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**“Multilateral Versus  
Regional Trading  
Arrangements:  
Substitutes Or  
Compliments?”**

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**MULTILATERAL VERSUS REGIONAL TRADING  
ARRANGEMENTS:  
SUBSTITUTES OR COMPLIMENTS?**

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## ABSTRACT

We summarise salient developments in the interaction of the multilateral trading system and multilateral trading agreements (MTAs) on the one hand and regional trading agreements (RTAs) on the other. We then consider the economic effects of RTAs, comparing customs unions with free trade agreements. We argue, contrary to much received wisdom, that either may produce more economic benefits than the other, depending on the specific context in which they are introduced. There follows a discussion of the political economy effects of RTAs. Some of these have unfavourable, some neutral and some favourable effects on the progress of further MTAs. We conclude that the case against RTAs as eroding the MTS and inhibiting further MTA negotiations, as expounded by such economists as Krueger and Bhagwati, is not well founded. There remain grounds for optimism that the process of competitive liberalisation in RTAs will lead eventually to further multilateral liberalisation.

**KEY WORDS:** customs unions, free trade areas, multilateral agreements, multilateral trading system, regional agreements, rules of origin, scale economies, trade creation, trade diversion.

JEL classification: F 13, F53, F 59

## MULTILATERAL VERSUS REGIONAL TRADING ARRANGEMENTS: SUBSTITUTES OR COMPLEMENTS?

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## MULTILATERAL VERSUS REGIONAL TRADING ARRANGEMENTS: SUBSTITUTES OR COMPLEMENTS?

In recent years, there has been much debate about the advantages and disadvantages of the proliferation of Regional Trading Arrangements (RTA), both customs unions (CUs) and free trade areas (FTAs). The key question that we ask in this chapter, whether multilateral and regional trade liberalisation initiatives are substitutes or complements, raises issues concerning both the economic and political economy effects of RTAs. As with most real world policy issues, these are second best issues in which context matters: the initial starting position and the subsequent evolutionary dynamics affect both the immediate economic balance of trade creation and trade diversion and the longer term political economy implications for the multilateral trading system (MTS) – a system that has developed over the sixty five years since the launch of the Bretton Woods post war trade and payments system.

The economic advantages and disadvantages of RTAs are quite well known. However, some economists, Cooper and Massel (1965) in particular, have been sceptical about their benefits, arguing that any advantage that is conferred on a country by an RTA could be obtained much easier by a unilateral reduction of its tariffs. The Wonnacotts in their paper in this volume refute this view by considering the gains to export industries that arise from RTAs but are not available from unilateral tariff reductions. We consider their analysis later in our paper explaining why this leads us to accept the traditional view that RTAs cannot be judged as being either beneficial or harmful in general. Instead, each case must be judged on its own merits by balancing its context-specific economic advantages against its context-specific disadvantages.

Compared with the large volume of work on the economic effects of FTAs, there has been much less analysis of the political economy effects. Do they have a positive or a negative effect on the Multilateral Trading System (MTS)? At one extreme, some economists argue that these effects are unambiguously unfavourable. Anne Krueger (1997a, 1997b, 1999a, 1999b) argues that RTAs change the political economy of the participating countries by reducing their willingness to engage in subsequent multilateral trade liberalization. Bhagwati (2008) sees a systemic threat to the non-discrimination principle that is central to the MTS. He fears that this principle is being eroded by the recent proliferation of RTAs. He is particularly concerned about overlapping FTAs involving countries in different parts of the world and the costs of multiple rules of origin (ROO). He has colourfully expressed his worries by saying that RTAs are termites relentlessly eating away at the multilateral trading system. A middle position is taken by Baldwin (this volume) who sees regionalism as here to stay, even if it is an untidy way to organize trade. He then goes on to suggest reforms to multilateralise regionalism. At the other extreme, Scholtt (1989) and Lipsey and Smith (1989) argued that the political economy effects of RTAs were on balance favourable.

The remarkable proliferation of regional agreements in the period since the creation of the WTO in 1995 while the multilateral Doha negotiations in the WTO remained stalled (as of 2009) might be thought to support Krueger and Bhagwati's political economy pessimism. However, we see no compelling arguments that these effects are unambiguously unfavourable. One possibility is that the existence and creation of many regional RTAs reduces the chance of success of the Doha and other

similar future rounds by reducing the RTA members' interest in reaching multilateral agreements. A second possibility is that the problems of the Doha round may be mainly those of reaching agreement among 153 WTO member nations with diverse and often conflicting agendas. If so, the existence of a plethora of RTAs may be irrelevant to the success of the Doha and other similar multilateral rounds. There is a third possibility: the political economy dynamic of RTAs may be favourable. In particular: (i) a few member countries with common interests may be able to negotiate more economic gains under a RTA than many countries with diverse interests can accomplish within the WTO, and these may even point the way to deeper multilateral integration; (ii) internal pressures within an RTA may work towards increasing trade liberalization among the members, compared with what was established in the original agreement; (iii) internal pressures may work towards further external trade liberalisation through initiatives by RTA partners to negotiate the formation of further RTAs with other partners, to engage in multilateral negotiations, or to undertake unilateral liberalisation; (iv) external pressures can even contribute to increasing incentives for multilateral liberalisation by prodding reluctant parties to join in multilateral negotiations.

In this chapter, we first survey the relevant history of both multilateral and regional liberalising efforts. We then go on to consider the economic effects of RTAs, taking issue with the view that customs unions are unambiguously economically superior to free trade areas. This is followed by a discussion of the political economy effects in which we study forces set up by FTAs that are unfavourable, neutral or favourable to the progress of further multilateral liberalisation. Here we conclude that the case against RTAs as inhibiting multilateral negotiations is not well founded. The chapter ends with a short section containing summary and conclusions.

## **I. BACKGROUND AND HISTORICAL EVOLUTION**

We begin with a brief summary of salient developments in the trading system, starting with the current context and then reflecting on its historical evolution. In this, the multilateral and regional negotiating processes and the outcomes have mutually interacted. An assessment of the interaction of RTAs and the MTS needs to take this historic evolution into account.

### **The Current Context**

Since the creation of the World Trade Organization (WTO) in 1995, RTAs have proliferated. Some 421 RTAs have been notified to the GATT/WTO since the creation of the GATT in 1947 up to December 2008 of which about 230 agreements remained in force at that date. Of these, 324 RTAs were notified under Article XXIV of the GATT 1947 or GATT 1994; 29 under the Enabling Clause; and 68 under Article V of the General Agreement on Trade in Services (GATS) under the WTO. About twice as many RTAs have been notified to the WTO since 1995 as compared to all the RTAs notified to the GATT from 1947 up to 1994. Fiorentino's paper in this volume examines this data in more detail.

Many RTAs have been announced or are under negotiation at the present time. If we take into account RTAs which are in force but have not been notified, those which are signed but not yet in force, those which are currently being negotiated, and those which are in the proposal stage, we arrive at a figure of close to 400 RTAs which are scheduled to be implemented by 2010. Of these RTAs, free trade

agreements and partial scope agreements (PSAs) account for over 90%, while customs unions account for less than 10 %. (The box gives definitions of the relevant terms.)

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**[TEXT BOX]**

### **TYPES OF TRADE AGREEMENTS**

*Customs Union (CU):* A regional agreement which removes internal tariffs on substantially all trade and establishes a common external tariff in accordance with GATT Article XXIV.

*Free Trade Agreement (FTA):* A regional agreement in which the members retain separate commercial policies for trade with third countries but remove tariffs and other restrictions from substantially all trade with their partners for products meeting the agreement's rules of origin in accordance with GATT Article XXIV.

*Partial Scope Agreement (PSA):* An agreement providing for reduction and/or elimination of duties on a limited number of products and thus not in accord with Article XXIV. Partial scope agreements are allowed under the GATT/WTO Enabling Clause but only for developing countries.

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The proliferation of RTAs creates a complex trading regime simply because there are so many agreements with many overlapping memberships. Until recently, regional arrangements were among groups of contiguous countries such as the Benelux customs union which foreshadowed the European Economic Community (EEC) and the NAFTA. Since the formation of the WTO in 1995, not only has the number of such RTAs expanded, but many countries have initiated FTAs with countries in regions, or even continents, other than their own. For example, Singapore not only has FTAs with the other members of ASEAN, -- Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Thailand, and Vietnam --, but also with Australia, Chile, China, India, Japan, Jordan, Korea, New Zealand, Peru, the United States, and The European Free Trade Association (EFTA) which includes Switzerland, Iceland and Norway. Although Singapore is exceptional, many countries have entered into bilateral FTAs outside their own geographic region or continent.

### **A Brief Historical Overview<sup>1</sup>**

It is useful to put this current situation into historical context since the debate about multilateralism versus bilateralism or regionalism is a product of post-war era. Although there had been Most Favoured Nation (MFN) trade treaties in the 19<sup>th</sup> century up until the First World War, it is only after the Second World War that there was anything that could reasonably be called a formal multilateral trading system.

### **The First Wave of Globalisation**

Before the First World War, the payments system was anchored by the gold standard and the dominant role of the British economy with the Bank of England as

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<sup>1</sup> See Diebold (1988) for a superb essay on the history of the multilateral trading system and the role of the U.S. from the 1850s to the 1980s.



the guarantor and lender of last resort. There was no formal multilateral trading system as such with common rules, but the series of bilateral MFN treaties created a form of multilateral regime for tariffs which were the main instrument of trade protection. The lack of an internationally agreed set of rules for these treaties was a source of problems because the MFN treaties led to numerous disputes and were often revoked. For example, the Cobden Chevalier treaty between Britain and France, which was regarded as a breakthrough in 1860, was revoked by France with the protectionist *Meline* tariffs thirty years later. There were also difficulties since key economies, notably Germany and the United States became increasingly assertive and aggressive in trade policies in the late 19<sup>th</sup> century. The United States emerged from the Civil War with high tariffs on manufactures and the tariffs were increased until the McKinley Tariff of 1890. Germany increased its agricultural protection and protected many infant manufacturing industries after 1878. The United States revoked the MFN treaty with Germany in the 1890s and a trade war almost erupted between the two countries over preferences granted by the US to Cuba. Several European countries and the United States adopted a *conditional* MFN approach, which meant that MFN was only extended through further bilateral negotiations and not automatically as the treaties stated. This *conditional* approach undercut the fundamental principle of MFN. Also as Viner (1950) noted, the principle of MFN was often evaded by the trick of making small distinctions in the tariff lines for similar products in order to discriminate among trading partners in the duty rates.

