

**The Clash of Liberalizations:
Preferential Trade Agreements as a Stumbling Block to Multilateral Liberalization**

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All great economists produce seminal contributions and provide their students and colleagues with brilliant insights; Jagdish Bhagwati has certainly done so. But he has done much more. Through his wit and energy he has communicated those insights to the public and wielded our best science to improve trade policy making. In this note we address the question in which his unique blend of academic and policy work has been most valuable in the last 15 years: whether preferential trade agreements (PTAs) are a stumbling block to multilateral trade liberalization (MTL). Given that all WTO members except Mongolia are now members of a PTA and yet most are also non-members of most PTAs this question has arguably become the most important one in trade policy. Bhagwati first launched the warning in 1991 and challenged trade economists to tackle it. His work has inspired a voluminous theoretical literature as well as recent evidence that suggests there is indeed a clash between preferential and multilateral liberalization.

In his seminal contribution Viner (1950) shows that trade liberalization through PTAs lowers a member's welfare if it causes trade diversion. The first surge of research into PTAs followed with important insights from distinguished economists such as Johnson, Meade, Lipsey and others. Bhagwati (1971) also contributed to the static analysis of PTAs, showing that to rule out welfare improvements in the presence of a trade-diverting customs union the import elasticity at home must be zero *and* the elasticity of supply from the partners must be infinite. A point that has since become familiar to trade economists.

Bhagwati (1968) stands as a precursor to his interest and influence in the policy issues of the day. According to the Cooper-Massell-Johnson-Bhagwati conjecture LDCs

could minimize the cost of industrialization through PTAs among themselves. This is formally proved by Bhagwati and Krishna (1997) using the insight from Kemp-Wan augmented with an instrument to deal with the extra objective of industrialization. This suggests that perhaps the original conjecture benefited from the insights of the seminal work of Bhagwati and Ramaswami (1963).¹

The second wave of PTAs in the 90's generated another surge of research and debate in which Bhagwati has been a key protagonist. The key question that arose was not the static effects of PTAs on its members but whether PTAs would be a "building block" or a "stumbling block" to worldwide MTL as Bhagwati (1991) so aptly recognized and put it.² That this is the central issue is obvious today given that over 141 PTAs are in force and many others are under negotiation or discussion. But we should recall that by the start of 1990 there were only 25 PTAs in force and that the earlier wave of regionalism in the 60's had failed.³ Bhagwati (1993) argued there were several differences in the new wave, such as the US "conversion" to regionalism, and correctly predicted that it would endure unlike the first one.⁴

¹ They show that in the presence of a domestic distortion the deployment of an additional instrument restores the optimality of free trade. Similarly, in Bhagwati and Krishna (1997) the additional instrument re-establishes the Pareto superiority of a type of trade policy (the customs union) in the presence of a non-economic objective.

² Some of the analysis focused on the static effects with several authors arguing against the concerns with trade diversion since PTAs were expected to occur among "natural trading partners" where diversion was less likely. Bhagwati and Panagariya (1996) and Panagariya (1996) strongly contested this point showing that members could incur a large welfare cost from PTAs precisely when they were "natural partners" as defined by high volumes of trade--the criteria used in Wonnacot and Lutz (1989) and Summers (1991). Krishna (2003) concludes that there is no empirical support for the natural trading partners' hypothesis for the US.

³ The figures were calculated from WTO secretariat data in Crawford and Fiorentino (2005). Bhagwati (1991) was based on his Johnson lectures given in 1990.

⁴ The US frustration with the European Community's opposition to a new multilateral trade round in 1982 changed the US's traditional opposition to PTAs, which it started to pursue as an additional form of liberalization. The objective of some proponents of PTAs in the US was to use them "to bring other trading partners to the table". However, as Bhagwati (1991a) points out there were others, such as Ambassador

In addition to challenging trade theorists to address this issue Bhagwati also provided a valuable conceptualization of it. Bhagwati (1993) frames the issue as the “dynamic time-path” question. The time path of liberalization can be divided into two alternatives. In the first, the time-path of world trade liberalization through discriminatory agreements (PTAs) and non-discriminatory ones (via multilateral trade negotiations) are independent. In this case PTA’s can be a building block to worldwide free trade if their time-path is one of continuous expansion until all countries are eventually part of a single agreement. Baldwin (1995) provides a model in which the expansion of PTAs increases the benefits of further non-members to join suggesting that PTAs are a building block. However, he assumes free entry into PTAs thus ignoring the objections to entry from existing members. The second alternative is that the time-path of PTAs and multilateral negotiations are not independent. In this case we ask how PTAs affect the incentives to pursue MTL, i.e. if they are “friends” or “foes”. Most of the theoretical literature has focused on this latter question.

