

— † CHAPTER ONE † —

Introduction and Overview

1.1 Objectives

Preferential trade agreements (PTAs) are now in vogue. Even as multilateral approaches to trade liberalization – through negotiations organized by the Geneva-based multilateral organization, the General Agreement on Tariffs and Trade (GATT), and its more recent incarnation, the World Trade Organization (WTO) – have made progress in reducing international barriers to trade, various countries have recently negotiated separate preferential trade treaties with each other in the form of GATT-sanctioned Free Trade Areas (FTAs) and Customs Unions (CUs). Among the more prominent are the North American Free Trade Agreement (NAFTA) and the MERCOSUR (the CU among the Argentine Republic, Brazil, Paraguay, and Uruguay).

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Although by no means historically exceptional, this widespread implementation of PTAs does contrast strongly with the recent history of international trade relations. After the establishment in 1945 of the International Trade Organization (the ur-GATT) as a multilateral forum for trade-policy negotiations, few preferential treaties were initiated in the early post-war period. The European Community (EC), established subsequent to the 1957 Treaty of Rome, was a nearly singular exception with few successful imitators.

Many observers have argued that GATT negotiations were making such inroads on trade barriers during the early post-war period that PTAs fell out of fashion. In the period 1945–1975, trade barriers were reduced substantially through several multilateral negotiation rounds, each involving a growing number of member countries. This success has itself been attributed to a fundamental principle of the GATT: non-discrimination. Non-discrimination (as implied by the infelicitously labeled Most Favored Nation [MFN] clause of the GATT) requires that import duties applied by a country shall not depend on the partner from which an import originates. When combined with the reciprocity usually demanded in trade negotiations (where tariff reductions by one country are expected to be matched by tariff reductions by the

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partner countries), non-discrimination proved to be an extraordinarily useful lever in opening the doors to free trade. Non-discrimination obliges countries that reduce tariffs to apply the reductions to imports from all member countries; reciprocity, in turn, obliges those countries to provide matching tariff reductions. Together, they generated increasing momentum toward a complete dismantling of trade barriers.

However, this success with multilateral negotiations did not continue for long. The evident weaknesses of the GATT's dispute-settlement mechanisms, the exclusion of important sectors of the economy (e.g., agriculture, textiles, and the increasingly important services sector) from its ambit, and the proliferation of new and more complex instruments of trade protection (e.g., anti-dumping procedures) that enabled countries to effectively sidestep GATT agreements led, by the 1980s, to numerous calls for the extension and reinforcement of the system. A number of countries turned to bilateral (i.e., preferential) arrangements. The GATT's Uruguay Round of trade negotiations, concluded in 1994, created the WTO and the GATT itself (now expanded to finally include agriculture and textiles, *inter alia*) was folded into the WTO's mandate. The Uruguay Round also gave the WTO two other

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agreements to oversee: the General Agreements on Trade in Services (GATS) and the agreement on Trade Related Intellectual Property Rights (TRIPS). Important changes to strengthen the dispute-settlement process and to make it more efficient were implemented. However, the interest in PTAs did not wane; several dozen additional agreements were signed in the 1990s and several more are now under consideration.

This renewed tendency toward preferential trading has led to a parallel revival of academic and policy interest in the *desirability* of such agreements. Although even seasoned analysts in the popular press and in policy circles have mistakenly equated free-trade agreements with free trade, it is well understood by specialists, at least since the classic analysis of Viner (1950), that, in contrast to the more popular notion that freer trade is economically improving (“welfare-improving” in academic parlance), discriminatory liberalization may in fact be economically worsening (“welfare-reducing”) for the liberalizing country. These theoretical possibilities make the economics of PTAs unusually complex and interesting. In recent discussions on PTAs, the question of the welfare impact of PTAs has been revisited and reexamined in a number of different ways. Several new issues have been raised and addressed as well, including the following:

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- How can welfare-improving PTAs that eliminate the possibility of welfare loss for both member countries and non-members be designed? How do the political desires of governments (e.g., to shield workers in particular industrial sectors or maintain the level of output in others) interfere with the problem of designing welfare-improving PTAs?
- Which types of PTAs are most likely to result in welfare improvement? In the face of the possibility of welfare reduction with preferential trading, the question has arisen as to whether we can identify any country characteristics that make economic improvement rather than worsening the likelier outcome. Following the analysis of Viner (1950), a number of prominent analysts attempted in the early 1960s to theoretically identify country characteristics that would render unlikely adverse outcomes. Nevertheless, much of the early research on this topic (notably Meade [1955], Lipsey [1958, 1960], Johnson [1962], and a later synthesis by McMillan and McCann [1980]) yielded results that were generally considered mostly taxonomic and of limited practical applicability and operational significance. In this context, a number of influential analysts (e.g., Wonnacott and Lutz [1987], Krugman [1991], and Summers [1991]) have suggested

