CHAPTER 1

Introduction
A World of Trading Blocs

Trading blocs have been dramatically expanding throughout the world economy. In 1992, the European Union (EU) completed the single-market program and began a historic initiative for monetary union. The United States, Canada, and Mexico launched the North American Free Trade Agreement (NAFTA) in 1994. Even Japan, for years the only industrial country that was not a member of any regional arrangement, completed a trade agreement with Singapore in 2001. Overall, half of the regional trade agreements notified to the General Agreement on Tariffs and Trade (GATT) were negotiated in the last decade—133 in all since the creation of the World Trade Organization (WTO). At this writing, several post-Soviet states and past members of the Eastern bloc have lined up to enter the EU; thirty-four countries in the Americas envision free trade "from Alaska to Tierra del Fuego"; the Association of Southeast Asian Nations (ASEAN) is preparing to establish a free trade area; and Japan is exploring trade pacts with the Philippines, Thailand, Malaysia, and South Korea.

This book analyzes how domestic politics has driven the formation of trading blocs.[1] Its central claim is that states construct trading blocs in response to political pressures from organized interests in society. Understanding the formation of trading blocs and their external effects, I argue, requires an examination of the domestic system and the process of national policy-making. To accomplish this, the book develops an analytical framework that specifies the

1. The book uses the terms *trading blocs* and *regional trading arrangements* interchangeably. In general, there are three types of trading blocs. In *customs unions,* countries eliminate all restrictions on trade with one another and maintain common trade policies toward nonmembers. In *free trade areas,* members eliminate all restrictions on their mutual trade but retain separate, autonomous external trade policies. In *preferential trading arrangements,* members reduce barriers to trade within the group but do not practice free trade with one another or establish common policies toward nonmembers.

trade preferences of domestic actors and tests this framework in a comparative analysis of trading blocs from the 1920s through the 1990s.

The book's principal contribution is to demonstrate the significance of economies of scale in domestic pressure for trading blocs. Economic analyses, press accounts, and government reports routinely highlight larger-scale production as a benefit of regional integration, but its importance in motivating group lobbying has not been systematically examined. This study, however, finds the same actors repeatedly pushing for inclusion in a wider trading area: from Imperial Japan and the British Commonwealth to the EU and NAFTA, businesses in industries with large returns to scale have been key forces in the emergence of trading blocs. In addition, the book shows how the growth of multinational production sharing has spurred the creation of trading blocs. As businesses move discrete stages of manufacturing to different countries, they become interested in opening trade and harmonizing standards across the borders that link their investments. When groups that rely on scale economies or production-sharing networks have political clout, the book argues, trading blocs are likely to form.

Many previous studies of trading blocs treat states as unitary actors and examine the strategic incentives for participation in these arrangements. This work usually reaches pessimistic conclusions about the global effects of regional arrangements. Bhagwati (1998, 286) predicts that "divisions will be sharpened and the world economy fragmented" because trading blocs, once formed, "invite . . . defensive, if not retaliatory" reactions. Gilpin (2000, 8, 42) warns of a regressive spiral if "each regional movement attempts to enhance its own competitive position vis à vis other regions," and he concludes that the "unity and integration of the global economy are increasingly challenged by the spread of regional economic arrangements." Others (e.g., Thurow 1992; Garten 1993; Hatch and Yamamura 1996; Pomfret 1997) emphasize the perils of fortress Europe, a yen bloc, protectionism in NAFTA, and introverted, restrictive regional arrangements elsewhere. Some suggest that a three-bloc trading system is particularly volatile and dangerous (Krugman 1991; Froot and Yoffie 1993; Bergsten 2001).

The experience of the 1930s offers a vivid backdrop for anxiety about the recent drift toward regionalism. In this period, Britain and France established preferential trade with their colonial territories; Japan and Germany sought expanded empires of their own, first through trade, later through conquest. The growth of imperial blocs coincided with rising and sometimes prohibitive barriers against foreign goods: Japan increased import duties throughout the 1920s, the United States passed the Smoot-Hawley tariff in 1930, Britain's General Tariff reversed its longstanding free trade policy in 1931, France tightened import quotas that same year, and Germany imposed rigid exchange controls under its New Plan of 1934. The collapse of the trading system, the Great Depression, and World War II ensued, each in succession contributing to the destruction of the integrated world economy that flourished before 1914.

