initiative should not, however, prevent speculations in a scenario in which common sense about where the basic interests of both the US and developing countries in the system lie eventually prevails. If that occurs, presumptions are that developing countries, as small economies, should strongly favour the adoption of a multilateralist approach to trade policy. Not only, as argued above, a FTA with the US is certainly at most a second-best option as compared with MFN liberalization on purely economic grounds but, as widely believed²¹, a multilateral rules-based system - as opposed to an asymmetric bilateral deal - is to be preferred by the weak. As to the US, it is to be hoped that the view will eventually hold that to avoid free riding and achieve greater trade liberalization by developing countries - especially the larger developing GATT signatories which have not yet committed themselves to trade liberalization programs - the provision of conditional balance of payments finance, either bilaterally or through multilateral institutions, is certainly less disrupting for the system and a more effective carrot than the lure of its large domestic market.

²¹ See, for instance, Duncan (1950) for the classic arguments.

Conclusions

This paper discussed the implications of the apparent drive in current US trade policy towards the formation of bi or minilateral free trade arrangements, from a developing country perspective. Both the existing a priori inducements to these small countries to form a FTA with a large trade partner as well as the systemic consequences of the new US initiative were analysed.

As far as the inducements to developing countries are concerned, it was noted that the high trade barriers generally prevailing in the South poses a fundamental difficulty to comprehensive free trade agreements with the US, as demanded by existing GATT rules. The basic problem is that, as the adjustment costs of freeing trade with such a huge partner are equivalent to those of multilateral trade liberalization, they are likely to be high and thus the formation of the FTA is to face strong domestic opposition. It can, therefore, be argued that the real policy issue is whether the country is willing to liberalize and if this is so, there is no economic reason to do so on a bilateral basis. Besides efficiency arguments, incentives to MFN liberalization also stem from the fact that the selective removal of high trade barriers in favour of the US imply high discrimination against third parties in the developing country market and a great probability of retaliation. This is bound to be especially felt by other OECD countries competitive with the US which, by usually being substantial importers from LDCs, have strong powers of retaliation.

Thus, one can say with a reasonable degree of confidence that the number of comprehensive agreements covering a substantial portion of trade between the US and individual developing countries is likely to be very small. There is, nevertheless, the possibility that the political momentum generated by the current US drive may lead to a number of sectorally restricted agreements exploring cross-border industrial specialization and integration opportunities envisaged by US corporations especially in, but by no means restricted to, the countries in the Caribbean and Pacific basins.

As to the systemic issues raised by the US initiative, two points seem to be of interest to developing countries. The first is that liberalization through multilateral free trade deals allows no free riding and thus imply the abandonment of S&D. The second is that, as the lack of incentives imply that the number of developing countries forming FTAs with the US is likely to be small, no great erosion of the MFN principle or of the importance of the GATT should be expected.

This proposition could be falsified, however, with the formation of an US-Japan FTA which, because of positive externalities associated to the direction of existing trade flows, may look an attractive free trade partner to some of the East Asian developing countries. The formation of a large and comprehensive trans-Pacific FTA may generate reactions from Europe which would reinforce the drift towards strengthening large

regional blocs which, in turn, will hurt the trade position of many diversified LDCs and have far reaching consequences to the future of the multilateral trading system. One cannot, therefore, underestimate the crucial systemic importance of the unfolding of the formation of an US-Japan FTA to world trade policy and, in particular, to developing countries. If these conjectures are correct, the current situation illustrates to perfection the dictum attributed to Prime Minister Trudeau that the grass not only trembles when elephants fight, but also when they make love.

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