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Trade Regionalization, Exchange Rate Policies and EU-US Economic Cooperation

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Abstract :

This paper demonstrates that trade regionalization has important monetary and exchange rate implications. It goes on and argues that EU increased importance in the monetary field following the euro's introduction and the anticipated development of its international role may contain the hazard of confrontation between the major blocks and therefore lead to a system less stable than a unpopular system. Appropriate arrangements for cooperation between the poles will be crucial to the stability of the system.

Keywords: *Regionalization, regional economic integration, exchange rate policies*

JEL Classification: F15, F33, F42

1. Introduction

Despite the increase in international trade the trend towards trade regionalization is well evident. World Trade Organization (WTO) members are required to grant the same favorable conditions to all "WTO members". However, the WTO also allows a departure from this principle in the case of regional trade agreements. Nearly all of the WTO members have concluded regional trade agreements (RTAs) with other countries: 137 RTAs were in existence as of end of 2000 (www.wto.org/wto/develop/regional.htm). In the real world the implications of trade blocks such as the overall growth in the market and the impact on companies of expanding productions and achieving economies of scale as well as trade diversion (trade shifts to countries in the group at the expense of trade with countries not in the group) appear more appealing than unilateral trade disarmament. Most trade groups contain neighboring countries because:

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1. The distances the goods need to travel between such countries are short.
2. Consumers' tastes are likely to be similar, and distribution channels can be established in adjacent countries

In addition Countries—even if they're not neighbors—will form trade alliances/groups agreements if their political ideologies are similar.

In this paper we focus on the European Union (EU) and the North American Free Trade Agreement (NAFTA) because of the high level of integration in both areas and especially the size and degree of integration in the EU. That is not to minimize the importance of other groups (such as the European Free Trade Association (EFTA), the Central European Free Trade Agreement (CEFTA) and the Association of South East Asian Nations (ASEAN)) to their member countries, but we will use these groups to illustrate different types of regional economic integration. We also consider the possible effects of EMU on the structure of the international monetary regime.

2. Regional Economic Integration
The case of the north american free trade agreement (NAFTA)

NAFTA, which includes Canada, the United States, and Mexico, went into effect in 1994, but it was preceded with the Canada-U.S. Free Trade Agreement. The U.S. and Canada historically have had various forms of mutual economic cooperation. Long negotiations between these two countries resulted in the Canada-U.S. Free Trade Agreement (FTA), effective on January 1, 1989. In the early 1990s, Mexico approached the United States to establish a free-trade agreement. The negotiations that included Canada were finally led to North American Free Trade Agreement, effective on January 1, 1994.

NAFTA has a logical rationale, in terms of both geographic location and trading importance. U.S.-Mexican and U.S.-Canadian trade was significant when the agreement was signed. The two-way trading relationship between the United States and Canada is the largest in the world. NAFTA is a powerful trading bloc with a combined population and total GNP greater than the 15-member EU. Significantly in importance, especially when compared with the EU, is the tremendous size of the U.S. economy in comparison to those of Canada and Mexico.

NAFTA covers the following areas:

- *Market access*: tariff and non-tariff barriers, rules of origin, governmental procurement. Trade rules -safeguards, subsidies, countervailing and antidumping duties, and health and safety standards.
- *Services*: equivalent safeguards for trade in services (consulting, engineering, software, etc.).
- *Investments*: investment rules governing minority interests, portfolio investment, real property and majority-owned or controlled investments from the NAFTA counties.

- *Intellectual property*: adequate and effective protection and enforcement of intellectual property rights, while ensuring that enforcement measures do not themselves become barriers to legitimate trade.
- *Dispute settlement*: a dispute settlement process that will be followed instead of countries taking unilateral action against an offending party.

An important component of NAFTA is the concept of rules of origin and regional value content. Because NAFTA is a free trade agreement and not a customs union, each country sets its own tariffs to the rest of the world. That is why a product entering the United States from Canada must have a commercial or customs invoice that identifies the product's ultimate origin. Otherwise, an exporter from a third country would always ship the product to the NAFTA country with the lowest tariff and then re-export it to the other two countries duty-free. According to local content rules, at least 50 percent of the net cost of most products must come from the NAFTA region.