Lessons drawn from the interwar period and its aftermath are central to debates about how to interpret present trends. In the conventional wisdom, the rise of imperial blocs was a primary factor in the outbreak of beggar-thy-neighbor protectionism and mercantilist warfare. The belief that open, nondiscriminatory trading systems tend to be peaceful while closed, compartmentalized economic relations create conflict is implicit in most discussions about trading blocs, if not plainly stated in analogies to the 1930s. "Tariff discriminations," wrote Jacob Viner (1951, 355), a pioneer in the economics of regional integration, "poison international relations and . . . make more difficult the task of maintaining international harmony." Conversely, a world free of empires and exclusions is widely viewed as more cooperative and tranquil.

The U.S. diplomats who designed the blueprints for a new world order after World War II certainly thought so. Secretary of State Cordell Hull, who designated Britain's Imperial Preference "the greatest injury, in a commercial way, inflicted on this country since I have been in public life," regarded "trade discrimination . . . as the handmaiden of armed aggression" (Gardner 1969, 19). In applying this conviction, the State Department pushed foreign governments during the war to pledge to end unequal treatment and dissolve imperial trading links. The GATT codified these national commitments to nondiscrimination and multilateral liberalization, as the most favored nation (MFN) clause enabled members to share the benefits of significant tariff reductions achieved in a series of trade rounds after 1947.[2] Under the GATT, the European Community (EC) was the only trading bloc to realize lasting success; regional arrangements among developing nations in Latin America, Africa, and Asia amounted to mere acronyms that failed to open regional trade or collapsed amid acrimony—or both. As Hull and his cohorts had hoped, trade was liberalized, regionalism was infrequent, and a repeat of the interwar calamity was averted.

Recently, however, trading blocs have multiplied and flourished, as figure 1

2. GATT Article XXIV amended Article I to allow free trade agreements and customs unions to deny MFN treatment to other countries provided that these arrangements liberalized "substantially all" trade and did not "on the whole" increase "the general incidence of" trade barriers against nonmembers. An annex to Article I also permitted certain colonial and regional preferences to remain in force. On the origins of Article XXIV, see Chase 2005.

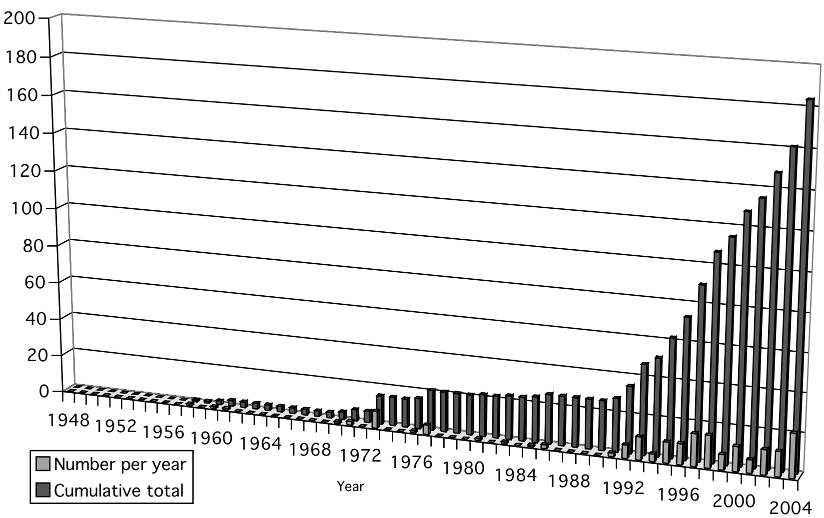

Fig. 1. The proliferation of regional trade agreements, 1948–2004. (Data from WTO, "Regional Trade Agreements Notified to the GATT/WTO and in Force," http://www.wto.org/english/tratop_e/region_e/eif_e.xls.)

demonstrates. While prior work tends to focus on particular regional arrangements—usually the EU or NAFTA—this book places them in the context of other integration efforts, including the more insidious imperial and regional schemes of the interwar era. In doing so, the book finds that the forces driving regionalism of late do not fully resemble those of the past. The case chapters show that while similar actors pushed for trading blocs in both periods, proponents of regionalism typically sought external protectionism in the 1930s but not in the 1990s. The argument and evidence suggest that businesses in contemporary regional arrangements have been more favorably inclined to external trade openness because these trading blocs have created opportunities to restructure production more efficiently. The book therefore rejects the 1930s analogy and concludes that today's regionalism is not a threat to the global trading system.