### *The Interwar Period*

The interwar period was beset by payments problems and macroeconomic instabilities. These were reinforced by a collapse of efforts to negotiate trade cooperation and a resulting slide into protectionism. Notable in this development was the enactment of the Smoot Hawley tariff in the United States in 1930. This led to retaliatory tariffs and other restrictions such as quotas imposed by many countries in a combination of retaliation and emergency balance of payments measures, all of which aggravated the downward spiral of a global depression. Subsequently, the resulting economic chaos of the Great Depression induced the United States Congress to grant the Secretary of State, Cordell Hull, negotiating authority in the Reciprocal Trade Agreements Act of 1934. In the period 1935-1939, the process of dismantling the tariffs was begun when the U.S. negotiated several bilateral trade agreements, which were extended to other trading partners through MFN clauses. MFN agreements were concluded with Britain, Canada, Cuba and several other Latin American countries. The 1935 agreements with Britain and Canada were renegotiated and expanded in 1939. This process was ended by the onset of World War II.

### *The Post-War Bretton Woods*

At the end of the Second World War, policymakers conceived the Bretton Woods system with the International Monetary Fund to foster macroeconomic stability, the International Bank for Reconstruction and Development to finance the rebuilding of the war-shattered economies, and a proposed new International Trade Organization (the ITO) to govern trade. While the ITO was under negotiation, the trading rules in the General Agreement on Tariffs and Trade (GATT) were negotiated and accepted on an interim basis by a small group of countries. The ITO foundered because it was rejected by the US Senate so that the GATT continued for almost five decades with a steady accretion of member countries.

The GATT rules as agreed in 1947 provided for RTAs either in the form of customs unions or free trade areas. However, these were viewed as primarily of interest to small groups of contiguous countries, such as those in the Benelux customs union that linked Belgium, Luxembourg and the Netherlands. In the 1950s, interest in RTAs increased with negotiations that led to the formation of the European Economic Community (EEC) by Belgium, France, West Germany, Holland, Italy, and Luxembourg launched in 1958. Subsequently, the European Free Trade Association was established in 1960 by Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom who wished to benefit from freer trade but did not wish to accept all the other conditions of what was then the EEC.

Under the GATT there were six successive rounds of multilateral negotiations focused on progressively reducing the high tariffs of earlier decades. Starting from 1947 until the Kennedy Round in 1967, negotiations were conducted on a bilateral request-and-offer basis with the country that was the principal supplier of a particular product to the importing country normally taking the lead. There was an effort to balance the values of trade covered by tariff concessions in any two countries agreeing to a bilateral set of reductions. For example, Britain would cut tariffs on wine if France cut tariffs on whiskey. Although this bargaining process had a mercantilist aspect and has been called *mercantilist bargaining*, the results of the bilateral negotiations were included in MFN tariff concessions extended to all other GATT members. Although the process of reciprocal negotiations was viewed with scepticism by some economists (e.g., Johnson (1965)), the results cumulated over the decades to a major liberalising of trade over particularly in manufactured goods. The Wonnacotts writing in this volume consider this issue in more detail.

As more countries participated in GATT negotiations, this bilateral bargaining became increasingly complex. As a result, tariff negotiations were altered somewhat in the Kennedy Round. A tariff reduction formula was first agreed and was then supplemented by bilateral bargaining, the results of which were extended to all members on an MFN basis. In their paper in this volume, the Wonnacotts draw on their earlier work to show that negotiators could have been seeking to balance the potential terms of trade gains from the removal of foreign barriers.

Although some economists such as Johnson (1965), did not see a rationale for this bargaining technique, it has more recently been viewed as a response to the *free-rider* problem of MFN tariff negotiations. Finger (1979) provides evidence that in the first six GATT rounds (1947-1967), the U.S. was more inclined to bargain reciprocal tariff cuts with countries that had participated in the negotiations than with those that had not participated.

The focus on reciprocal concessions meant that these tariff negotiations were mainly among developed countries. However, once the negotiations were concluded for each round, all the tariff schedules were *bound* as GATT commitments and made available to all GATT members. Developing countries were allowed to be *free riders* in that they received the benefits of MFN tariff reductions but were not expected to make significant tariff concessions themselves. One unfortunate consequence of this arrangement was that MFN tariff reductions by developed countries did not focus on products of major interest to developing countries since they were not active participants in the negotiations.

### *Tokyo Round*

The Tokyo Round tariff negotiations in the 1970s were concluded on a similar basis to earlier rounds with few commitments by developing countries and with developed countries making tariff reductions in products of interest to their key trading partners in other developed countries. Developing countries were focused on retaining preferential access to developed country markets, such as the General System of Preferences (GSP), which had been available previously only by time-limited waivers from the general rule of MFN.<sup>2</sup>

By the time of the Tokyo Round, with about 90 members in the GATT, developed countries had become concerned about the MFN free-rider problem, the widespread use of non-tariff barriers to trade, and the convoyö problem trade negotiations moving at the speed of the most reluctant countries just as convoys moved at the speed of the slowest ship. The tariff negotiations were conducted on an MFN basis as before but new rules concerning non-tariff barriers were negotiated on a different plurilateral basis with smaller groups of countries volunteering to take on the obligations. The latter approach produced a series of plurilateral agreements or öcodesö on non-tariff barriers where participation was open to the likeminded countries that were willing to accept the same obligations on rules for non-tariff barriers. These Tokyo Round codes on non-tariff barriers included agreements on:

- Subsidies and countervailing measures
- Technical barriers to trade
- Import licensing procedures
- Government procurement
- Customs valuation
- Anti-dumping
- Bovine Meat Arrangement
- International Dairy Arrangement and
- Trade in Civil Aircraft

Developing countries were sceptical about the öcodesö and blocked the creation of new rules permitting selective safeguards which were contrary to the GATT principle that safeguards for import surges needed to be applied on an MFN basis. The negotiating *quid pro quo* for permitting the plurilateral codes to be negotiated that was obtained by developing countries was the 1979 öEnabling Clause.ö This provided much more flexibility for Regional Integration Arrangements (RIAs). The RIAs included RTAs, some broad preference schemes to promote South-South trade among developing countries and also provided more latitude for preferential access by developing countries to developed country markets.

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<sup>2</sup> The General System of Preferences arose out of the debate concerning the New Economic Order in the 1960s and permitted the developed countries to provide preferential tariff rates for products imported from developing countries.

### *Uruguay Round*

The 1980s were fractious times in international trade relations. After the collapse of the GATT ministerial in 1982, the Uruguay Round of negotiations was launched in 1986 with some difficulty and the negotiations were protracted. Successive deadlines for completing the negotiations were missed. Yet despite the difficulties, the negotiations became more ambitious over time.

These negotiations faced many of the difficulties that the Doha negotiations have encountered subsequently. Although developing countries had always resisted taking on obligations and making tariff concessions in the GATT, they were full participants in the Uruguay Round negotiations. As a result, it proved difficult to conclude these complex multi-issue negotiations with a very large group of participating countries. In this context, the willingness of the United States to negotiate free trade agreements provided a prod to other countries to negotiate multilaterally. Paradoxically a rising threat of protectionism in the United States, a resurgence of US unilateralism in the form of threatened trade retaliation, and a shift to more open markets in many countries after the collapse of the Soviet Union were all factors that contributed to the eventual successful conclusion of the Uruguay Round.

The results of the Uruguay Round negotiations, which led to the creation of the WTO in January 1995, limited greatly, and sometimes eliminated, the ability of countries to use various exceptions to the GATT 1994 (the original GATT terms as amended in the Uruguay Round) under the WTO as compared with the GATT 1947. For example, various exceptions to the GATT 1947 rules that guarantee non-discrimination and prohibit quantitative restrictions, are precluded by the WTO under the GATT 1994 rules. In addition, sectors such as agriculture and textiles, which had special rules that permitted trade restrictions and/or export subsidies, were reintegrated into the system of the WTO's normal trade rules. The WTO also incorporated new rules for trade in services, including investment under the General Agreement for Trade in Services (GATS) and intellectual property rights, as well as establishing a strengthened and integrated dispute settlement mechanism, which applies to the agreements for trade in goods, trade in services and trade related intellectual property rights.

### *Trade Liberalization under the WTO*

Although it has proved very difficult to bring the Doha multilateral negotiations to a conclusion, there has been a significant liberalization of trade in the WTO since 1995. This has occurred through several modalities as follows:

- At the first WTO ministerial in Singapore, there was a successful negotiation of the Information Technology Agreement (ITA), which eliminated tariffs on a large number of computer and telecommunications products for many WTO member countries.
- There were negotiations on financial services and telecommunications under the GATS, which resulted in significant liberalization. However, these were essentially a completion of unfinished business left over from the Uruguay Round and were driven in part by some major countries refusing to extend access benefits (MFN exceptions) in this sector until the offers were improved.