Most free trade agreements in the world are based solely on reducing tariffs. However, NAFTA is a very different free trade agreement. Due to strong objections to the agreement by labor unions and environmentalists, two side agreements covering those issues were included in NAFTA. More specifically, the labor lobby in the United States forced the inclusion of labor standards, such as the right to unionize, and the environmental lobby pushed for an upgrade of environmental standards in Mexico and the strengthening of compliance. The NAFTA Commission, a cabinet-level body established with the responsibility of implementing the agreements and side agreements, focus specifically on labor rights and environmental issues.

Although a NAFTA Secretariat was established to administer the NAFTA dispute resolution processes, the Agreement encourages parties to resolve trade conflicts together without using the Secretariat. Given the US dominance the three countries concerned can not negotiate as equals on trade disputes.

3. How much territory will regional integration cover

Will regional integration be the wave of the future, or will the WTO become the focus of global economic integration? The WTO's objective is to reduce barriers to trade in goods, services, and investment. Regional groups attempt to do that and more. Although the EU has introduced a common currency and is increasing the degree of cooperation in areas such as security and foreign policy, the WTO will never engage in those issues. Regional integration deals with the specific problems facing member countries, while the WTO needs to be concerned about all countries in the world.

NAFTA and the EU are the key regional groups where significant integration is taking place. In the future, these groups would continue to expand to include other countries.

When the United States began its discussions with Mexico and Canada, it perceived a future effort to integrate North, Central, and South America into an "Enterprise of the Americas." The idea was to have the United States enter into a series of bilateral trade relationships with Latin American countries that would result in a "hub and spokes" arrangement, with the United States as the hub and other countries at the other end of the free trade spokes. Eventually, these bilateral relationships would result in one huge multilateral relationship between all of the Americas—Canada and Mexico included. However, that has not taken place. U.S. protectionism has kept the United States from entering into other bilateral relationships, but that has not stopped Canada and Mexico. Both countries have entered into a free trade agreement with Chile, perceived to be the next country that could join NAFTA, and the agreements were modeled after NAFTA. In addition, Mexico entered into a free trade agreement with the European Union that would end all tariffs on bilateral trade by 2007. The key for NAFTA will be whether or not the U.S. Congress can avoid getting caught up in protectionist sentiment and allow expansion to take place. If it does not, Canada and Mexico will continue to engage in bilateral agreements with non-NAFTA countries in the region along the lines of the NAFTA agreement.

The EU will continue to expand east until it meets Russia, and then its expansion will stop. The enlargement of the EU is planned to include at least 12 and possibly as many as 20 new members, most of them former communist countries in Central and Eastern Europe

Regional integration in Africa will continue at a slow pace due to the existing political and economic problems there, but Asian integration, primarily in APEC, will pick up steam as the economies of East and Southeast Asia recover.

4. The link between trade and exchange rate policy

The core element of the EU which all economists approve is the completion of the free market program with free movements of goods and factors of production. Here it is essentially to stress the clear division that exists between the proponents and opponents of the EURO.

The proponents of the EURO argue that a fixed exchange rate system and the introduction of a single currency is a necessary precondition for the acceptance, maintenance and success of the Single Market. On the other hand, the opponents ague that flexible exchange rates provide a useful instrument of adjusting to external, balance of payments, shocks and therefore allows a free and open international market to operate smother.

In fact, as it has been pointed out above, the NAFTA involved many contentious points, but concern over exchange rates has been conspicuously absent from the discussions. The question therefore raised is that if NAFTA is proceeding without requiring side agreements over exchange rates; why then in the case of the Single Market in Europe such a requirement was necessary?

Given that exchange rates can be used as instrument of demand switching policy (switching demand away from imports in favour to domestically produced goods) and therefore have an equivalent effect on trade as tariff barriers, trade agreements have significant exchange rate and monetary implications. In other words, countries, such as France, will not be prepared to leave their economies open to free movement of goods, enterprises and factors of production if they suspect that other countries (e.g. Italy) are trying to obtain an unfair trading advantage, for example by competitive devaluation. If there is to be freedom of trade and migration, there should also be an agreement on exchange rates

One difference between North America and Europe in this respect may have been that Mexico has been following a strong peso as a counter-inflationary policy, while the Bank of Canada has been undertaking a generally restrictive monetary policy in pursuit of a domestic target for price stability. As far as monetary policy focuses, either through regulatory provisions or administrative practices, on an internal target for nominal incomes, or price stability, then there would marginal need for an agreement on exchange rates. But the objectives of monetary policy can change. Should the monetary authorities, in one part of a free trade area, be perceived to be giving weight to considerations of competitiveness, relative exchange rates and employment, then its partners are likely to become concerned, and seek agreement. The "benign neglect" of monetary policy and exchange rate issues in the NAFTA negotiations may be the product of the particular conjuncture of current monetary policy postures in Mexico and Canada. If the latter was to change, the omission of any side-agreement on monetary relative exchange rates might sometime prove quite troubling.