Analytical Puzzles and Proposed Solutions

The rise of trading blocs raises three fundamental questions for international economic relations. First, why do governments form or join regional arrangements? Second, what impact do trading blocs have on the multilateral integration of the world economy—do their members tend to raise trade barriers against the outside world or reduce them? Third, how does the creation of trading blocs affect economic, political, and military conflict and cooperation between regions?[3]

These questions are sequentially linked, yet many studies examine one in isolation from the others. In international relations theory, realists and liberals debate the third step, how regional arrangements affect outcomes at the systemic level. To realists, trading blocs signal a failure of international cooperation; to liberals, they are a method for successful collective action. The two approaches offer different conjectures about how trading blocs affect regional relations with the rest of the world, but they do not address how external policies are determined endogenously in the political systems of the countries involved. In economics and political economy, a large body of work examines step two, whether members of trading blocs are likely to raise or reduce foreign trade barriers. Yet much of this work presupposes a set of motives for regional integration that are not validated empirically: proponents of the regional arrangements as "building blocks" thesis often assume the dominance of pro-trade interests, while adherents to the "stumbling blocks" line of argument tend to emphasize incentives for protectionism.[4]

In short, we cannot understand step three without step two, or step two without step one. Instead of cutting into the problem from the middle and taking prior decisions as given, analytical work on trading blocs must start at the beginning. The book's theory proceeds from a set of analytical propositions about the motives for organized groups—principally firms and trade associations—to seek regional arrangements. The argument emphasizes two key factors in the political calculus of domestic actors that want to be part of a trading bloc. A primary consideration is the desire to gain scale economies. When small national markets inhibit the concentration of production in a country (or a region), firms that can capture unexploited scale economies in an enlarged market will push for trading blocs. A second important motive in pressure for regional arrangements is the ability to locate stages of production in different countries to take advantage of factor price differences.[5] If manufacturing can be divided and dispersed,

3. Economists are interested in a related set of questions but cast them differently. For example, Frankel (1997) examines the effect of regional blocs on trade patterns between the bloc and the outside world, on the welfare of the members of the bloc, and on world welfare. The first question is empirical; the latter two are normative. My objective in this book is to present explanations for the questions that I seek to answer and then to systematically evaluate these proposed explanations against the available evidence. While this exercise has important implications for the welfare issues that economists such as Frankel investigate, the purpose is positive and analytical, not normative. It is this difference that distinguishes modern *political economy* from *economics,* as chapter 2 explains.

4. The terms *building blocks* and *stumbling blocks* first appeared in Bhagwati 1991 (77).

5. Factor prices are the cost of inputs or resources used in the production process, usually labor, capital, and land.

then firms that can integrate production tasks across borders will seek regional arrangements. Thus, the formation of trading blocs reflects first and foremost the aggregate number and political strength of businesses that rely on scale economies or production-sharing networks to survive and prosper in the world market.

Building from this foundation, the book examines the conditions under which domestic actors are likely to seek to increase or reduce trade barriers against countries outside a regional arrangement. The key point is that regional integration is a dynamic process that affects—and potentially alters—the trade preferences of organized groups. If forming a trading bloc enables businesses to gain scale economies or deepen production sharing, then they will become more favorable to external liberalization. In this case, a protected regional market provides temporary shelter while firms restructure. But if firms cannot reorganize to expand product runs or outsource high-cost processes, domestic support for external trade protection is likely to persist. To the extent that regional trade liberalization increases import competition in activities with high comparative costs, protectionist pressures from these industries will intensify.