- There were transition provisions in the WTO agreements and in the schedules of commitments from the Uruguay Round that have been implemented over time.
- Many dispute settlement cases have led to many countries fulfilling their obligations and commitments.
- The 25 countries that have acceded to the WTO since 1995 have liberalized their trade regime through accepting all WTO obligations and making extensive liberalisation commitments in their schedules for trade in goods and services. China is the largest of these economies.
- There was a significant agreement at the launch of the Doha Round in 2001 by developed countries to grant what is called "Duty Free and Quota Free Access" to the least developed countries on most of their exports without reciprocal reductions. Most developed countries including the European Union (EU), the US, Japan and Canada,<sup>3</sup> have acted on this commitment.

Although the WTO has achieved a significant degree of liberalization of trade in goods and services from its inception until the present, much of the liberalization that has occurred has resulted from the accession of new members such as China, and, as the list above indicates, from the implementation of WTO obligations and commitments from the Uruguay Round, and from services negotiations associated with unfinished business from the Uruguay Round. As far as new commitments are concerned, there have been substantial difficulties in bringing the Doha multilateral negotiations to a successful conclusion. So far, the only example of a successful multilateral tariff negotiation in the WTO is the ITA in 1996. We will examine this case below in more detail in considering the political economy of multilateral and regional negotiations.

### **Regional and Preferential Agreements under the GATT/WTO**

The principle of Most-Favoured Nation (MFN) treatment was one of the key elements of the GATT 1947 and was incorporated in Article I. In part, the architects of the GATT hearkened back to the system of MFN treaties in the 19<sup>th</sup> century. More importantly, the economic and political success in the midst of the Great Depression of the negotiation of bilateral MFN treaties under the U.S. Reciprocal Trade Agreements Program of Cordell Hull was the direct inspiration for the negotiation of the GATT.

#### *The Protocol of Provisional Application*

Since MFN was a cornerstone of the GATT, only two exceptions were permitted under the GATT 1947. First, under the Protocol of Provisional Application, existing preferential tariff arrangements such as the British Preferential System and the French Union were "grandfathered." These systems were regarded as anomalies and the existing margins of preference were not to be raised. It was anticipated that these would be reduced through future multilateral negotiations in the GATT, and that proved to be the case. The remaining "grandfathered" arrangements were eliminated with the creation of the WTO.

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<sup>3</sup> The countries are listed in order according to the value and volume of such imports.

### *Article XXIV*

Second, Article XXIV of the GATT provided for an exemption from MFN covered in Article I of the GATT as well as other GATT articles, for CUs and FTAs. In both cases, the requirements are that the members of a regional agreement should form, "within a reasonable period of time," an arrangement such that "duties and other restrictive regulations of commerce" are eliminated on substantially all the trade between the constituent territories in products originating in such territories<sup>4</sup>.

### *The Enabling Clause*

Later, a third exception was added by the Tokyo Round. The 1979 Decision on "Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries" ("1979 Enabling Clause") provides permission for generalized tariff preferences by developed countries in favour of developing countries and for regional trade arrangements among developing countries without meeting the requirements of Article XXIV. The latter element permits partial scope agreements among developing countries.

## **II. ECONOMIC ANALYSIS OF RTAs**

To consider both the economic and the political economy effects of multilateral and regional trade agreements, we need first to compare mutual tariff reductions that take place in either RTAs or MTAs with unilateral tariff reductions (UTRs).<sup>5</sup> In their paper in this volume, the Wonnacotts criticise the widespread view that unilateral tariff reductions can accomplish everything that can be accomplished by reciprocal tariff reductions. Against this view, they argue that the gains from being able to export more are in addition to the gains from increasing imports of products that can be obtained from abroad at a lower real cost than they can be produced at home. These enhanced export gains arise from at least two important sources.

The first is changes in the term of trade. Even a small country trading at fixed international prices in foreign markets suffers a reduction in its terms of trade when others levy a tariff on one of its products. This is because the foreign tariff forces the export price down by the amount of the tariff in order to sell in the foreign market at the given foreign price. This transfers some of the gains from trade to the country levying the tariff. Thus, a reduction in the foreign tariff transfers some of these gains back to the producing country, even if its exports remain unchanged. The second is the ability to exploit economies of scale in various lines of a differentiated product about which we have much more to say later. For a full analysis, see the Wonnacotts' article in this volume where they refute the view that all gains that can be obtained through reciprocal negotiations can be also gained by UTR.

### **Customs Union Theory**

The classic customs union theory of Viner (1950) and Meade (1955) assumed Ricardian technology with fully constant costs leading to perfectly elastic supply curves of standardized commodities produced under conditions of perfect

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4 The quote is from Article XXIV 8(b) of the GATT 1947, which applies to FTAs, but the language of Article XXIV 8(a) for CUs closely parallels this language (GATT Secretariat 1994).

5 In their article in this volume, the Wonnacotts refer to these as RTR, MTR, and UTR respectively.

competition, hereinafter called the Ricardian case (See Lipsey (1960) for a review of this theory.) It then focussed on the welfare effects of the trade creation and trade diversion that accompany the shifts in production caused by the formation of a CU. The analysis also applies, with necessary corrections, to free trade areas.

To summarise the possibilities, consider two countries A and B and one product,  $X$ , for which A has the highest costs of production, B the next highest and the rest of the world, C, the lowest. As is typical with the Ricardian case, there is water under the tariff – the domestic price is lower than the foreign price plus the tariff. (We consider this assumption in detail later but for now we just note it is typical of the genuine constant cost case unless tariff rates are carefully chosen just to protect each industry and no more.) Let A and B form a CU. The various possible pre-CU tariffs give rise to five possible cases, assuming that A's pre-union tariff is always greater than B's and that the post-union tariff rate on  $X$  lies somewhere between the two countries' pre-union rates.<sup>6</sup>

**Case 1:** Tariffs in both A and B are high enough to protect domestic industries producing  $X$ . After the CU is formed, there is trade creation with B capturing the whole union market.<sup>7</sup>

**Case 2:** B's tariff is high enough to protect a domestic  $X$  industry while A's is not. Before the CU is formed, A is importing  $X$  from C but afterwards A buys its  $X$  from B in a case of trade diversion.<sup>8</sup>

**Case 3:** A's (very high) tariff protects its domestic  $X$  industry while B's (much lower) tariff does not protect its  $X$  industry. Before the CU, B imports  $X$  from C while A produces  $X$  under tariff protection. There are now three sub-cases depending on the level of the post-union tariff.<sup>9</sup>

**Case 3a:** The common post-union tariff protects the  $X$  industry in neither A nor B. This case gives rise to trade creation as A now buys  $X$  from the lowest cost foreign producer, C, rather than producing it at home.<sup>10</sup>

**Case 3b:** The common tariff is high enough to protect the  $X$  industry in B but not in A. This produces a mixed case. There is trade diversion as B now produces  $X$  at home rather than buying it from C. There is trade creation because A buys its  $X$  from B rather than producing it at home and although B is a higher cost producer of  $X$  than C, it is a lower cost producer than A.<sup>11</sup>

**Case 3c:** The common tariff is high enough to protect the  $X$  industry in both A and B. The results are the same as in Case 3b. Although the tariff is high enough to protect the  $X$  industry in both A and B, the lower cost B producers will capture the

<sup>6</sup> As these cases can become confusing, it may help to outline each in symbols. Let the price of  $X$  in each country be equal to full cost and symbolized by  $p_a$ ,  $p_b$  and  $p_c$ ; let the specific tariff on  $X$  in each country be  $t_a$ ,  $t_b$  and  $t_c$  and let the post union common tariff be  $t_u$ . The basic cost assumptions are  $p_c < p_b < p_a$ .

<sup>7</sup> Case 1:  $p_b < p_a < (p_c + t_b) < (p_c + t_u) < (p_c + t_a)$ .

<sup>8</sup> Case 2:  $p_b < (p_c + t_b) < (p_c + t_u) < (p_c + t_a) < p_a$ .

<sup>9</sup> Case 3 (and 3ø):  $(p_c + t_b) < p_b < p_a < (p_c + t_a)$ .

<sup>10</sup> Case 3a:  $(p_c + t_b) < (p_c + t_u) < p_b < p_a < (p_c + t_a)$ .

<sup>11</sup> Case 3b:  $(p_c + t_b) < p_b < (p_c + t_u) < p_a < (p_c + t_a)$ .

whole union market. So there is trade creation with respect to the new A-B trade and trade diversion with respect to the elimination of imports of  $X$  into B.<sup>12</sup>

**Case 4:** Tariffs in both A and B are not sufficiently high to protect domestic industries in either country but A's tariff is high enough to protect B's  $X$  industry in A's market. Now the outcome depends on where the common post CU tariff rate is set.

**Case 4a:** If the common tariff is set at or near the high extreme of A's tariff, trade diversion occurs as the source of  $X$  for both A and B shifts from C to B.

**Case 4b:** If it is set at or near the low extreme of B's tariff, that leaves neither country with a protected  $X$  industry so the CU has no effect on the pattern of trade in  $X$ .<sup>13</sup>

**Case 5:** Tariffs in both A and B are not sufficiently high to protect domestic industries in either country and the post union tariff on  $X$  is not high enough to protect B's industry. Now both partners continue to buy  $X$  from C so the CU has no effect on the pattern of trade in  $X$ .<sup>14</sup>

In addition to the effects of these reallocations of production are effects both from possible changes in partners' terms of trade analysed by the Wonnacotts and discussed above and the reallocation of consumption analysed by Lipsey and Lancaster (1957: Section 5, 'A problem in the theory of customs unions') who used these effects as an illustration of the general theory of second best. Earlier Lipsey (1957a, 1957b) had shown that the reallocation of consumption following a preferential removal of some tariffs can sometimes bring sufficient gain to outweigh the harmful effects of some significant amount of trade diversion. Lipsey (1970: 97-99) also showed that although these effects can be either favourable or unfavourable, they were more likely to be favourable the higher the proportion of total foreign trade that was done with the country's union partners (not surprising) and the higher the ratio of domestic trade to imports from non-partner countries, the volume of trade with partners being irrelevant *ceteris paribus* (perhaps a surprising result).<sup>15</sup> Nonetheless, consumption effects are usually ignored in the evaluation of trade policies. This may be because producers have more concentrated interests than consumers or just that production effects are more visible and easier to calculate than consumption effects.

