

On the Relationship between Preferential Trade Agreements and the Multilateral Trading System

Soamiely Andriamananjara *

U.S. International Trade Commission

Remarks prepared for the PECC Trade Forum Meetings at the Institute for International
Economics, Washington, DC.

April 22, 2003

* Research Division, Office of Economics, U.S. International Trade Commission, 500 E Street SW,
Washington, D.C. 20436, USA, phone: 1-202-205-3252, fax: 1-202-205-2340, email: soamiely@usitc.gov.
The views and conclusions expressed in this paper are those of the author. They are not the views of the
U.S. International Trade Commission as a whole or of any individual Commissioner.

On the Relationship between Preferential Trade Agreements and the Multilateral Trading System

A. Introduction

An individual country wishing to promote trade is faced with the strategic question of whether to opt for the unilateral, the preferential, or the multilateral liberalization route. In general, there is a consensus over the superiority of the multilateral approach. However, given that the international policy environment makes negotiating a multilateral trade agreement extremely difficult (and that domestic politics preclude unilateral liberalization), preferential arrangements have been put forward as being a more practical and feasible route to reach broad liberalization. Preferential Trade Arrangements (PTAs) have flourished so rapidly all over the world that nearly all WTO members are now party to at least one arrangement.

At the outset, one has to recognize that there is no guarantee that PTAs necessarily benefit their member countries. In fact, although they can create trade and improve terms of trade vis-à-vis non-members, they can also divert trade away from lower-cost producers in non-member countries.¹ More importantly, PTAs can be harmful to the excluded countries by virtue of their discriminatory nature, in terms of both their exports to the PTA market and their terms of trade (i.e., they have decrease their export prices in order to remain competitive in the preferential market). This is particularly relevant since many of the recent preferential trade initiatives leave out many of the world's poorest countries.

These potential negative effects—not present in a multilateral (i.e., non discriminatory) trade liberalization—have triggered a heated debate regarding the relationship between preferential trade agreements and the multilateral trading system. The so-called “Regionalism versus Multilateralism” debate spurs those who consider preferential agreements as harmful distractions from the multilateral system, against those who believe that they will promote broader global liberalization.² Even high level officials have weighted in on the debate. For instance, WTO DG Supachai Panitchpakdi has recently warned that “the present panorama of a criss-crossing web of RTAs” creates a complex network of trade regimes, and ultimately poses

¹ The seminal work on the trade-creation trade-diversion tradeoff is by Jacob Viner, *The Customs Union Issue*, Washington, DC: Carnegie Endowment for International Peace, 1950.

² For a survey of this literature, Jagdish Bhagwati and Arvind Panagariya, “Preferential Trading Areas and Multilateralism—Strangers, Friends, or Foes?” in J. Bhagwati and A. Panagariya, eds., *The Economics of Preferential Trade Agreement*, Washington, DC: American Enterprise Institute Press, 1996, and Anne O. Krueger, “Are Preferential Trading Arrangements Trade-Liberalizing or Protectionist?,” *Journal of Economic Perspectives*, Volume 13:4, Fall 1999.

systemic risk to the global trading system.³

Starting from the general proposition that global welfare is higher under global free trade than in a world divided into competing inward-looking blocs, this article focuses on the following question: *Does the current proliferation of PTAs encourage evolution toward globally free trade, or does it place impediments in its way, and perhaps even increase the likelihood of trade wars between competing blocs?* This question is tackled from two different but related angles. The first approach (Section B) investigates whether PTAs have a tendency to expand their memberships or to merge, and whether this tendency will continue so as to eventually yield global free trade. The second approach (Section C) deals with the effects of the establishment of a PTA on trade barriers between member and non-member countries. Section D offers some concluding insights.

B. “Competitive Liberalization”: Stagnant or Expanding Membership?

Recently, U.S. Trade Representative Robert Zoellick has argued that PTAs will trigger a “competitive liberalization” which could be an alternative route to global free trade as nations compete to open their markets to one another.⁴ In particular, he asserted that the fear of being excluded from narrower deals can induce non-member countries to join the group or/and to accept a broader agreement. Thus, the belief is that NAFTA preferences in the US market would encourage other countries in the Western Hemisphere to become part of the Free Trade Area of the Americas (FTAA), as the FTAA itself would stimulate a multilateral round of trade liberalization.