Because the approach offers predictions about the circumstances under which domestic groups are likely to support or oppose trading blocs, and the conditions that cause them to favor external protectionism or further trade liberalization, it provides insights into systemic outcomes such as the distribution of regional arrangements over time, the openness or closure of the global trade regime, or conflict and cooperation across trading blocs. However, the book does not attempt to explain systemic outcomes. Such a theory would have to include interstate bargaining and factors in the strategic environment that are outside the argument's scope. Rather, the approach confronts one aspect of these larger puzzles—how domestic distributional pressures affect the formation and evolution of trading blocs. In doing so, it lays a foundation for uniting theories of strategic interaction with domestic politics to develop more refined expectations about systemic outcomes.

Other Explanations

The book's explanatory framework draws from a large body of work in economics and political science, but it is distinct from both. Economic approaches provide useful first principles for understanding the distributional issues in regional integration at the domestic level (between industries or factors of production) and in interstate bargaining (between states). However, economic theory cannot explain the formation of trading blocs because these arrangements—like any policy other than total free trade—conflict with the national welfare assumptions at the core of all trade models. Economic studies therefore treat trading bloc formation as an exogenous decision and evaluate the static impact of this event on national and world welfare. Realist and liberal theories of international relations, in contrast, are sensitive to the political context in which trading blocs form and the dynamics of policy responses at the interstate level. Yet the exclusive focus on the geopolitical environment has led work in political science to disregard, until recently, the importance of political forces operating at the domestic level.

Customs Union Theory

Viner's *Customs Union Issue,* published in 1950, is the starting point for the economic analysis of trading blocs. In this seminal work, Viner did not offer a positive theory of the formation of customs unions. Instead, his purpose was to assess how shifts in the source of supply of goods after regional integration affected national and world welfare. He found that customs unions could have positive or negative welfare effects on members and nonmembers based on the net of "trade creation" and "trade diversion."[6] Since his analysis treated the decision to form a customs union and the level of the common external tariff as exogenously given, the welfare gain or loss in any particular case depended on factors outside the scope of his theory. Years later, Kemp and Wan showed that a customs union could, in principle, adopt a "compensating common tariff" that left nonmembers no worse off. Yet the decision to establish such an arrangement remains a puzzle for welfare-based trade models because the motives to stop partway along the road to free trade are unclear.[7] Eliminating all tariffs is always better for social welfare, so regional integration is a "second-best" policy. Thus, economists (e.g., Johnson 1965) concluded long ago that the motives must be "noneconomic."

An exception to the "second-best" finding is the case in which regional integration enables members to exploit market power over states outside the group. In this approach, a trading bloc can impose an optimal tariff that re-

6. Trade creation occurs when customs liberalization allows imports from one partner country (a more efficient source) to replace domestic production in another (a less efficient source); trade diversion occurs when imports from a partner country (a less efficient source) supplant imports from nonmembers (a more efficient source) due to the wedge between the intrabloc tariff and the external tariff (Viner 1950).

7. As Kemp and Wan (1976, 96) explain, countries have "an incentive to form and enlarge customs unions . . . until the world is one big customs union, that is, until world free trade prevails."

duces the demand for foreign imports and shifts the terms of trade to its benefit. Since the terms of trade improve with the height of the tariff and the number (or size) of countries in the bloc, trading blocs have incentives to raise tariffs and divert trade. This creates conflict in strategic interaction between regions, as each bloc's attempt to redistribute wealth reinforces a downward spiral of protection and retaliation (Krugman 1991; Saxonhouse 1993; Srinivasan, Whalley, and Wooton 1993). Yet even the authors of these models concede that they provide a "grossly unrealistic . . . description of trade politics" (Krugman 1993, 61). Thus, normative trade theory provides rigorous models but no compelling analytical scenario of the formation and evolution of trading blocs. More plausible explanations lie in the realm of politics.

Realist and Liberal Approaches

International relations theories examine the organization of trade in the geopolitical context of the international system. These approaches suggest that open trade is difficult to achieve because countries in an anarchic interstate system prefer to free ride by gaining access to others' markets without opening their own. Since states cannot credibly commit to liberalize without acting opportunistically and no central authority exists to monitor the fulfillment of national commitments, open trade requires costly contractual and enforcement mechanisms to overcome incentives to defect under anarchy (Keohane 1984).