So far we have examined production effects from the perspective of the Ricardian case following the classical approach. There are other technology and market structures to consider.

One such case is the case with homogeneous commodities, constant returns to scale and perfect competition where the aggregate supply curve is upward sloping due to a fixed factor or economy wide supply constraints. We consider this case later.

<sup>12</sup> Case 3c:  $(p_c + t_b) < p_b < p_a < (p_c + t_u) < (p_c + t_a)$ .

<sup>13</sup> Case 4a:  $(p_c + t_b) < p_b < (p_c + t_u) < (p_c + t_a) < p_a$  and Case 4b:  $(p_c + t_b) < (p_c + t_u) < p_b < (p_c + t_a) < p_a$

<sup>14</sup> Case 5:  $(p_c + t_b) < (p_c + t_u) < (p_c + t_a) < p_b < p_a$ .

<sup>15</sup> Lipsey isolated the consumption effect by studying the case in which a small country is specialized in the production of a single commodity whose production is unchanged when a union is formed. In this case, the union's only effect is to cause a reallocation of consumption when some tariffs are removed.



Another case is that of product differentiation and economies of scale in production, which give rise to either monopolistic competition or oligopolistic market structures. Many product groups are characterised by this structure. Again this case will be considered later. Product differentiation and scale economies create the potential for pro-competitive and scale effects from regional or multilateral integration.

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## Comparison of Customs Unions and FTAs

Until this point, we have been analysing some of the economic effects of CUs. Next we compare customs unions with FTAs. We continue for the moment to make Ricardian assumptions and consider the previous example, this time with an FTA rather than a CU.

The continuation of the different pre-union tariff rates against C in both A and B after the FTA is formed has no effect on cases 1, 2, 4b and 5. However, the customs union cases 3 and 4a are different and we call their FTA manifestations cases 3ø and 4aø.

In case 3ø, A's tariff is high enough to protect a domestic  $X$  industry but B's (much lower) tariff is not. Thus before the FTA is formed, B imports  $X$  from C while A produces it at home under its very high tariff rate. After the FTA, A's unchanged tariff remains high enough to keep C's  $X$  out of its market but B's  $X$ , which has a lower cost of production than A's  $X$ , will capture A's market. Thus B will continue to import  $X$  from C but it will now sell  $X$  to A, eliminating A's  $X$  industry. Compared with the CU cases 3b and 3c, there is the same trade creation as A buys its  $X$  from C instead of producing it at home, but no trade diversion as B continues to buy its  $X$  from C rather than switching to produce it at home as it does with the CU. This case of trade creation is rather an odd one. B imports  $X$  from C to satisfy its own consumption but produces  $X$  which it sells to A. This clearly requires effective rules of origin to prevent C's  $X$  from entering A through B.

In case 4aø, the FTA is clearly superior to the CU. In both cases, A shifts from buying its  $X$  from the low cost producer C to the higher cost union partner B. However, while B shifts from buying its  $X$  from C to producing it at home under the CU, under the FTA it continues to buy from C. So the pattern of post FTA trade is similar to that of 3ø with B buying its  $X$  from C but producing  $X$  to sell to its partner A.

In contrast to 4aø, in case 4bø, the CU, which produces neither trade creation nor trade diversion, is superior to the FTA, which produces the same pattern of post FTA trade as 4aø with trade diversion occurring as A shifts from buying  $X$  from C to buying it from its partner B.

Comparing 3ø with the three possible cases under a CU, produces ambiguous results. Case 3a, where A shifts to buy its  $X$  from the lowest cost supplier C, is clearly superior to case 3ø where A shifts to buy its  $X$  from B. However, cases 3b and 3c are clearly inferior to 3ø. Under both the FTA and the CU there is trade creation as A shifts from making  $X$  at home to buying it from B. But under the CU there is an offsetting trade diversion as B shifts from importing  $X$  from C to producing it at home. In the FTA this trade diversion does not occur.

Similarly case 4 produces ambiguous results. With the high post union tariff the FTA is superior to the CU, but with the low post union tariff the CU is superior to the FTA.

The reason for these results is interesting. On the one hand, under an FTA, the low tariff partner's external tariff is unchanged. Under a CU this tariff rate is increased as long as the common tariff is any weighted average of the partners' pre-CU rates. This gives rise to the possibility of an offsetting trade diversion as the lower tariff country's domestic industry gains more protection than it would have had under an FTA. On the other hand, the high tariff partner's external tariff is not reduced under an FTA as it would be under a CU. This gives rise to the possibility that under an FTA the lower cost union partner may capture the high tariff partner's market, which would have continued to be served by the low cost outside supplier under a CU.

The results in 3 and 4 may seem unlikely at first sight. In this Ricardian case, a formerly non-existent  $X$  industry grows up after the RTA is formed to serve the partner's market but not its own. However, when we go to the more usual case of differentiated products, some  $X$  is likely to be produced in each country with different tariff rates determining each country's ratio of domestic production to imports of the range of all the differentiated varieties of the generic product. Alterations in the degree of protection in the various markets can then lead to changes in the ratios of home production of  $X$  to exports and imports of that product.

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So here we have the usual second best result. In spite of all attempts to derive a general result that one form of organisation is superior to another, the result depends on the context. CUs are superior in some initial specifications of costs, and pre and post RTA tariff rates, while FTAs are superior with other specifications.

### **Kreuger's analysis of FTAs**

Let us turn now to Krueger's analysis (1997a, 1997b, 1999a, 1999b) of FTAs. She shows that in particular industries with a rule of origin with high content requirements in an FTA, a particular supplier industry in the low tariff partner can benefit from protection in the partner country that has the higher tariff on the intermediate and the final products.<sup>16</sup> She considers the NAFTA cases of the textile and automobile industry, both of which sell differentiated products with many different variants. She argues that the high Canadian and Mexican tariffs relative to those in the U. S combined with the high content requirements for incorporating North American yarn and textiles into clothing in order to qualify for FTA tariff reductions allowed upstream suppliers and final assemblers in the United States to gain market share in the partner countries at the expense of third country imports in a clear case of trade diversion.

This is just Viner's analysis of the trade diversion effects of a customs union transferred to an FTA. In Viner's analysis, the industry with the lowest costs in the customs union will gain market share throughout the trading zone and divert trade from lower cost third country suppliers who face the barrier of the common external tariff (provided that country's costs are lower than the foreign cost plus the tariff). In

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<sup>16</sup> The term restrictive rule of origin refers to a rule of origin with a high content requirement for the final product in the value chain to qualify for FTA tariff treatment.

an FTA the lower cost industry within the FTA will also tend to gain market share in the combined markets at the expense of third country suppliers because if the industry fulfils the rules of origin it will benefit from tariff preferences especially in the higher tariff partner(s) in the FTA. However, this is a two edged sword. In so far as the imports from the lower cost partner displace imports from even lower cost suppliers in the rest of the world, this is trade diversion. But in so far as they displace local production in the high cost partner, this is trade creation. These two cases are respectively the analogues of the CU (and FTA) case 2 and the FTA case 3ø analysed above.

Although Rules of Origin in an FTA can create scope for trade diversion, they also serve to limit that scope since they are normally associated with variations in the MFN tariffs of the partners. If the rule of origin for a particular industry has such high content requirements that no trade among the FTA/PSA partners qualifies for preferential tariff treatment, it is equivalent to excluding the particular industry from the agreement. In such a case there will be neither trade diversion nor trade creation in terms of direct production effects in that industry and the MFN tariff regime is maintained de facto.<sup>17</sup> In the more typical scenario where high content requirements in the rules of origin limit the volume of intra-FTA trade, the effects of the restrictive rules of origin serve to limit potential trade diversion and also can limit potential trade creation.

Consider the case of textiles and apparel. There are several stages of production including making yarn, weaving the fabrics, colouring and finishing the fabrics, cutting the clothing, and sewing the clothing products. Different fabrics and production processes can be utilised in the production of the clothing. When we break down the supply chain by the different stages of production the scope for trade creation and trade diversion effects becomes more complex. Removing intra FTA tariffs on textiles could lead to trade diversion as higher cost US textiles replace third country imports, while a lower price level for fabrics, especially in Canada and Mexico, could lead to trade diversion in apparel since the costs of inputs declined within the FTA while MFN barriers remained high leading to an increase in effective protection for apparel production as compared with third country producers. Once again focusing on production effects, in so far as any replacement occurs of imports from the low cost outside world at each stage of the supply chain, this is trade diversion; but in so far as it is replacement of the higher cost partner's production by that from the lower cost partner, this is trade creation.

### **Kreuger's comparison of FTA and CUs**

Kreuger does not share the typical second best view that there can be no unqualified either/or preference for one arrangement over another; instead all real world judgments must be context specific.<sup>18</sup> Instead she argues:

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<sup>17</sup> A product can be simply excluded from the schedule of intra-FTA tariff reductions. Alternatively the level of content required in order to qualify according to the rules of origin, can be made very high in a particular industry in order to limit the potential quantity of products which might qualify for intra-FTA tariff reductions. In the extreme case this could be equivalent to excluding the product from the FTA.

<sup>18</sup> This second best message is considered in the modern context in Lipsey (2007).

*“an FTA cannot lead to any more trade creation than can a customs union and, when ROOs export any protection, an FTA leads to more trade diversion than does a customs union. The proof is straightforward. All that needs to be assumed [!] is that [1] the customs union adopts a common tariff for each commodity at a level somewhere between that prevailing pre-union in the higher-tariff country and the lower-tariff country, [2] that the common external tariff be such that effective rates of protection are not increased under customs union, [3] there is no 'water' in either country's tariff schedule, and [4] that cost curves are either constant or upward sloping.”* Krueger (1997b: 180) (emphasis added)

To examine Krueger's claim we need to look carefully at her four assumptions. Assumption [1] seems a reasonable one given all the historical evidence from the many existing RTAs and we consider the others in the following three subsections.