5. Looking into the future: International economic cooperation after emu

According to the EU Commission "The Euro Area will have a single exchange rate policy formulated within the framework given by the Maastricht Treaty. The predominance of the domestic pricwe stability objective and the likely reduced sensitivity of the euroarea to exchange rate fluctuations will not lead to an attitude of bening neglect by the euro-erea. The euro exchange rate will be an important variable both for economic agents and policy makers. The Combination of the ECB aiming at price stability and the Unino's strong commitment to budgetary discipline, re-enforced by the Stabilitry and Growth Pact should result in a balanced policy mix. The move to EMU would enable the EU to speak with one voice in echange rate discussions at G7 level might influence the possibilities of international co-ordination within the present international monetary regime. EMU should increase the symmetry of international monetary relations, thereby opening the way to more international economic cooperation. The Eu's increase importance in the monetary sphere is likely to result in increased calls for coordination internationally"

At present significant problems tend to arise from the inter-play of fiscal policies, largely under the command of the national authorities and monetary policy. It is well recognized that the inter-action of monetary and fiscal policy may determine the exchange rate. Thus if the EU should wish to achieve some particular outcome for the exchange rate, and with monetary policy predicated to the achievement of internal price stability, then the EU fiscal policy in aggregate has to be adjusted to that end. There is able skepticism about the ability of the stability pact to achieve any desired aggregate fiscal outcome for the EU as a whole. Given the uncertainty about the appropriate stance of fiscal policies, the wider range of differing objectives which fiscal policy fiscal policy pursues, including allocative, distributive, stabilizing, etc. and the political difficulties of making any such changes, coordination of national fiscal policies for purposes of external policy coordination seems highly unlikely. Fiscal policy is the last area where national sovereignty is prepared to be surrendered.

It is therefore reasonably to assume that the EU will not be in a position for the foreseeable future, credibly to commit itself as a single entity to the achievement of any particular fiscal outcome. The EU is not alone in this respect. The executive branch of the US government has seldom been able to control fully its fiscal stance, or to coordinate the thrust of monetary policy (controlled by the independent Fed) with that of fiscal policy, (controlled partly by Congress).

The second main claim above is that the EC is likely to be able to improve its bargaining stance, especially vis-a-vis US. At present, Europe appears as a collection of medium-sized policy centres facing two major poles, the US and Japan. According to the EU officials this asymmetry implies that cetefis paribus the United States has presently less to gain than Europe in transatlantic coordination. Since co-ordination always involves risks and costs, at least those which arise from domestic political considerations, the incentive for the US to engage in such an exercise is weak. To some extent, the United States can exploit this asymmetry by making its policy choices in an non-co-ordinated fashion without suffering much from a similar behaviour of European nations.

In addition, always according to the same arguments, the greater weight and unity of the EU would cause to the USA extra losses from lack of co-operation, and hence would not only drive the US to co-ordinate more closely with the EU, but would also shift the benefits from such international relationships more in favour of the latter, at any level of policy cooperation.

While these arguments may have some partial validity we view the conclusion, that the USA will be induced to co-ordinate, on a more even basis, with the EU with some scepticism. The implication appears to be that, because of its greater comparative power and size, the USA has hitherto been able to avoid serious participation in international economic bargaining. Instead the evidence indicates that most initiatives for the positive co-ordination of national policies have initiated from the US and have more frequently run into opposition and objection from other G7 partners.