In realist thought, global trade liberalization occurs only when there is a dominant or "hegemonic" power to supervise and enforce compliance with an open, multilateral trade regime (Krasner 1976; Kindleberger 1973). When the distribution of power is relatively equal, however, open trading systems break down. In these conditions, states increase protectionist barriers and form trading blocs.[8]

Though there are cases of declining hegemonic powers seeking refuge in trading blocs—a weakened Britain turned to Imperial Preference in 1931 and the United States embraced regional initiatives in the 1980s after its postwar preeminence had decayed—the proposition that open trade benefits the hegemonic power, while large, nonhegemonic states gain from closure, rests on shaky theoretical ground (Lake 1988; Stein 1984). Critics suggest that very large countries have incentives to exploit market leverage or to "limit price" to reap monopolistic advantages without encouraging potential challengers (Conybeare 1987; Gowa 1989). Following this reasoning, other realist argu-

8. Krasner (1976, 324) links trading blocs with hegemonic decline and "[p]eriods of closure." Also see Gilpin 1971, 407–9.

ments contend that powerful countries seek to gain private advantages rather than provide public goods. In one view, trading blocs are nested inside military alliances to limit trade-related "security externalities" and maximize the relative power of alliances (Gowa 1994; Gowa and Mansfield 1993; Mansfield 1993). Studies supporting this view suggest that trading blocs have malignant effects on global commerce because they are tied up with military disputes.[9] Another approach casts trading blocs as a means through which the strong exploit the weak, as large states can extract concessions from small neighbors by fostering close trade ties that would impose asymmetric costs if broken.[10]

Liberal approaches instead focus on how interdependence, market failures, and coordination problems affect trade relations. One set of arguments explains trading blocs as a response to conditions within a region. In these "functionalist" accounts, growing economic interactions have external consequences that are beyond the capacity of any state to manage individually, so countries that have reached a threshold level of market integration form regional arrangements to provide supranational regulation. Cooperation in one policy area in turn has "spillover" effects that motivate successively deeper levels of regional integration, as it is difficult to maintain different regulatory, customs, and administrative rules and procedures in the presence of intense intraindustry trade and large-scale capital flows.[11]

A second set of arguments emphasizes conditions in the global trade regime that promote regional cooperation.[12] Liberal institutional theories argue that transaction costs, incomplete contracts, and large numbers plague multilateral negotiations.[13] In this view, regionalism alleviates global collective action problems when international institutions are ineffective and hegemonic leadership is absent. In particular, regional arrangements speed initiatives to liberalize trade by reducing the number of participants and limiting monitoring and enforcement costs. Thus, small groups of countries with similar political, institutional, and cultural backgrounds can achieve "deeper integration" (Lawrence 1996) than is feasible multilaterally.

In contrast to the realist view that trading blocs are designed to enhance

9. At the same time, members of the same preferential arrangement are less likely to engage in military conflict with one another (Mansfield and Pevehouse 2000).

10. Hirschman (1945) outlines how Nazi Germany exploited the "influence effect" of trade to gain leverage in central Europe. Also see Gruber 2000.

11. Haas 1958 is the seminal functionalist work. Moravcsik (1998) and Mattli (1999) critique and modify elements of this approach.

12. Mansfield and Reinhardt (2003) empirically assess how conditions in the multilateral trading environment motivate the formation of regional arrangements.

13. See Yarbrough and Yarbrough 1992.

relative power or political influence, liberal theories regard regional arrangements as devices to exploit mutual gains from trade that are unrealized in global negotiations. These approaches suggest that regional blocs are not likely to raise new barriers to trade with outsiders; rather, they are useful halfway houses along the road to free trade to wean governments of their dependence on protection. For one, interregional interdependence constrains the development of self-contained trading blocs as long as threats to punish defection are credible and retaliation costly. Moreover, postwar regional arrangements have been embedded in the multilateral GATT-WTO structure. Finally, large countries remain committed to the multilateral process and nondiscrimination in international trade, even as they pursue regional initiatives (Haggard 1997; Lawrence 1996; Fishlow and Haggard 1992).