### *Effective protection*

Krueger's assumption 2 is a strong assumption that the hypothesised customs union to which an FTA is being compared does not increase effective protection for industries at different stages of the supply chain. In the Viner case, the CU must increase the effective protection of the lower-tariff union partner, while the FTA does not. In the more complex case of supply chains and differentiated products, the creation of a CU can lead to subtle changes in rates of effective protection for different stages of production in the supply chain as compared with competition with third country producers. With between 10,000 to 20,000 tariff lines, which is typical of most countries, the process of 'averaging' the external tariffs of partners forming a customs union can easily increase effective protection at various stages in production in any, or indeed all, of the partners as compared with third countries, depending on the details of the common tariff schedule created by the CU. For example, lowering input tariffs for an industrial activity will raise effective protection relative to third country producers even if the tariff on the output remains constant. Krueger acknowledges these possibilities but argues that non-members of the CU in the WTO would not accept any increases in effective protection when a customs union is formed.

One wonders how easy it would be to discover any increase in effective protection in such cases and, if discovered, what could be done about it. Krueger assumes that non-members of a CU are very clever in understanding possible shifts in effective protection affecting their exporting industries and are able to press their claims in the WTO effectively while simultaneously assuming the opposite for non-members of an FTA. The latter are assumed often not to understand possible shifts in effective protection affecting their exporting industries and, when they do understand, to be unable to press their potential claims in the WTO. This asymmetry seems implausible.

In any case, the GATT/WTO has never had very effective disciplines on the formation of RTAs under Article XXIV whether customs unions or FTAs. Non-members of a customs union can request renegotiation of tariff and market access schedules in the GATT/WTO if they believe their export interests are affected adversely by the formation of a customs union but these negotiations can drag on for

years or even decades. In the case of CUs, FTAs or PSAs formed under the Enabling Clause there are essentially no obligations on developing-country WTO members.

It seems clear that either a CU or an FTA can alter effective protection at different stages of the supply chain, giving rise to both trade creation and trade diversion. In a CU the details of creation of the common external tariff can have effects on the pattern of effective protection against third country producers and can influence the potential for trade creation and trade diversion. In an FTA the original MFN tariffs are retained but the removal of the intra-FTA tariffs and the incentive effects of rules of origin can affect the pattern of effective protection against third country producers causing trade creation and trade diversion.

#### *Water in the tariff*

Krueger's third assumption is that there is no water under the tariff. This situation can arise for two quite distinct reasons. First, marginal costs may be increasing for reasons such as are analysed in the Heckscher-Ohlin model. In this case, domestic marginal cost will be closely related to the tariff burdened foreign price, at least under perfect competition. We discuss this case below. Second, domestic oligopolistic producers may price their product up to the foreign price plus the tariff, while their costs are much lower. They then absorb the difference in extra profits. There is substantial evidence that restrictions to competition often lead to the second result.

If we consider this second reason for water under the tariff, we have the above cases 3ø vs. 3a-3c and 4a vs. 4aø as possible results of a FTA-CU comparison. From this it is clear that there are circumstances in which CUs can cause more trade diversion than FTAs. Once again, this is a second best result that depends on the context-specific environment in which the comparisons are made.

#### *Cost curves are either constant or upward sloping*

We have already considered the constant cost (Ricardian) case above and found that in some situations an FTA can lead to less trade diversion than a CUs and in other situations to more. In the case of upward sloping supply curves, and with the added assumption of no water in the tariff, there will be a positive correlation between a country's costs of production and its pre-RTA tariffs. With homogenous commodities and perfect competition, the domestic price will tend towards the world price inclusive of the tariff. With product differentiation and imperfect competition, the relationship between the costs and the tariff rates will be less direct, but as noted above, firms will tend to price up to the tariff. Of course, the net economic effects will still depend up the precise structure of the CU tariffs compared to the pre-RTA structure as well as the production cost structure.

#### **Regional Integration and Intra-industry Trade**

Much of the early policy analysis of FTAs was based on the Ricardian case, while ignoring consumption and terms of trade effects. The introduction of economies of scale and product differentiation to which we now turn has important further implications for the analysis of the welfare effects of both RTAs and multilateral liberalization.<sup>19</sup>

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19 See Brander and Krugman (1983) and Lancaster (1980).

Early work by Eastman and Stykolt (1960) indicated the potential for intra-industry adjustments to trade liberalization in oligopolistic industries where economies of scale create gains from tariff reductions greatly in excess of those that would occur in the Ricardian case. The theory of intra-industry trade was more fully developed by Grubel and Lloyd (1975). These authors observed that the EEC integration in the 1960s, led to increased two-way trade in differentiated products with increased intra-industry specialization within specific variants of differentiated products and simultaneously to less inter-industry shifts in output than most observers had foreseen. For example, the result of the EU's formation was not the domination of one country's car industry but a great increase in purchases of various foreign-made cars in each of the EU countries, many of whom continued to make and purchase domestically made cars as well. Subsequently, similar observations of other developed countries forming RTAs led to a wider consideration of monopolistic competition and oligopolistic industries characterised by product differentiation.<sup>20</sup>

It is now understood that because developed countries typically contain many monopolistically competitive and oligopolistic industries producing differentiated products, the new trade that results from an RTA is relatively less in homogeneous products with the consequent large inter-industry shifts and relatively more in different variants of each differentiated product. Thus a new RTA results in complex intra-industry adjustments. These result in scale effects, product specialisation effects, pro-competitive pricing effects, and induced direct investment and innovation effects occurring separately from actual direct trade effects. The increase in contestability also becomes important.

The incorporation of product differentiation and economies of scale into international trade theory provides an explanation not only for the vast expansion of intra-industry trade but also for the expansion of intra-industry foreign investment flows among the developed countries in recent decades. Greatly increased competition has been created by the mutual interpenetration of markets by multinational enterprises. In this environment, the multinational enterprise provides, among other things, an effective mechanism for the international transmission of technology.

Early empirical estimates of the economic gains from new RTA-induced trade were in the order of one percent of GNP, although these potential gains can be underestimated due to aggregation bias. (For examples see Johnson (1964), Verdoorn (1960) and Wemelsfelder (1960).<sup>21</sup> These studies were based, either implicitly or explicitly, on the assumptions that industries were characterized by constant returns to scale and competitive structures. In contrast, the pioneering work by the Wonnacotts (1967) indicated that given the then-existing economies of scale in manufacturing industries, the gains to Canada from free trade with the United States would be much larger, ranging up to ten percent of GNP. Similarly, the Harris-Cox (1983) analysis of

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20 The introduction of imperfect competition and scale economies has been linked to new models of international trade under imperfect competition, drawing abundantly from industrial organisation economics (Helpman and Krugman 1985, Smith and Venables 1988). A different but complementary line of analysis emphasises differences in technology and endogenous technologies. See Romer (1986), Aghion and Howitt (1998) and Lipsey, Carlaw and Bekar (2005).

21 As shown by Feenstra (1995) the use of average tariffs for industry or products groups can lead to serious underestimation of the costs of tariffs to the economy.

Canada-U.S. free trade in the 1980s and the analysis of completing the internal market in the European Community obtained substantial gains from further trade liberalization because of the existence of economies of scale and product differentiation, as well as pro-competitive responses by oligopolistic industries. (See also Cecchini (1988).) Trefler (2004) produced even more dramatic results in a retrospective assessment of the Canada U.S. FTA.

In these studies, the gains from trade liberalization result both from reducing domestic trade barriers and from obtaining better access to foreign markets. The latter induces rationalization of the domestic industrial structure to exploit scale economies, which enhance productivity. The literature of industrial organisation points to several sources of these internal economies. They arise not only from being able to produce at, or closer to, the minimum efficient scales (MESs) for the product variants being exported but also in spreading over a larger output the fixed costs both of design of new variants (that are necessary for continued success in the fierce world of international competition) and of marketing the products.

In addition to these economies of scale that are internal to firms, there are potential dynamic gains from trade that result from economies of scale external to firms.<sup>22</sup> Since external gains are difficult, if not impossible to measure, they are frequently ignored or neglected in policy analysis. The sources of these external economies derive from such factors as the development of skilled human capital with specialized expertise and the diffusion of technology among firms in an industry and across industries. Open and outward-looking trade and payments regimes enhance efficiency in the allocation of scarce investment capital, reduce the incentives for investment of entrepreneurial talent and capital in rent-seeking and lobbying activities. Also, by stimulating investment and competition, they may encourage innovation, adaptation, and diffusion of technology throughout the economy.

### **Strategic Trade Policies**

The analysis of trade theory with economies of scale and product differentiation led to a literature exploring the scope for strategic trade policy (STP) interventions.<sup>23</sup> Various strands of this STP literature derive optimum tariff or subsidy policies by home governments which enable them to collude with domestic firms in order to improve economic welfare of the home country at the expense of foreign companies and governments. However the links between STP and regional integration have not been explored to the same extent.<sup>24</sup>

There are several caveats that apply to this strategic trade policy literature. First, as Eaton and Grossman (1986) have observed, the subsidy or tariff policies that are optimal under one set of hypothesized assumptions are not robust with respect to

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<sup>22</sup> For a more detailed study of these externalities that can be massive see Carlaw and Lipsey (2002).

<sup>23</sup> This literature has been extensively surveyed. See, for example, Richard G. Harris (1989), J.A. Brander (1987); and A.K. Dixit (1986).