Not only did Bhagwati introduce key concepts that have now been used in a vast literature, he also provided preliminary arguments that fuelled some of the formal analysis. Bhagwati (1993) notes that PTAs are a “balance of trade-creating and trade-protecting forces” and so it is possible that those who benefit from the protection generated by it will oppose further expansion. Grossman and Helpman (1995) show that when producers form lobbies the PTAs most likely to arise are the trade-diverting. Krishna (1998) arrives at a similar conclusion in a different setup and argues that these PTAs can reduce the incentive for multilateral free trade because the export rents they

Brock who was the US trade representative under Reagan, who viewed PTAs as a distinct path to multilateral liberalization and not necessarily as a tactic to force others to negotiation in the GATT.

generate disappear when countries liberalize multilaterally, and so the producers that benefit from those rents oppose MTL, i.e. the “trade protecting” force at work. Bhagwati (1994) argued that if a country is a hegemon it may maximize its payoff by pursuing a sequence of PTAs with individual countries smaller than itself, which would allow it to more effectively use its bargaining power than a simultaneous bargain. Sequential vs. simultaneous trade policy bargaining by a hegemon is the approach that Aghion, Antras and Helpman (2004) pursue to show that PTAs may be a stumbling block or a building block.

Several other authors have provided interesting insights into the interaction of PTAs and MTL. Here are two examples. Levy (1997) models how a PTA may lead the median voter to reject multilateral free trade even though he would have accepted it if the PTA had not been available. Bagwell and Staiger (1998) show that, in a repeated game, PTAs are a stumbling block if countries are very patient and a building block otherwise.⁵ Given the second best nature of the question it is not surprising that both outcomes are possible and more generally that the issue will not be settled through theory alone.

Although Bhagwati (1993) notes that “it is hard to imagine that the arbitrary groupings of countries that seek PTAs are dependent on economic arguments as their key determinants” and that “Often politics seems to drive these choices” virtually all formal analysis of the time-path question was confined to pure trade models. Limão (2002) is an exception. He provides a model where the main motive for a country to provide preferences is to pay for cooperation in a non-trade issue that is under the control of its

⁵ For a survey of other important contributions see Winters (1999). A different strand of the literature started by Krugman (1991) analyzes the welfare path for exogenously expanding trading blocs. Panagariya (2000) provides a broader review of the regionalism literature.

partner. This captures the numerous unilateral preference programs where the US and the EU provide market access and in exchange require their partners to comply with conditions on intellectual property, environment, labor standards, drugs or terrorism. By modeling the interaction with MTL, Limão shows that such PTAs can cause a stumbling block to MTL for the relatively larger countries since they have an incentive to maintain a high preference margin to exchange for cooperation in non-trade issues. A notable point is that even agreements with countries that are small from a trade perspective can affect the MTL of large countries. This greatly expands the set of agreements that were thought to affect MTL since in most previous research MTL is affected only if the PTAs changed trade volumes and prices within the PTA.

Despite the growing importance of PTAs and the ambiguous results from the theoretical research until recently there was no systematic evidence of their causal effect on MTL. In fact most of the theoretical predictions generated were extremely difficult to test econometrically for two reasons. First, the initial research that identifies MTL with free trade effectively focuses on whether a PTA changes the probability of a multilateral round. This is a fine theoretical approach, which arose perhaps out of the experience with stalled negotiations with the Uruguay Round. However, it generated, or perhaps consolidated, the view among many trade economists that “Empirically, it would be difficult to infer the impact of regional agreements on the pursuit of multilateral free trade, since the multilateral agreements of GATT are themselves so infrequent” (p. 335) as Feenstra concludes in his recent graduate textbook.

It is also important to note that the effect of PTAs on the probability of a round cannot by itself answer whether they promote or slow down MTL because, given a round,

the degree of liberalization may vary because of PTAs. Perhaps recognizing this last point several authors focus instead on deriving directly the level of the multilateral tariff with and without PTAs. The difficulty with testing the latter (and also the former) is that we never observe the counterfactual, e.g. if a country (or set of countries) has PTAs during a particular round it is impossible to observe how much liberalization it would have undertaken in the absence of those PTAs.