While these approaches illuminate conditions in the strategic environment that lead to alternative modes of organizing trade relations, both assume national preferences rather than explaining them. In realism, states prefer more relative power to less, and closed trading blocs are a strategy to enhance national power or the strength of alliances. In liberalism, states seek to maximize their gains from trade, and they pursue regional initiatives when transaction costs and free riding at the global level frustrate multilateral trade liberalization. These two strands of international relations theory yield opposing predictions: one is a theory of the 1930s calamity, when open trade and regional blocs proved mutually exclusive; the other is a theory of the last decade's apparent success, when the emergence of trading blocs coincided with progress (amid strain) at the multilateral level. Neither approach accounts for the range of possible outcomes within a common analytical framework.

Moreover, because structural theories focus on systemic outcomes, they miss important differences across countries in the same international structure and across industries in the same country. This variation is understandable only in the context of the policy process at the domestic level. Simply stated, realist and liberal theories are too abstract to fully explain the development and effects of trading blocs; systemic factors such as collective action, national power, and strategic interaction are insufficient. As a result, recent reviews of the study of regionalism (Haggard 1997; Mansfield and Milner 1999) call for scholars to examine national preference formation and domestic politics.

Domestic Perspectives

Domestic approaches illuminate the internal political factors that cause governments to pursue regional arrangements. A large body of work in economics and political science examines rent-seeking motives to form trading blocs. These approaches build from two premises: first, trade diversion provides rents for producers (who benefit from increased demand for their goods in a protected regional market) at the expense of consumers (who must pay higher prices); second, the costs of trade creation are concentrated on a small number of producers, while the costs of trade diversion are dispersed across a broad range of consumers (Johnson 1965; Cooper and Massell 1965). Trading blocs therefore tend to favor exporters that benefit from enhanced protection, because governments have incentives to exempt import-competing producers that would lose protection to ensure political support (Grossman and Helpman 2002, chap. 7; Hirschman 1981, chap. 12). Even when import-competing industries are liberalized, inefficient producers will seek to convert trade creation into trade diversion through higher barriers against third countries (Bhagwati 1993). Domestic groups also can abuse dispute settlement provisions and rules of origin against nonmembers to extend national protection to the regional level (Krueger 1997, 1999; Levy and Srinivasan 1996).[14] In this class of models, Levy (1997, 506) states, trading blocs "never increase political support for multilateral free trade."[15]

Other studies counter that regional arrangements facilitate trade liberalization by reducing rent-seeking pressure or strengthening protrade lobbies. If trading blocs establish a common external tariff or transfer authority to supranational institutions, protectionist national groups must reorganize at the regional level, where they will be larger, less homogenous, and more susceptible to free riding (Hanson 1998). Import-competing industries also lose political influence at the national level as their output contracts after regional trade liberalization (Richardson 1993). Third-country exporters injured by trade diversion will lobby to join trading blocs to regain lost markets (Oye 1992). In developing countries, regional trade agreements strengthen exporters and businesses with multinational ties and weaken import-competing firms and state-owned enterprises by ensuring that policy reforms are "locked in" (Tornell and Esquivel 1997; Maggi and Rodriguez-Clare 1998). Finally, regional arrangements help to overcome status quo bias when some groups are uncertain about the adjustment costs of multilateral trade liberalization (Wei and Frankel 1996).

However, these accounts generally fail to explain why states choose to liber-

14. Rules of origin are measures to block transshipment inside a free trade area. Their purpose is to prevent outsiders from exploiting tariff differentials among members by exporting to the least protected market.

15. Also see Krishna 1998.

alize regionally rather than multilaterally. Rather than treating trading bloc formation as an exogenous event that alters the preferences or lobbying capacity of protrade and antitrade interests, it is important to know why domestic groups prefer regionalism in the first place. Owners of locally abundant factors of production and producers of exported goods would gain more from multilateral or unilateral liberalization; they have few incentives to prefer a "second-best" policy unless superior alternatives are not feasible.[16] At the same time, regional trade liberalization erodes protection for locally scarce factors and import-competing producers, so these actors should prefer trade barriers at the national rather than the regional level. Because there are opportunity costs for competitive producers and adjustment costs for uncompetitive producers, explaining the creation of a domestic coalition supporting the formation of trading blocs is critically important.