However in these US initiatives have usually involved other countries, e.g. Germany and Japan, in changing their policies without much, or any, quid pro quo from the Americans in terms of shifts in the US fiscal/monetary policy. But this latter apparent immobility of US policies, especially fiscal policy, is usually explained, not in terms of an asymmetric use of relative power, but of the incapacity of the Executive branch in the US to control Congress and deliver any agreement. Now this may, to some extent, be a convenient fiction for bargaining purposes. The separation of powers in the US Constitution makes it extremely difficult for the USA to become a significantly more cooperative bargainer in future than it is now, at least without a fundamental Constitutional change, which at present seems highly unlikely.

Thus we consider the arguments expressed by EU Commission officials that the US has not previously bargained co-operatively, because of its greater power; that it will now face greater losses unless it should bargain on a more equal basis and hence will be induced to change its posture; and that the EU will reap benefits from the induced US change of posture, as invalid. If the view that a united Europe can more easily force concessions from the USA prevails in Europe, then then there is a serious hazard of mutual resentment, and even confrontation. It would be far better if it were accepted that independent, and quite different, political systems leave very little room for policy co-ordination, in the monetary field at least.

This leads on to the final question here which is whether a tri-polar system (USA, EC, Japan) will be more, or less, satisfactory than the prior system of a weakening US hegemony. That hegemony has eroded so far already, that the world has moved, through a period of more-or-less pure floating (with quite unsatisfactory results), to a somewhat managed float.

Compared to the USA, the European economies are medium-sized. Whereas Japan is comparatively more important, relative to the US, and certainly perceived as such in the US, the Japanese have not gone out consciously to form a Japanese dominated yen bloc in the Pacific area Japan has not taken up any politico-economic aggressive stance outside its boundaries.

In contrast, the EU aspirations go beyond simple monetary integration with the aim to develop a federal identity within its borders which will make it, by itself, of equal, or greater, weight in population and GDP to the USA. Moreover, it is already becoming a magnet for the peripheral countries in Northern and Eastern Europe, whose accession to the EU bloc will make it on paper much larger than the nations of North America.

However, the cohesion of the EU bloc, both within the EU core and the wider periphery, at least in the transition phase will be fragile. There is a hazard that there will be those within the EU who may seek to strengthen internal EU cohesion by pointing to an external opponent. Taking into account the current Japanese economic situation the USA seems to be the more obvious target for such rivalry in the field of macroeconomic policies. This risk may become more acute by the trend towards intergorvamentalism in the EU i.e. the weakening of the European Commission and the ascendancy of national governments in controlling the destiny of the EU.

Trade disputes would exacerbate this hazard. During the cold war there was a great number of serious trade disputes between the EU and the US. However, inspite of some unilateral acts of smooth retaliation, a degree of restrain was evident in all cases because both sides realized the danger of economic conflict spilling over into political area. For example when the WTO ruled that American export subsidies wereillegal, the EU could have lawfully raise tarrif barriers against a significant amount of American trade. However the EU holded off from doing so to protect the political relationship with the US. In spite of many argumments to the contrary, there had always been a loose linkage between trade and political cooperation and partnership. However, given the strong link between tade and exchange rate policies (which have been demonstrated in an earlier part of this paper) if serious strains arise on the one side of the relationship, there will be a significant danger that the other will suffer. Trade disputes may thus trigger a chain reaction that could foreclose macro-economic policies and bring international cooperation to a total halt.

Placing excessive emphasis on trade regionalization increases the likelihood of mutual resentment, and even confrontation. The key for NAFTA will be whether or not the U.S. Congress can avoid getting caught up in protectionist sentiment and allow expansion to take place. The recent decision of the US to impose tariffs on steel threatens wider EU-US cooperation and lives less hope for the future.

6. Conclusions

The establishment of a tri-polar international monetary system would of itself be a major cause for any shifting in geopolitical relationships, which contain the foundation of an economic enmity between the EU and the US. This would be a symptom of a rebalancing in politico-economic structures more broadly. The combination of disputable benefits of political cooperation, excessive emphasis on regional trade agreements and major bloc bargaining is a dangerous coctail involving the hazard of frustration, resentment and even confrontation which would be detrimental to world growth and trade..

How can we best proceed to minimise the hazard of such confrontation between the major blocs? One helpful step would be for both sides to recognize more clearly the political constraints preventing the other from adjusting flexibly; for both sides to recognize that the use of threats and power-plays to extort concessions from the other could have adverse longer-term consequences; and hence for both sides to appreciate that the room for positive co-operative behaviour, in the determination of macro-economic policy, is very limited.

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