According to the “competitive liberalization” strategy, PTAs would continue to expand and to merge until one single PTA encompassing the whole world is left. This line of reasoning is not new, and has been thoroughly discussed by a number of economists under the “domino

³ Supachai Panitchpakdi, WTO Director General, speech at the Fourth EU-ASEAN Think Tank Dialogue, European Parliament, Brussels, 25-26 November 2002 (http://www.wto.org/english/news_e/spsp_e/spsp07_e.htm)

⁴ “U.S., Singapore Near Pact on Trade Talks Are First of Many Bush Administration Plans to Pursue for Bilateral Deals,” *The Washington Post*, November 20, 2002. The term “competitive liberalization” has been widely used in APEC dialogue, and was first coined by Bergsten in 1996 in C. Fred Bergsten, “Competitive Liberalization and Global Free Trade: A Vision for the Early 21st Century,” Working Paper 96-15, Institute for International Economics. He argues for instance that the United States initiated the Kennedy Round in the 1960s and the Tokyo Round in the 1970s to counter the discrimination inherent in the creation and expansion of the European Community.

regionalism” label.⁵ Simple political economy models can show that, in fact, the expansion of a PTA increases the incentives of the excluded countries to apply for membership.⁶ The logic is straightforward. When an outsider country contemplates entry into a trading bloc, it faces a trade-off between (i) (*increased competition*) the costs of opening up its own market to the PTA members, and (ii) (*preferential access*) the gains from obtaining better (and preferential) access to the PTA’s market (or, the end of the losses from trade diversion).

It can be rigorously shown that the latter part (the market access gain) is always larger as long as the aggregate size of the PTA’s market exceeds that of the prospective member. Given that the larger the PTA, the larger an outsider stands to gain from joining (alternatively the larger it stands to lose from trade diversion if it remain excluded), *the incentive of a non-member country to apply for membership increase with the PTA size*. It is therefore very possible that outsider countries that initially had no interest in regionalism may become interested when the PTA size becomes large enough.⁷ Following the same logic, a PTA would keep expanding until all countries in the world belong to one super-PTA, which is global free trade.

This type of logic, though insightful, tells only one part of the story since it fails to consider the incentives of the PTA members for further expansions. In fact, the formation and the expansion of a trading bloc require a “coincidence of wants” among all the interested parties—members and non-members. On one hand, the non-members must want to join the PTA while, on the other, the members must be willing to accept new members. A complete theory of “competitive liberalization” should therefore look at the incentives of the existing members to accept or reject new members, instead of concentrating only on those of the non-members to join the PTA.

In the real world, PTA members can decide whether or not to allow a new member to accede to the bloc. As a matter of fact, given that Mexico already enjoys privileged access to the United States, it may no longer be interested in another expansion of NAFTA. Conceptually, when deciding whether to accept or to reject a new member, a representative PTA member compares (i) (*market enlargement*) the gains from getting preferential access to the new

⁵ See, for example, Richard Baldwin, “A Domino Theory of Regionalism,” *NBER Working Paper* 4364, 1995. He argues that the recent wave of regionalism was caused by two idiosyncratic events (namely, NAFTA and the EC’s 1992 programme) multiplied by a domino effect.

⁶ These models usually have a mercantilist bias (i.e., imports are bad, exports are good) given that producers tend to have a larger weight in the government’s objective function. The arguments presented in this section are rigorously supported by a stylized model in Soamiely Andriamananjara, “On the Size and Number of Regional Integration Arrangements: A Political Economy Model,” *Journal of International Trade and Economic Development*, Volume 11 Number 3, September 2002.

⁷ This has been confirmed recently with fervent multilateralists like Japan, Korea, or Singapore becoming very active in preferential trading.

member's market; and (ii) (*preference dilution*) the losses of having to share its original preferential market with the new member.

One can think of the analogy of a pie getting larger, but at the same time being shared by more people. When the bloc size is small, the gains from market enlargement are large enough to offset the losses from the dilution of preferences so that the insiders are willing to accept new members. As the bloc expands, however, the insider's incentives for further PTA expansion decrease and eventually go to zero before the PTA encompasses the entire world. Two conclusions emerge.