To fill this gap, recent work incorporates imperfect competition and economies of scale into explanations for trading blocs. This research emphasizes incentives to ensure stable markets and capture excess profits in industries with large returns to scale (Chase 2003; Milner 1997; Busch and Milner 1994; Froot and Yoffie 1993). Regional integration offers especially large benefits to small-country firms, which can move down their cost curves once they gain access to a larger customer base (Casella 1996). But the implications for the multilateral trading system remain open to debate. On the one hand, entry barriers in industries with large returns to scale encourage protectionism (Froot and Yoffie 1993). On the other hand, multilateral liberalization benefits industries with large returns to scale because they tend to be export dependent.[17]

This body of work provides a promising approach to domestic support for trading blocs. Moreover, it represents an alternative way of thinking about the political economy of trade. Recent surveys underscore the growing recognition that factors omitted from standard trade models—scale economies, product differentiation, and intraindustry trade—are theoretically and empirically important in modern trade politics (see Frieden and Rogowski 1996, 28–30; Alt et al. 1996, 693–95). Yet unresolved analytical puzzles remain, and empirical work to date has not examined these variables in a systematic fashion on a large number of cases. This book helps to fill these gaps by offering an explanation

16. As a result, some accounts also assume that large numbers and high transaction costs in multilateral negotiations inhibit progress toward global free trade.

17. Busch and Milner (1994, 273) conclude, "the firms most likely to demand regionalism are also the least likely to favor external protectionism." Milner (1997), however, suggests that industries with large returns to scale tend to receive more trade liberalization in regional than in multilateral agreements.

for the formation and evolution of trading blocs that begins with scale-economy considerations in the political calculus of firms and business associations.

Plan of the Book

Chapter 2 presents a theoretical explanation of the motives for domestic groups to seek trading blocs. This section of the book emphasizes how opportunities to exploit scale economies and establish production-sharing networks influence the political behavior of businesses. The framework is then extended to evaluate the conditions under which domestic actors are likely to seek to increase or reduce trade barriers toward the rest of the world. Lastly, the chapter offers generalizations linking group preferences to national policy decisions, and it discusses how to measure the variables in the analysis.

The second part of the book presents case studies of the period between the world wars. The growing scale of manufacturing after the second industrial revolution caused firms with small national markets in Japan, Britain, and Germany to push to expand empires and form trading blocs. In these cases, chapter 3 shows, businesses that could not exhaust economies of scale inside imperial blocs sought protectionist barriers to blunt U.S. competition. The United States, by comparison, had a vast continental market to sustain mass production, and chapter 4 analyzes how large U.S. businesses pressed to dismantle foreign empires, dissolve trading blocs, and liberalize trade from the Smoot-Hawley tariff until the 1960s.

The third section of the book examines modern trading blocs. Chapter 5 shows that European business groups campaigned for the single market because small national markets and ongoing barriers to trade prevented the concentration of production. While some "national champions" sought external protection to deflect increased competition internally, the 1992 program helped to prepare European industries for more vigorous external liberalization as businesses expanded and regionalized production. In North America, chapter 6 explains, U.S. multinationals sought free trade with Mexico and Canada to allow them to reorganize factories, outsource labor-intensive tasks, and rescale production for a regional market. Though the NAFTA treaty included some exclusive provisions, this chapter finds that most supporters of regional free trade also backed multilateral liberalization. Chapter 7 demonstrates that the reluctance of Japanese businesses to establish Asian production networks has inhibited the creation of a yen bloc in Pacific Asia. Even with tentative recent moves toward regional arrangements, this chapter argues, Japanese firms have too great a stake in the multilateral system to seriously pursue an Asian trading bloc.

Chapter 8 concludes by examining how regional arrangements affect outsiders. Though many foreign exporters are harmed, foreign multinationals can reap large benefits when they gain a foothold inside a trading bloc. Today most multinational companies operate in each of the world's major trading areas, so they are neither helped nor harmed by an increase in trade protection across regions. This chapter further suggests that discrimination and exclusion in regional arrangements can help to promote restructuring, particularly when established businesses have large sunk costs. Because restructured firms typically grow more favorable to external liberalization, the book concludes that present trading blocs are not a threat to the WTO or the multilateral system.