<sup>24</sup> In the literature, these policies are often referred to as strategic trade and industrial policies. However, these have no relation to the kinds of industrial policy for developing new industries and new technologies that are emphasised by the literature on evolutionary economics and that have had notable successes in such countries as Taiwan, Singapore, South Korea and Brazil, as well, of course, as notable failures. For detailed analyses see Lipsey and Wills (1996), Lipsey, Carlaw and Bekar (2005: Chapters 16 and 17), Wade (1990) and Westphal (1990).

alternative plausible assumptions about the behavioural responses of firms in imperfectly competitive markets. Second, firms have an incentive to over invest in lobbying activity designed to manipulate strategic trade policies.<sup>25</sup> Thus, in practice governments might implement policies that deviate substantially from the hypothetical optimal tariff and subsidy measures. Third, the models ignore potential retaliation by foreign governments or even the possibility that foreign governments will engage in similar practices.

In most of the models analysing strategic trade policies, the home country and the home firm collude to obtain economic benefits at the expense of the trading partner, which presumes that the foreign exporter does not notice, is unwilling to, or is unable to, mount a response. The impact on the foreign country of these types of trade interventions to shift the terms of trade in particular products is unambiguously negative, but this is not considered in the analysis. However, one plausible conjecture is that countries have negotiated the GATT/WTO rules, and RTAs that limit the use of tariffs or prohibit export subsidies in the industrial sector, in order to avoid such terms of trade losses. The 'mercantilist bargaining' in the traditional GATT negotiations, or in the negotiation of RTAs, can be viewed as mutual disarmament of both 'protectionist' and 'strategic' trade interventions. Thus STP provides a rationale for the attractiveness of RTAs both in terms of potential economic gains and in forestalling strategic trade policies. It is also worth noting that in the absence of RTAs, there could be greater recourse to protectionist or strategic trade policies that would restrict trade significantly and could ignite retaliatory trade wars.

### **Services and Investment**

So far the analysis of economic effects has focused on trade in goods. Now we turn briefly to the question of the implications for RTAs of trade in services and investment.

Historically the creation of the EEC, and the subsequent deepening of the internal market in the EU, and the Canada-US FTA and the NAFTA that followed it led the way in liberalising cross-border trade in services. They also had a major effect on investment flows by subjecting foreign investment to the 'national treatment clause' whereby any restriction on investment in a particular industry or sector had to be applied equally to domestic as well as foreign owned investment. At the time, these were path breaking achievements, and they provided guidance to the Uruguay Round negotiations that led to the General Agreement on Trade in Services (GATS) under the WTO.

One important limitation to analysis of these areas is that the analytical tools for quantitative measurement of barriers to trade in services and to investment are less developed than for trade in goods. This hampers the analysis of potential welfare gains and losses from removal of barriers to trade in services and to investment whether on a multilateral or regional basis. Thus it is more difficult to measure the potential welfare effects of the RTAs that have liberalised trade in goods and services compared with those that have been restricted mainly to trade in goods.

Since the creation of the WTO, many more RTAs have been notified under Article XXIV of the GATT (1994) than have been notified under Article V of the

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<sup>25</sup> See, for example, Bhagwati and Srinivason (1983).



GATS. Most of the latter correspond to, or build in a modest way on, the multilateral commitments of the RTA partners under the WTO and have been closely related to the obligations that the partner countries have under the GATS. Thus, at least to date there is not much scope for discrimination in trade in services or investment under RTAs that would give rise to issues analogous to trade creation and trade diversion for trade in goods. As a result, the analysis of customs unions and FTAs in terms of potential trade creation and trade diversion for goods is appropriate for analysis of most RTAs. This situation could change in the future if the multilateral negotiations in Doha remain blocked while new RTAs and amendments to existing ones begin to make more progress on liberalising investment flows and trade in services.

### **III. POLITICAL ECONOMY EFFECTS**

In the introduction, we noted that many economists, in particular Krueger and Bhagwati, argue that the political economy effects of RTAs, whether CUs or FTAs, tend to inhibit further global trade liberation through the WTO. In contrast, we suggest that there are considerations on both sides of the political economy issue. Any successful regional or multilateral negotiation changes the coalition dynamics for subsequent trade negotiations with effects that can be positive, neutral, or negative. Also, the effects in a particular case can be mixed with different responses in different industries. In this section, we elaborate on these issues.

We do not argue that the political economy effects are unequivocally beneficial, but rather that there are sufficient points on both sides that one should keep an open mind until further evidence is gathered – currently these effects have not had much systematic study, either theoretically or empirically. We list those effects that we can identify as having an unfavourable, neutral, or favourable influences. The favourable cases then subdivide into the four separate issues mentioned in the introduction and covered in the sub-headings in the following section.

While this section mainly applies to all RTAs, at the outset it is worth noting an important difference between FTAs and CUs in the process of subsequent trade negotiations with third countries. In an FTA each partner retains the right to negotiate separately with third countries. In a CU the subsequent negotiating position must be a joint position. This has two consequences. First it is easier for individual FTA members to negotiate subsequent reductions in trade barriers than for CUs to negotiate with third countries either multilaterally or regionally. Second to the extent that the effect of high third country tariffs is to provide greater protection to exporters from the FTA partners as Krueger suggests, then FTA partners are more likely to offer reductions in these high tariff barriers in subsequent reciprocal negotiations with third countries, especially if domestic production shrinks after the FTA is implemented.

#### **Unfavourable Influences**

Both multilateral and regional negotiations may reduce the interest of individuals, firms and government bodies in subsequent multilateral trade liberalization efforts. The reason is that the political economy of trade negotiations relies to a great extent on mercantilist bargaining to mobilise export oriented producer groups to counteract protectionist import competing interests.<sup>26</sup> Thus, any successful

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<sup>26</sup> Issues of this sort are explored theoretically in Grossman and Helpman (1995a, 1995b).

trade negotiation, whether regional or multilateral, can cause erosion of the political support for future negotiations because it has already achieved some industry's goals of assuring better access to its main export markets.

#### *RTAs inhibiting MTAs*

A possible example with respect to RTAs concerns the secure access to the large American market that is the most important destination for the exports of many Canadian and Mexican firms. The NAFTA might, therefore, have reduced the number of industries interested in participating actively in domestic coalitions supporting further trade liberalization, either regionally or multilaterally. This is the concern expressed by Krueger (1997a, 1997b, 1999a, 1999b) about the implications of NAFTA and other FTAs on the political economy of trade negotiations. Similarly for countries such as Turkey, access to the large contiguous EU market is very important and entry into that RTA might have similar effects. Unfortunately, there has been little research on this issue so that although it is distinct possibility, there is no compelling evidence that it is an actuality.

#### *MTAs inhibiting further MTAs*

In contrast, there are clear examples of MTAs having weakening effects on industrial participation in further MTA negotiations. One is the effects of the International Technology Agreement in the WTO in 1996. In this sector, the spread of the global supply chain for production of computer and telecommunications products is such that a significant number of WTO members were able to reach a consensus on eliminating tariffs on products at various stages of the supply chain for computer and telecommunications products. Although this was a remarkable success in the WTO, some commentators have suggested that it has contributed to subsequent difficulties in the Doha negotiations because it removed a major industry group from support of further trade liberalization in a significant number of countries

A different but related problem is that as a result of successive rounds of negotiations in the GATT/WTO, where the developed countries made greater tariff reductions than other members, the large emerging markets such as Brazil, China, India, Indonesia, Pakistan, Russia, and South Africa have higher tariffs on average and more tariff lines above 15 percent rates than do the EC, Canada, Japan and US.<sup>27</sup> Thus it is more difficult to engage in mercantilist bargaining due to the asymmetry in tariff structures.

For a final example, the success of the Doha negotiations in the granting by developed countries of unilateral Duty Free, Quota Free Trade to the least developed countries implies that the latter countries now have little to gain from further successful negotiations in the Doha negotiations while they stand to lose from erosion of their preferences.

In conclusion, it is worth noting that possibly the causation is the reverse of that assumed by those who think RTAs inhibit WTO negotiations. The slow and inconclusive nature of WTO negotiators may encourage those who wish to liberalise trading relations to resort to RTAs. We will return to this issue below.

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<sup>27</sup> Note the Russian Federation is not a WTO member, although it is negotiating accession.

## Neutral Influences

Some of the most important problems facing multilateral negotiations are apparently uninfluenced by the existence or non-existence of FTAs. In these cases, the negotiation of further FTAs will have little or no effect, either way, on the success of further multilateral negotiations.

The governments of countries that are also members of the major FTAs and CUs, such as the U.S., Canada and Mexico, show no signs of being less committed to the Doha round than others. It is possible that some particular industries are less interested, but their governments show no lack of interest in the MTS. The same can be said for Europeans. Indeed, the European Community was quite proactive in supporting the Doha negotiations despite reservations of some member states concerning liberalization of agriculture. A large group of developing countries has sought to retain preferences but these are unrelated to the existence of RTAs.

Of the many major reasons for resisting the changes being advocated in the Doha round, the following had little or nothing to do with membership in RTAs. India is concerned about protecting agriculture. Countries such as Brazil and India are reluctant to cut their high tariffs. China has lowered tariffs but takes the position that it made enough reductions in its trade barriers in the WTO accession negotiations to relieve it from further obligations to make reductions in trade barriers comparable to other countries in the Doha negotiations. Many developing countries, especially in Africa, do not want the Doha negotiations to succeed because they have tariff preferences in the markets of industrial countries, especially against China, which has been graduated from GSP in most products. Canada is protecting its agricultural marketing boards while the U.S. is protecting agricultural subsidies, both of which are exempt from the NAFTA. While the EU is protecting agriculture in multilateral negotiations, its common agricultural policy (the CAP) is permitted by EU rules. Another problem is that the EU and the U.S. have low tariffs and so have less to offer in mercantilist bargaining with the middle income countries. But these low tariffs are the result of bargaining under successive GATT rounds and have nothing to do with FTAs. Indeed the main countries who seem to be focused on retaining their own tariff preferences are the poorest African countries. Although technically they are not in FTAs, (except a few now in interim Economic Partnership Agreements (EPAs) with the EU) or in PSAs, they do get preferences under the enabling clause in the WTO, or the preferences of Duty-Free, Quota-Free access for the least developed countries. The latter was one "political" success of the Doha negotiations and of course unrelated to the existence or non-existence of RTAs.