- *If PTA membership is selective, (i.e., a PTA grants membership to a new member if and only if all existing members agree to admit the new member) the expansion of a PTA will fail to lead to global free trade because at some point member countries will refuse to accept new members.*⁸
- *If the PTA had an open membership policy, PTA expansion would continue until global free trade is achieved.*

Once PTA members decide to reject new applicants, then the excluded/rejected countries would have an incentive to create their own PTAs. This creates the possibility of the coexistence of competing trading blocs. One could then think about a more realistic expansion process whereby more than one PTAs form and merge simultaneously to yield progressively larger blocs. Will this continue so as to yield one single bloc (i.e., global free trade)?

The incentives facing the individual PTA members are very similar to those presented earlier (i.e., market enlargement and preference dilution). It can be demonstrated that in this type of simultaneous bloc expansion, the regionalism process is likely to fail to converge into a single bloc unless the external tariff (between blocs) happens to be low enough. That is, when the inter-bloc tariffs are low, the preference margin, which creates trade diversion and discourages bloc merger, is also low. This is an example of *open regionalism*, based on low external tariffs (not necessarily zero), leading to multilateral free trade. One direct policy implication of this is the following.

- *Global free trade can be achieved through bloc expansion and merger if trading blocs lower their external tariffs (not necessarily to zero) at the same time they abolish their internal tariffs.*

⁸ When the PTA members decide to stop further expansion, the rejected countries have an incentive to form their own PTA. It can be demonstrated that the possibility of a second bloc leads the members of the original bloc to preempt the losses associated with the creation and enlargement of a second PTA by choosing a group size larger than the one they would have chosen if only one bloc was allowed to form. Hence, the threat of regionalism by outsiders would encourage larger PTAs.

C. PTAs and Incentives for Multilateralism

A second approach in the “Regionalism versus Multilateralism” debate is to study the effects of the establishment of a PTA on the member countries’ trade policies with respect to non-members. Preferential trade policies alter the balance of gains and losses that members and non-members expect to experience from a MFN reciprocal trade liberalization. One can easily study the effects of regional integration on the incentives of PTA members and non-members to undertake multilateral trade liberalization (i.e., reciprocal non-discriminatory trade liberalization among member and non-member countries) using the same general concepts used in the previous section.⁹

As an illustration, consider a world with three countries. Assume that two countries form a PTA, and, while they still keep some tariffs between them, they grant each other preferential access relative to the third country. Note that the key variable of interest here is the margin of preference between the PTA members (i.e., how high is the external tariffs relative to intra-bloc barriers). The higher the degree of preference, the higher is the likelihood of trade diversion, which tends to benefit PTA producers at the expense of their excluded competitors.¹⁰

Consider first the changes in the incentives of a representative firm in the excluded country to support a multilateral deal. Generally, multilateral trade liberalization increases the firm’s profits in the PTA countries markets, but decreases those made in its own domestic market. When the level of discrimination that it faces (or the preference margin between the PTA members) increases, the domestic profit losses from multilateral liberalization remain unchanged, but the potential profit gains in the previously protected PTA market could substantially rise because of the leveling of the playing field. Given these different effects, one can deduce the following.

- *The larger the degree of preferences between the PTA members, the larger is the excluded country’s support for large multilateral liberalization.*

This is the basic idea of the “competitive liberalization” argument. Proponents of that

⁹ For a more rigorous formulation of the arguments presented here, see Soamiely Andriamananjara, “Regionalism and Incentives for Multilateralism,” *Journal of Economic Integration* 15(1), March 2000; 1-18.

¹⁰ As in the previous section, assume that producers’ profits play a decisive role in determining a country’s trade policies. That is, the gains and losses of domestic producers drive decisions regarding trade liberalization. It should be pointed that in a pure welfare sense trade diversion can be quite harmful to the member countries as it shifts the sourcing from an efficient to a non-efficient supplier. Additionally, the tariff revenue losses could be important.

approach has forcefully argued that WTO members would be hard-pressed to co-operate in the Doha round since many of them would lose heavily if those talks failed and the United States and the EU were “forced” to continue their preferential paths.

Just as in the previous section, this argument is in part valid, but it fails to recognize that countries that already belong to the PTA do not have the same incentives as the excluded economies. To get the full picture, consider a representative firm in one of the PTA members. Multilateral trade liberalization has three distinct effects on the profits of that firm: (i) it decreases the profits it makes in the local market as domestic protection are reduced, causing more competition from abroad, (ii) it increases the profits it makes in non-members’ markets though better market access, and (iii) depending on the preference margin, it may or may not increase the profits it makes in the other PTA member.

