Preferential Trade Agreements[1]

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It is a great pleasure and honor to be here at this conference celebrating Professor Bhagwati's 70th birthday. The topic I will discuss today, the economics of preferential trade agreements, is one of the many with which I gained my first acquaintance in Professor Bhagwati's course on trade policy here at Columbia University. At the time, I, like everyone else in the class, was overwhelmed by his mastery of the material and ability to combine theoretical insight with empirical intuition to address major policy questions. In retrospect, and only with my immersion in the literature over the last ten years, I have come to recognize and admire another of his great strengths: his capacity for framing the right questions. And, as I will discuss, he has done this to particularly great effect in the debate over preferential trade agreements (PTAs).

In discussing Professor Bhagwati's contributions to the literature on preferential trade agreements, however, I will start with his analysis of Jacob Viner's (1950) seminal contribution. Viner demonstrated that, contrary to standard intuition, not all trade liberalizations are desirable and in particular that preferential liberalization may harm the liberalizing country. When exactly would preferential liberalization be welfare-decreasing? Viner articulated the concepts of *trade creation* (referring to an increase in imports displacing less efficient domestic production) and *trade diversion* (where imports shift from an efficient outside supplier to a less efficient supplier due to the preferences granted to the latter) and, importantly, associated the former with welfare improvement and the latter with welfare reduction. However, subsequent papers by Lipsey (1957) and Bhagwati (1971) showed that trade diverting preferential liberalization may nevertheless be welfare improving (with Lipsey arguing that lack of substitution in consumption was necessary for Viner's identification of trade diversion with welfare reduction and Bhagwati arguing that fixity of the level of imports was sufficient instead). As Bhagwati (1971) importantly clarified, even though trade diversion implies a terms-of-trade loss for the liberalizing country, both consumers and producers within the country faced prices closer to the "true" international price-ratio. If these gains outweighed the terms of trade loss, a trade-diverting customs union (CU) would in fact be welfare improving.

The Viner-Lipsey-Bhagwati analysis posed the question of preferential liberalization in the standard manner: For a given preferential reduction in trade barriers, when does the liberalizing country gain or lose? Much of the subsequent analysis by researchers involved the examination of this question in a multi-dimensional world with varied configurations of endowments and trade patterns between countries. Unfortunately, the sensitivity of the results to the structural assumptions provided little in the form of additional insights and testified to nothing as much as the complexity of conducting policy analysis in second-best economic contexts.

However, in an important breakthrough—whose publication in the *Journal of International Economics* was overseen by Professor Bhagwati as editor—Kemp and Wan (1976) turned the question on its head. They asked instead what configuration of trade policy (towards non-members) would result in a necessarily welfare-improving CU. By posing the question in this way, Kemp and Wan made the problem tractable and an answer possible: Collect any subset of countries in a trading world. Hold their net trade vector with the rest of the world fixed (at the pre-CU level) and treat it as an endowment.

Maintaining standard assumptions, direct application of the first welfare theorem suggests that the union's welfare is improved when all internal barriers to trade are eliminated. The difference between external prices and prices within the CU (common to all CU countries) determined the common external tariff of the CU. Each country within the union could be made better off than before using a suitable scheme of lump-sum redistributions while the rest of the world is left no worse off. The beauty of the Kemp-Wan solution lay in its ability to provide this ambiguous welfare result sidestepping the problem of second-best intrinsic to the analysis of PTAs.

As Arvind Panagariya and I have subsequently discussed in our 2000 paper in the *JIE* on the "Unification of Second Best Results in International Trade," the Kemp-Wan solution, seen in a particular way, is really a direct parallel of the well-known Bhagwati-Srinivasan results concerning non-economic objectives. In the Bhagwati-Srinivasan formulation, any non-economic objective was best achieved by a policy instrument that acted exclusively at the relevant margin. How would the Kemp-Wan solution fit this framework? The fixed vector of extra-union trade—the key component of the Kemp-Wan construction—would be the "non-economic" objective in the language of Bhagwati and Srinivasan. Given the logic of Bhagwati and Srinivasan, this objective would best be achieved by using a suitable external tariff but keeping all other margins free of distortion—exactly as the Kemp-Wan solution proposes.[2]

[2] This is a bit of a digression, but I should note that the well-known solution provided by Dixit and Norman (1986) concerning Pareto-gains from trade without lump-sum compensation works in a very similar fashion. In Dixit and Norman's formulation, individual consumption and factor supply vectors with trade are forced to be the same as in autarky (thus guaranteeing individuals the same level of utility as in autarky). Once again, the Bhagwati-Srinivasan formulation would suggest that this would best be achieved by consumption and factor supply taxes (but letting production be free of distortions), just as Dixit and Norman proposed.