It is important to bear in mind that since the conclusion of the Tokyo Round in 1979 there has been only one successful conclusion of a broad multilateral negotiation and that was the conclusion of the Uruguay Round in 1993. The expansion of the number of countries engaged in trade negotiations and the asymmetries in trade policies and negotiating interests have made it increasingly difficult to conclude a major multilateral negotiation.

## Favourable Influences

There are many reasons why the political economy dynamic of RTAs may be favourable to further trade liberalisation.

### *More Common Interest Among FTA than WTO Members*

Both the customs union of the EU and the free trade area of NAFTA showed that when a small number of countries with major common interests negotiate, it is possible to reach agreement on a wide range of liberalising measures, including reduction of tariffs and non-tariff barriers, relaxation of restrictions on and protection of foreign investment, liberalisation of trade in services, the creation of an effective dispute settlement mechanisms, and solution of a host of specific problems, all in a relatively short period of time (measured against the slow pace of the Doha round negotiations). There is compelling evidence that this was the case prior to the formation of the WTO. Both the EEC and the EFTA pioneered approaches to dealing with non-tariff barriers, while the steady deepening of integration of the EEC through the internal market initiative led the way to the removal of barriers to trade in services and international investment flows. Similarly the Canada-US FTA and the NAFTA developed approaches to dealing with services and investment that contributed to the Uruguay Round negotiations and the development of multilateral rules for trade in services under the General Agreement on Trade in Services under the WTO.

Most of the recent FTAs have been confined mainly to trade in manufactured goods, with some additional measures affecting investment and services that tend either to incorporate or make very modest additions to the commitments under the WTO. However, both the EU and the NAFTA show that when a small number of countries with relatively common interests are determined to do so they can create arrangements that go deeper than existing multilateral arrangements. When these are shown to work, they can act as templates for subsequent multilateral agreements.

### *Favourable Internal Pressures for Deepening Existing RTAs*

Internal pressures within an FTA often work towards more trade liberalization among the members than was established initially when the agreement was negotiated. This is because the rationalisation of production and trade that follows from the creation of an FTA leads to a lowering of the cost structure of industries, both through their expansion and through the restructuring of imperfectly competitive industries. As they become more confident of their ability to compete due to falling cost and expanding intra-industry trade, there can be a dynamic favouring deeper integration within the RTA.

The evolution of the EEC into the European Community and now the European Union provides an excellent example of this dynamic. The EU has deepened through development of common standards, liberalisation of trade in services, investment and labour mobility. The ASEAN Free Trade Area (AFTA) provides another example, as it gradually evolves from a limited PSA into a more comprehensive FTA with Framework Agreements on services and investment. Over time, multilateral liberalisation through unilateral tariff reductions and gradual development of AFTA has led to the expansion of regional production networks which has reinforced the integration process.

### *Favourable Internal Pressures for External Liberalisation*

Internal pressures within an FTA often work towards further reductions of barriers against trade with the outside world. The rationalisation of production and trade that follows from the creation of an FTA leads to changes in the cost structure of

industries both through their expansion or contraction and through the restructuring of imperfectly competitive industries.

To illustrate, consider a country, *A*, suffering trade diversion as a result of entering an FTA. It was importing product *X* from the rest of the world in spite of its tariffs, while its new partner, *B*, was producing *X* at home under its tariff protection. When the union is formed, *B*'s *X* can undersell the tariff burdened *X* coming from abroad.

First, consider the Ricardian case. Because there was no industry producing *X* in *A*, there are no local protectionist pressures coming from an *X* industry located there. After the union, *A*'s tariff revenue on *X* is eliminated and the external tariff serves only to distort trade flows. These changes set up several political economy pressures for *A* to reduce its external tariff on *X*. (1) Since there is no domestic industry to protest tariff reductions on *X*, reduction of *A*'s tariff on that product is a good bargaining chip in multilateral liberalising negotiations. (2) If after the RTA is formed *A* reduces its tariff on *X* sufficiently, it will restore trade in *X* with the outside world and gain in living standards as the lower real cost producers in the outside world replace the higher cost producers located in its union partner. (3) The shift to sources outside of the RTA will restore some of the tariff revenue that disappeared when its partner displaced the outside world as supplier of *X* to *A* (not completely because the tariff must be below its pre-FTA level to make the imported product competitive against *B*'s tariff free export to *A*).

Second, consider a homogeneous product produced by price taking firms with constant returns to scale but with an upward sloping industry supply curve due to either Heckscher-Ohlin factor market effects or sector specific factors with diminishing returns. For example, farmland can be shifted between livestock grazing and crops depending on relative prices but some farm land will be infra-marginal and other farm land will be marginal in one of the crops. In this case, there could be some high cost production in *A* behind its high MFN tariff. As the tariff is reduced to zero for the FTA partner, imports from the low cost third country supplier will shrink and imports will rise from the FTA partner. In this case, there will be trade diversion when imports fall from the low cost third country producer to be replaced by imports from the partner *B* and trade creation from replacing high cost domestic production in *A* with lower cost imports from *B*. Tariff revenue on the imports from third countries will also be reduced. In terms of the political economy effects, the benefits of the MFN tariff in terms of market share and terms of trade effects will accrue primarily to *B*'s exporters after the FTA is implemented. The political economy effects for the *A* will be similar to those of the classical case discussed above.

Third, consider the more common case of product differentiation and scale economies in the production of each variant of that product. Now what was an either-or case under Ricardian assumptions becomes a matter of degree. All three areas *A*, *B*, and (the many different parts of) the outside world are likely to have industries producing at least some of the variants of product *X*. But because country *A* is less efficient in *X* than country *B*, it will likely have a smaller industry than the more efficient industry in *B*. When the FTA is formed, *A*'s industry will need to restructure to meet increased price competition from its FTA partner. What happens next depends on how the industry in *A* responds. Consider two polar cases.

At one extreme, *A*'s industry *X* was producing at very high cost and is unable to cut its price or restructure sufficiently to respond successfully to increased

competition in the FTA. It will lose market share to imports from B. In the extreme case, the A's domestic industry may exit the production of the all variants of X. Here the political economy effects are similar as those outlined above in the classical case.

At the other extreme, A's X industry is able to respond successfully to both the increased price competition from B and the opening of B's market. The response will likely take two forms. First pricing will come closer to costs (where before the FTA, A's industries priced their products just below what the tariff burdened price of imports would have been). Second, there will be restructuring to produce those variants in which its costs relative to B are lowest thus taking advantage of scale economies of longer production runs. Intra-industry trade in X will expand among the FTA partners and the unit costs in both A and B's X industry will decline as the industries in both countries gain economies of longer production runs of a smaller set of variants of product X. Typically, third country imports of X will shrink. Also, the increased competition between B and A will create incentives for innovation.

The political economy of this case is interesting. The X industry's original belief that its continued existence depended on high tariff will be eroded as it finds that it can stand up to competition from B. Also, it will receive diminishing direct benefits from the high tariff on X from third countries because, as the industry becomes more competitive within the FTA, it must also become more competitive with third countries. Although the domestic industry may continue to obtain somewhat higher prices and better profit margins in the domestic market due to the higher MFN tariff, increased competition within the FTA will tend to limit this effect. As A's X industry restructures within the FTA and expands exports to its FTA partner, it will become more difficult to make the political case for retaining the high MFN tariff because production and employment will be less directly linked to limiting competition from third country sources. In some cases where the restructuring of A's X industry is particularly successful, the industry will see new opportunities to expand exports through reciprocal negotiations with third countries, either in subsequent FTAs or through multilateral negotiations. An example is the Canadian wine industry that feared elimination in the original Canada-U.S. FTA. Instead, with some transitional government assistance, it restructured to improve quality and became so successful that it now not only competes well with wine from California and other U.S. sources, but exports many wines, some of which have won prizes in Europe.

It is true that in some protected sectors in existing FTAs, the rules of origin are restrictive and the MFN trade barriers have remained relatively high. Yet typically over time as the FTA is implemented, some restructuring of these protected sectors occurs within the FTA and further trade liberalisation becomes politically possible. Both the Canada-U.S. and the ASEAN FTAs provide examples.

The textile and apparel industry in both Canada and the United States had resisted liberalisation in the GATT. The industry had succeeded in lobbying the governments to retain both high MFN tariffs and to support other developed countries in the restrictive Multi-Fibre Arrangement (MFA), which from the 1960s to the 1990s provided for managed trade in textiles and apparel through export quotas. Now, highly restrictive rules of origin created major barriers to countries outside the Canada-US FTA and its successor, the NAFTA. Although, as this discussion reveals, the textile sector in North America in the 1990s could hardly be described as a bastion of global free trade, the relevant questions in terms of Krueger's conjecture are: "Did they become more protectionist after NAFTA?" and "Did they become more

influential in obtaining protection?ö The answer seems to be ðNoö to both questions. Indeed, there has been significant multilateral liberalisation in this protected sector subsequent to the NAFTA. During the Uruguay Round, the textile and apparel industry in both countries agreed, albeit reluctantly, to a ten-year phase out of the special rules and quantitative restrictions for textile trade under the WTO.<sup>28</sup> Again reluctantly, the industry agreed to the accession of China to the WTO, albeit with special safeguards, which were subsequently invoked. Also, as noted above the textile and apparel sectors experienced increased competition in the domestic marketplace from the introduction of Duty Free and Quota Free access for less developed countries as a decision taken at the time of the launch of the Doha negotiations. Furthermore, in some cases the rules of origin in textiles in NAFTA have subsequently been liberalised to allow more third country imports to be utilised in products qualifying for intra-NAFTA trade after the industry had restructured. Thus the restrictive rules of origin in textiles in NAFTA cited by Krueger (1997a ,1997b) as an example of unfavourable political economy effects have in fact been liberalised as the implementation of the NAFTA has proceeded. More importantly, there has been significant multilateral liberalization of textiles and apparel trade since the NAFTA.