When the degree of preference is high, the domestic firm already has a privileged access to the other member’s market so that the profit gain from multilateral liberalization in that country is likely to be low. It may even be negative because producers from the non-member countries can start exporting duty free into that previously restricted market. This makes the insiders more reluctant to undertake large multilateral liberalization: the more preference an insider gives and gets from other insiders, the less market access it is willing to give and get from the outsiders.

Most countries pursuing regional initiatives are attracted by open markets and, more precisely, by preferentially open markets. It is the economic rents stemming from trade diversion that those countries find so appealing in preferential deals. To pursue MFN liberalization entails forgoing those rents, and would likely be resisted. It is perfectly conceivable that countries like Mexico or Chile, which already enjoy privileged access to the two largest markets in the world (the United States and the EU), lose interest in or even resist a multilateral trade deal that will dilute their preferential access to these markets. In a consensus-based forum like the WTO, the reluctance of a couple of countries could be much more decisive than another country’s strong leadership. The resulting policy implication is straightforward.

- *An increase in the degree of preference in the PTA can reduce a PTA member’s willingness to undertake large multilateral trade liberalization.*

A number of academic economists have reached this conclusion, and it has even been asserted that that, given sufficient trade is diverted away from non-members, multilateral liberalization that was feasible before the PTA can cease to be so afterwards.¹¹ One related but

¹¹ See, for instance, Pravin Krishna, “Regionalism and Multilateralism: A Political Economy Approach,” *Quarterly Journal of Economics* 113(1), 1998: 227-51.

marginal point has also been made in that the increased resources required for the negotiation and administration of preferential agreements may divert attention away from efforts at the multilateral level.

D. Conclusion

The prevailing trade policy doctrine contends that since multilateral liberalization is difficult, preferential deals should be adopted as a second best route to achieve broader liberalization. This article examines whether these deals actually encourage evolution toward global free trade, or whether they place impediments in its way and increase the likelihood of trade wars between competing trading blocs.

The discussions presented here are of theoretical nature and are based on admittedly stylized assumptions. In practice, incentives vary from country to country, as well as for different types of PTAs. Furthermore, some PTAs have been established more for political reasons than for economic ones. Keeping these limitations in mind, the preceding discussions could still be useful in thinking about the incentives of members and non-members and the implications of the recent proliferation of PTA on the global trading system.

One of the main results is that the “competitive liberalization” argument is generally correct with respect to the incentives of the excluded countries, in the sense that PTAs induce them to seek accession to existing blocs and/or to support broader multilateral liberalization. Preferential initiatives seem to be able to build political momentum for multilateral liberalization in the excluded countries. In fact, it was demonstrated that if it was only up to the non-member countries, the preferential route will definitely lead to global free trade.

However, the argument fails to look at the incentives of the actual PTA members. Using simple economic logic, this article shows that the expansion of a PTA may not converge to global free trade because, at some point, member countries will refuse to admit new members. Similarly, it is demonstrated that an increase in the margin of preference in the PTA can reduce its member’s willingness to undertake large multilateral trade liberalization. Intuitively, countries pursuing preferential initiatives are generally attracted by better “preferential” market access. They are chasing the economic rents resulting from the trade diversion associated with the preference (or discrimination). MFN liberalization lowers the margin of preference and entails forgoing those rents. Thus, it is likely to be resisted by PTA members.

This last point is rather disturbing. On the one hand, difficulty and slow progress in multilateral liberalization seems to have led to the current proliferation of preferential

arrangements. On the other hand, the discussions in this article seem to indicate that those arrangements themselves may render multilateral liberalization more difficult and less feasible. If those points are both true, the outlook is rather bleak: Choosing the preferential route as the path of least resistance may lead the multilateral trading system into a vicious circle of *competitive discrimination* – rather than a *competitive liberalization*.

On a more positive note, this article has suggested at least two directions in which current rules may be adapted in order to make regionalism more consistent with multilateralism. First, it was demonstrated that making PTAs adopt an “open membership” policy can potentially make regionalism a practical route towards global free trade. Secondly, bloc expansion and merger can lead to global free trade if accompanied by decreases in the MFN tariffs facing the rest of the world (not necessarily to zero). WTO members should not lose sight of the superiority of global free trade over a world divided into competing trading blocs. In that respect, recent U.S. proposals (elimination of all tariffs on agricultural and industrial trade, massive cuts in farm subsidies and liberalization of services) for Doha round of negotiations are ground for optimism.