The evidence that was initially put forth did suggest there was a correlation between PTAs and some countries' *unilateral* trade liberalization (as opposed to their multilaterally negotiated protection). Panagariya (1999) notes that Mexico, Mercosur and Israel raised some of their external tariffs after entering PTAs. However, it is hard to establish causality based on timing alone. In the case of Mexico for example the Peso crisis coincided with NAFTA. Another alternative is to compare aggregate liberalization across countries. Foroutan (1998) finds lower average MFN tariffs for Latin American countries with PTAs after the Uruguay Round but says that no causality can be drawn from such a correlation because those countries were moving away from import substitution during the 90's, which implied considerable unilateral liberalization independently of any effects from PTAs. This issue of causation is partially addressed by Bohara, Gawande and Sanguinetti (2004) who estimate that the Argentine unilateral tariffs were lower in industries where the value of imports from Mercosur to value added in Argentina was highest. A large fraction of the applied tariffs of Latin American countries, which are used in the work above, are set below their multilaterally bound tariffs, and should therefore be viewed as unilateral tariffs. Moreover, neither paper

models MTL empirically in the context of a trade round so, even if we set causation issues aside, there is no systematic evidence that PTAs lead to more MTL.

Given the points above the most productive route is not to try to explain the probability of rounds or aggregate MTL of a country over time but rather to pursue detailed econometric studies using product level data for individual countries, particularly, as Bhagwati (1993) also stresses, the large ones since they have the largest potential impact on non-members. In this setting what counterfactual is the most reasonable in answering how PTAs affect a country's own MTL? Limão (forthcoming) argues that if PTAs affect MTL that effect is strongest on PTA goods, i.e. the subset that a country imports under PTAs, and thus proposes estimating the direct effect of the PTAs on a country's MTL by using non-PTA goods as the counterfactual for the outcome in the absence of PTAs.⁶ This is a prediction derived directly from Limão (2002) and its extension in Karacaovali and Limão (2005). It is also supported by anecdotal evidence such as the fear of developing countries that MFN liberalization of countries that provide them with preferential treatment will erode those preferences and how it is focused on the specific set of products that they export.⁷

Article XXIV, under which several PTAs are authorized in the GATT/WTO, forbids increases in MFN protection after PTAs.⁸ However, this is easy to circumvent by

⁶ This raises the question of whether the goods that are chosen to receive preferences are not random, which is an issue that the author addresses in detail both through various controls and instrumental variables.

⁷ The possibility that preference erosion would reduce MFN liberalization was actually noted long ago; According to Johnson (1967, p. 166) it was a concern voiced by opponents of the generalized system of preferences when it was originally proposed.

⁸ Note however, that the preferences under the Enabling Clause have a stronger requirement that they "shall not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a most-favoured-nation basis." Therefore the findings in Limão (forthcoming) and Karacaovali and Limão (2005) that the US and EU preferences under the Generalized System of Preferences caused an impediment to their MFN reductions is a direct violation of that clause.

simply implementing those increases in the form of smaller reductions during the MTL round after the PTA takes place. Therefore Limão (forthcoming) examines the Uruguay Round and econometrically establishes a causal relation from PTAs to MTL. He finds that the US cuts in MFN tariffs for PTA products were on average only about one half of the reduction for similar products that did not receive preferences. Thus he argues that the US MFN tariffs on its PTA goods--nearly 90% of all goods in the sample--would have been cut by twice as much in the absence of its PTAs. Karacaovali and Limão (2005) find similar results for the EU.

It is also important to note two other points about the stumbling block effect found for the US and the EU. First, it is estimated to be considerably stronger than that of tariff reciprocity, which the authors also model empirically. That is if other countries wanted the US and EU MTL not to reflect the stumbling block effect they would have had to cut their own tariffs by substantially more than they did in the Uruguay Round. Second, the effect is present even when the preferences are granted to small countries. Limão and Olarreaga (2005) quantify the welfare effects from this lost MTL and find they are non-negligible for countries that grant preferences, those receiving them and outsiders even if the switch occurs only for the preferences given to least developed countries by the US, EU and Japan.

Trade economists successfully met the challenge launched by Bhagwati in 1991. We may even argue we have gone beyond it in providing evidence that PTAs are a stumbling block to MTL. Although there are still open empirical questions--such as the effect of PTAs on non-tariff barriers (see Limão 2005)--there is good reason to fear that

PTAs are a stumbling block to MTL. Our task is now to devise economically sound rules to protect MFN treatment and avoid any further clash of liberalizations. It is also essential that we publicly advocate these and nobody does it better than Jagdish Bhagwati. Therefore on his 70th birthday we celebrate his many academic contributions, thank him for his tireless role in exposing this “dracula to the light” and look forward to his continued leadership in doing so.

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