Another example of gradual liberalisation in protected sectors after the formation of an RTA is the ASEAN FTA (AFTA) in South East Asia. Initially, the AFTA was a partial scope agreement with many product exceptions for the most protected sectors. Yet over time through seven rounds of AFTA negotiations, these product exceptions have gradually been brought into the AFTA coverage. At the 14<sup>th</sup> ASEAN summit in 2009, there was a commitment to eliminate the remaining exceptions by 2015. In a number of cases, the AFTA partners have negotiated additional FTAs with third countries including China, Korea, Japan, Australia and New Zealand, which have led to a widening of the number of countries whose producers are eligible for the lower duties and which aim for elimination of most duties. Thus there has been a step by step dynamic in ASEAN to widen the coverage of the AFTA and considerable willingness to negotiate FTAs with third countries.

The political economy effects that can be positive for trade liberalization involve primarily the restructuring of import-competing industries. Of course export oriented industries may also restructure as a result of the FTA and may become more export oriented, particularly with industries producing differentiated products, but we do not consider this case further.

#### *Pressures for multilateralism at the systemic level.*

In contrast to concerns that RTAs contribute to the erosion of the multilateral trading system, there are also reasons why membership in RTAs can lead to greater willingness to participate in multilateral negotiations. One reason is that smaller countries who negotiate FTAs with large developed countries will lock in a more comprehensive liberalisation of their trade regime. (See Ethier (1998).) Since small countries often retain considerable latitude for trade restrictions in the WTO through tariff bindings that are above the applied rate and other measures, the ðlock-inö effect of FTA disciplines commits them more firmly to an open trade regime through

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28 The negotiation of new rules for intellectual property rights in the Uruguay Round was important to some segments of the textiles and apparel industry.

subsequent negotiations and reduces the likelihood of volatile domestic politics reversing the liberalization.

The willingness of some key countries to negotiate further RTAs may provide a spur for others to enter multilateral negotiations as an alternative to being left out of further RTAs. For example, although developing countries had always resisted taking on obligations and making tariff concessions in the GATT, they were for the first time full participants in GATT negotiations of the Uruguay Round. It proved difficult to conclude these complex multi-issue negotiations with a very large group of participating countries. However, as mentioned in an earlier section, the willingness of the United States to negotiate free trade agreements with some countries provided a prod to other countries to negotiate multilaterally. In an earlier example, the belief that negotiation of FTAs was a credible strategy to induce other countries to engage in multilateral negotiations was widely held in the debate during the negotiations of the Canada-US FTA and the NAFTA. See Smith (1993).

Another reason arises when an RTA concentrates a member's trade with its partners. There may then be political pressures to diversify, under multilateral negotiations. For example, over 80 percent of Canada's foreign trade was with the U. S. after the completion of the NAFTA. This concentration on one export market worried policy makers who took whatever opportunities presented themselves to push for more trade agreements, MTAs or RTAs that would lessen that dependence. Currently, Canada is negotiating for an FTA with the EU, which would accomplish significant trade liberalisation while reducing Canada's dependence on the U.S. market.

Finally, the proliferation of overlapping RTAs inevitably leaves some countries out. The process of competitive liberalisation in RTAs puts pressure on countries not participating actively in RTAs to engage more actively in multilateral negotiations. Furthermore, the multiple ROOs in overlapping FTAs do impose administrative and compliance costs on firms thus reducing the trade gains. Thus enterprises operating within RTAs may support further multilateral liberalisation in order to minimise the costs of compliance with ROOs and to widen further their production networks.

#### **IV. CONCLUDING REMARKS**

While we agree that MFN is a key principle in the MTS, it is important to take note of some important facts. First, from the second half of the 19<sup>th</sup> century, problems arose with the MFN treaties. Tariffs and other trade restrictions were on a rising trend, reaching successively higher peaks in the 1890s, after WWI, and in the early 1930s. The MFN treaties of the 19<sup>th</sup> century collapsed in a longer term trend of rising protectionism which reached its apex in the interwar period.

Second, the Golden age of MFN tariff negotiations was the first two decades after WWII when a small group of developed countries were involved in the negotiations. It was also a time when tariffs were high as a legacy of the peaks of protectionism reached in the interwar period.

Third, compared to the early post war period, multilateral trade negotiations have become much more difficult to conclude due to several factors. The last successful major multilateral negotiation was the completion of the Uruguay Round in 1993 and there have only been two major rounds in the last four decades. More



countries have become involved in the negotiations and there are significant asymmetries in trade regimes. The legacy of six decades of liberalisation by developed countries in the GATT/WTO means that their bound tariff schedules in the WTO are much lower than many developing countries. As a result there is less scope for mercantilist bargaining in the WTO today. Also the agenda for the multilateral negotiations has become much broader dealing with tariffs, non-tariff measures, trading rules, trade in services and intellectual property. In addition, unilateral preferences for many developing countries have been a further important departure from the principle of MFN in addition to provisions for FTAs and CUs under the GATT/WTO and their interests in limiting erosion of tariff preferences reduces support for multilateral negotiations. In this context it is not surprising that the Doha negotiations have proved difficult.

At the outset, we posed the question of whether MTAs and RTAs were complements or substitutes. We have offered many reasons why they can complement each other as well as evidence that they have actually done so in several important cases. When this happens, they interact in a mutually reinforcing, positive feedback dynamic. However RTAs may also act in some ways as substitutes for MTAs, but for two very different reasons. First, the pessimists may be right in that membership in RTAs diminishes the interest of individuals and firms in supporting further multilateral negotiations, in which case they are substitutes in a harmful sense. But if further multilateral negotiations become increasingly difficult to conclude satisfactorily, they may be substitutes in the beneficial sense that they are a second best alternative for trade liberalisation when the first best of multilateral negotiations proves unworkable.

In support of the complimentary hypothesis, we believe that the relatively optimistic view we took twenty years ago about the potential evolution of trade liberalisation has proved valid (Lipsey and Smith 1989). There have been no major rounds of multilateral tariff reductions negotiated since the creation of the WTO but the NAFTA partners and the European Community and its member states, all actively supported the completion of the Uruguay Round and the creation of the WTO in spite of being already involved in fairly deep integrations through their respective RTAs. The reason was that both sets of countries had broader market access issues and policy choices that could only be addressed in a multilateral context. The successful conclusion of the Uruguay Round and the resulting creation of the WTO has had great significance for the multilateral trading system.

The large number of cross-region RTAs that have been negotiated in recent years suggests that the WTO member countries continue to be willing to engage in more open commerce and that the restructuring of production and trade that occurs as a result of RTAs may on balance have a positive influence on further trade liberalisation. Although this might well lead to a greater willingness to engage in multilateral trade liberalisation by some industries, other industries may lose interest in further negotiations. It is thus impossible to predict conclusively the net effects of this rapidly evolving process. However, given the number of political economy pressures pulling in both directions, the pessimistic view that existing RTAs will definitely inhibit further trade liberalisation in general, and MTAs in particular, seems unwarranted.

In conclusion, we note two possible scenarios for the future. In the first, the Doha round succeeds and the prospects for success in subsequent rounds looks good.

MTAs then remain the main vehicle for liberalising trade in goods and services and investment flows. One then has to ask if RTAs would inhibit further multilateral negotiations, or would be neutral in the process, or would stimulate further trade liberalization. Our analysis of these three possibilities suggests that there are effects operating within an FTA that will tend to have positive effects on the political economy of trade liberalisation and these could partially, fully, or more than fully offset the potential negative effects. If our optimistic view is correct, RTAs remain an important complement to the MTS. If the pessimists are correct, RTAs exert a drag on further MTAs, although we hasten to add that the case for this eventuality seems weak to us. In any case, with this scenario the successful conclusion to the Doha negotiations and a broad lowering of MFN tariffs greatly reduces the scope for trade diversion from RTAs. If the margins of preference are low, the welfare costs of trade diversion, and benefits of trade creation, are likely to be small, at least when viewed from the classic Vinerian perspective. But viewed from a more modern perspective of imperfect competition, especially among oligopolies producing differentiated products, there still remain significant potential gains to be reaped both from specialisation in particular product lines to reap scale economies and from increased competitive pressures to innovate. (After all as Schumpeter long ago observed, increases in living standards over the long term come mainly from innovations in new products, processes and forms of organisation, rather than from increasing static efficiency, no matter how desirable the latter may be.)

In a second scenario, the Doha negotiations remain blocked. More RTAs then become the second best alternative to doing nothing while the MTS negotiations are stalled. Again it matters how further RTAs affect the chances for the revival of negotiations for MTAs. Making what seems to us to be the conservative assumption that further RTAs are on balance neutral with respect to their influence on the negotiation of further MTAs, this makes the second best alternative of RTAs an excellent one. It should also be noted that the further proliferation of RTAs in this scenario may eventually spawn a movement for simplification by subsuming many of the overlapping RTAs in a more general MTA. After all, the more that countries have RTAs with their major trading partners, the less they have to worry about negative effects from MTAs and the more they have to gain from removing the administrative costs associated with ROOs in multiple overlapping RTAs. Thus, over the long term run, the proliferation of RTAs that seems so messy in the short term could be the only realistic road to really embracing MTAs.

Finally, we suggest that because the current wave of RTAs is embedded within a robust trading framework in the WTO, there are grounds for optimism that the process of competitive liberalisation in RTAs will lead eventually to further multilateral liberalisation.

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