Seeing the Kemp-Wan result through the framework of Bhagwati and Srinivasan brings a number of additional analytical benefits as well. Consider the argument developed by Cooper and Massell (1965) that developing countries could form a trade bloc, retaining protection against the North in order to achieve a target level of industrialization, while reducing the cost of this industrialization by liberalizing trade amongst each other. The Cooper-Massell argument presumed the exploitation of scale economies by developing countries within the CU specializing in different industries. However, as Professor Bhagwati and I demonstrated (Bhagwati and Krishna (1997)), introducing the targeted degree of industrialization as an additional objective into the Kemp-Wan CU (as is straightforward to do when analyzing the question using the Bhagwati-Srinivasan architecture) tells us that "industrialization" within a developing country CU could simply be achieved through the use of an additional industrial policy instrument and, importantly, that the rationale for such a CU did not depend on scale economies at all, contrary to what Cooper and Massell had presumed.

Thinking through the Kemp-Wan solution in Bhagwati and Srinivasan's terms also enabled Arvind Panagariya and me to recognize, in our 2002 paper in the *JIE*, a solution to a different problem concerning welfare-improving free trade areas. As is well known, the Kemp-Wan solution is concerned only with customs unions and the somewhat abstract methodological approach taken by it does not allow for a direct extension to the important case of free trade areas (FTAs), a more prevalent form of preferential trade. Thinking about the problem through the architecture of Bhagwati and Srinivasan, however, it can be seen that freezing the external tariff vectors of member countries individually – effectively introducing as many non-economic objectives as member countries – the bloc's welfare is improved by eliminating all internal barriers to trade (while preventing transshipment) and using member-country-specific tariff vectors to support the external trade objective. Since member countries are jointly better off and the rest of the world is no worse off under this scheme, we will have a necessarily welfare-improving FTA.

But perhaps Professor Bhagwati's most important contribution to the debate over preferential trade agreements lies elsewhere. His magisterial 1993 paper, "Regionalism vs. Multilateralism: An Overview," provided an excellent analytical overview of the recent history of preferential trade, distinguishing between what he referred to as the "first regionalism" (occurring in the 1960s and characterized by numerous failed attempts by developed and developing countries to form preferential trade agreements) and the "second regionalism" (more recent and with the United States as a prominent proponent), whose persistence he, with considerable prescience, predicted. More importantly, he articulated important analytical questions giving rise to a large and growing theoretical and empirical literature on the political economy of PTAs. Specifically, in addition to the "static" welfare issues that had dominated the literature, he argued that it was necessary to examine a "dynamic time path" question. This crucial question comparing regionalism with multilateralism was framed as follows, "will regionalism lead to discriminatory multilateral free trade for all through continued expansion of the regional blocs until universal free trade is reached, or will it fragment the world economy? And, will such a dynamic time-path show that regionalism will get us closer to the goal of multilateral free trade for all than multilateralism will?"

Professor Bhagwati's call for the careful analysis of economic and political incentives created by trade bloc members, so that we may understand better their behavior towards non-members and multilateralism in general, has been well heeded by researchers working in the area. Dozens of papers have already been written on this topic. Levy's 1997 paper in the *AER* proposed that the question of regionalism versus multilateralism be asked in the context of a political process in which trade policy was determined by majority voting and found that the median voter may well reject initially feasible multilateralism once a bilateral agreement was in place. My own 1998 paper in the *QJE*, which emphasized the role of interest groups in the policy making process, found that trade-diverting free trade areas were more likely to receive political support and that such agreements would reduce the incentives for multilateral liberalization and make multilateralism ultimately less feasible. Indeed, both my co-panelists, Limao (2002) and Panagariya and Findlay (1996), have valuable contributions to this literature (which I suspect they will spend some time discussing), as do Bagwell and Staiger (1997), Cadot, DeMelo and Olarreaga (1999), Freund (2000), Dinopoulos and Syropoulos (2002), Saggi (2005) and many others….The list just goes on.

And Professor Bhagwati's influence goes on, not only in this field but across the whole of international economics. In all of these areas, the more you know, the larger Professor Bhagwati looms, and the harder it is to find an important contribution, which, however mixed its parentage, is free of his paternity. We will need, and I hope he will have, many more birthday celebrations in order to comprehensively map out his contributions to the field of economics in the twentieth and twenty-first centuries.

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