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a criterion that is remarkably simple and whose implementation would perhaps only require the most readily available data: geographic proximity. They have argued that we should encourage PTAs between geographically proximate countries over PTAs with distant ones because the former are more likely to avoid the adverse possibility of welfare reduction and to lead to a larger improvement in welfare. Preferential trade between the geographically proximate has thus been argued to be “natural.” But, do regional (i.e., geographically proximate) countries indeed make for “natural” trading partners in the context of preferential trading? Or is there no basis for “regionalism” in preferential trade?

- What is the impact of bilateral agreements between countries on the multilateral trading system? The recent academic literature has been substantially concerned with the issue of the impact of PTAs on the multilateral system symbolized by the GATT/WTO. This is because preferential trade treaties, although sanctioned by the GATT (under Article XXIV), stand as an exception to the GATT's own fundamental principle of non-discrimination, thus raising the question of whether such discriminatory arrangements undermine the multilateral framework under which so much success had been achieved in liberalizing

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trade. What are the incentives faced by member countries in a PTA for further multi-lateral liberalization? Are trade blocs, indeed, stepping stones toward multilateral free trade? Or will they instead inhibit multilateral progress?

This monograph presents results from my research on a number of these issues and places them in the context of ongoing discussions on these topics.¹

1.2 Outline and Summary of Major Results

The book is organized as follows. Chapter 2 outlines the basic economics of PTAs. This treatment is intended to provide a rudimentary and intuitive background to the issues that this book addresses and is aimed at readers without any previous exposure to the analytics of PTAs. In particular, the central idea regarding the possibility of welfare reduction with PTAs is developed in detail. This provides an intuitive foundation for the analysis that follows in subsequent chapters.

Chapter 3 discusses the design of welfare-improving PTAs that ensure gains for member countries without negatively impacting outsiders. We introduce first the classic analysis

¹ See Bhagwati (1993), Panagariya (2000) and Schiff and Winters (2003) for survey discussions.

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of Kemp and Wan (1976), which provided an extraordinarily simple theoretical solution to this problem for the case of CUs. Then, after discussing the problems inherent in extending the Kemp–Wan solution to the case of the more popular type of PTA – the free trade agreement (in which countries retain their right to independent external tariff policies) – the recent result of Panagariya and Krishna (2002), which nevertheless develops a welfare-improving FTA solution analogous to that of Kemp and Wan (1976), is described in detail. The design of welfare-improving PTAs in the presence of additional “non-economic” constraints, which draws on the work of Krishna and Bhagwati (1997), is also described. Finally, practical and institutional issues that arise in the implementation of such necessarily welfare-improving PTAs are discussed.

Chapter 4 describes the analysis of Krishna (2003a) of the putative role of geography in preferential trade. It starts by discussing the arguments made by Krugman (1991) and others in support of regionalism in preferential trade. Then, a simple theoretical framework is developed that serves as a platform for empirical investigation of this issue. Specifically, expressions for the welfare change that would result when one country preferentially reduces tariffs against any partner are derived and the parameters that need to be

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estimated to assess welfare change with preferential tariff reduction are identified. A strategy to investigate the merits of a policy of regionalism is then discussed. This involves the use of trade data of a country to estimate the relevant parameters and obtain assessments of the potential welfare effects that would result from preferential reduction in tariffs by that country on imports from various geographically dispersed potential partner countries, and to then examine correlations between these estimates of the overall welfare effects with the distance of the partner countries from the home country. The econometric methodology is described in detail. Finally, Chapter 4 presents empirical results obtained using data on trade flows from the United States. The findings, however, are in the negative. Distance is not found to be significantly related to welfare change with preferential trade reduction.

Chapter 5 departs from the “static” analysis of PTAs and moves on instead to what Bhagwati (1993) has called the “dynamic” or “time-path” question where, instead of single or one-step arrangements, the successive *expansion* of existing PTAs to include ever more countries is considered. Are there incentives for FTAs to keep expanding with more members so as to move toward multilateral free trade eventually, or will there be incentives instead to keep new

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members out? This question regarding the potential interaction between bilateralism and multilateralism has been a dominant issue in the recent revival of interest in PTAs, with one popular contention being that PTAs offered a faster way to global free trade than did multilateral approaches. The results of Krishna (1998) – which argue that PTAs reduce the incentives for multilateral liberalization, sometimes rendering infeasible previously feasible movements to global free trade – are developed and discussed along with other recent contributions in this area.