

Are Preferential Trading Arrangements Trade-Liberalizing or Protectionist?

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Until the 19th century, most tariff rates were negotiated between pairs of countries. As a result, the same imported commodity was often subject to varying tariff rates, depending on its country of origin. But trade officials often discovered that after they had engaged in strenuous bilateral bargaining to reduce the tariffs of their trading partners, any benefit they had gained was eroded as similar or even better tariff rates were extended to other trading partners. Therefore, nearly all European countries began using “most favored nation” (MFN) clauses in their bilateral trade agreements, which assured that their exports would face only the lowest tariff granted to any other trading partner. Until 1923, however, the United States continued to insist on bargaining over tariff structures one country at a time. That year, the United States began to recognize that this unilateral approach was costing much, and gaining little, and U.S. trade negotiators began changing to MFN clauses in bilateral treaties of Commerce, Friendship, and Navigation (Viner, 1924). When Cordell Hull, a believer in open trade, became Secretary of State in the 1930s, the Reciprocal Trade Agreements Act codified the MFN approach.

During World War II, the establishment of three multilateral economic institutions was envisaged: the International Monetary Fund, the International Bank for Reconstruction and Development (the World Bank) and the International Trade Organization (ITO). However, while the U.S. Treasury drove the negotiations forward for the IMF and the World Bank, responsibility for planning the ITO fell to the State Department, which lagged behind. A charter for the proposed ITO was drawn up at the Havana Conference in 1947. The proposed ITO charter was a schizophrenic document; half of it was designed to underpin an open trading

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regime, while the other half was designed to enable countries to adopt whatever trade policies they deemed necessary to assure domestic objectives. But U.S. negotiating authority to cut tariffs by 50 percent (with negotiated reciprocal tariff reductions by other countries) was due to expire before the ITO charter could be ratified, so the General Agreement on Tariffs and Trade (GATT) was drawn up as an interim measure to underpin a first round of reciprocal tariff reductions. It turned out that the ITO charter was never ratified, and so the GATT articles became the basis for the international trading system (Krueger, 1999). The U.S. adherence to an open multilateral trading system became a key underpinning for the postwar international economic architecture.

In the early negotiations over the international trade institutions, it was envisaged that the only exemption from the multilateral regime would be a customs union—that is, an arrangement in which two or more countries eliminate all tariffs between them and adjust all tariffs external to the customs union to a common level. There are two stories as to why this decision was reversed and free trade agreements between pairs or groups of nations were permitted. In one story, Syria and Lebanon proposed that free trade agreements be permitted (WTO, 1995, p. 8). In the other, Canada and the United States were holding secret negotiations over the possibility of entering into a free trade agreement, an agreement falling short of a customs union, in which the two countries would reduce their tariffs with each other but maintain their existing tariffs with the rest of the world. Thus, the wording of the GATT articles was changed to permit certain free trade agreements as well as customs unions (Hart, 1994). The upshot was that Article XXIV of the GATT allowed “preferential trading arrangements,” provided that: 1) preferences were 100 percent (that is, tariff levels between the partners were zero); 2) there would be a definite plan and timetable for achieving free trade among the participants; 3) the PTA was to be phased in on a definite timetable; and 4) the PTA did not increase protection against the rest of the world (Dam, 1970). The overall import of these conditions was that a “preferential trading agreement” should lean closer to the notion of a customs union, rather than representing a return to the old regime of bilaterally negotiated sector-by-sector tariffs.

In the first three decades of GATT, from the late 1940s into the late 1970s, the trend toward multilateral free trade dominated any tendencies toward customs unions or preferential trading agreements. Indeed, most of the preferential trading agreements and customs unions that were formed during this time were relatively unimportant or complete failures. For example, there was a Latin American Free Trade Area which lasted for two decades, but had little impact, and an East African Customs Union, which was eventually disbanded. The European Union (under a series of names) was by far the most successful customs union. The European Free Trade Area (EFTA), the most prominent of the free trade agreements, was created largely in response to the European Union; in effect, the EFTA countries joined the EU with respect to manufactures, but not other sectors of the economy.

It should be noted that U.S. policy strongly supported both the formation of the European Common Market and the open multilateral, nonpreferential trading

system. These two apparently contradictory policies were reconciled in part by perceptions that the western European arrangement was motivated as much by political considerations as by economic issues, and that it was unique, and in part by insisting that multilateral trade liberalization occur simultaneously with the increasing integration of the European economies. Indeed, in the postwar period, the EU was lowering its tariffs and expanding trade with the rest of the world at a very rapid rate. With this experience in mind, most policymakers and economists accepted the view that, since a customs union removed trade barriers between its members without raising other barriers, it was trade-liberalizing and therefore consistent with economists' support for free trade.

As a matter of economic theory, however, Jacob Viner (1950) had pointed out that the welfare effects of a customs union could be ambiguous. A customs union could result in both beneficial trade creation among its members, as trade barriers within the group were reduced, and also trade diversion, in which the increased trade between countries forming the preferential trading agreement comes at the expense of trade formerly with third countries. Trade diversion can create a situation in which members of the preferential trading agreement end up buying from higher cost sources—their partners in the preferential agreement—while also losing the tariffs they would previously have charged to those outside the preferential trade agreement, and thus reducing their welfare. The countries outside the agreement can suffer as well. During the 1950s, a spate of analytical contributions, well-summarized in Lipsey (1960), clarified some aspects of “customs union theory,” as it was then called.

But as the open multilateral system increased in importance, and as efforts to form preferential trading agreements outside the EU and EFTA met with extremely limited success, academic interest in preferential trading agreements died down.¹ Through seven rounds of multilateral trade negotiations, the world witnessed a reduction in average tariff levels of manufactured goods among developed countries from over 40 percent to about 7 percent prior to the Uruguay Round of negotiations. When the Uruguay Round reductions are entirely phased in, the average tariff levels for the European Union, Japan and the United States will be in the range of 3–4 percent. This low average understates the true extent of protection for a variety of reasons: for example, it doesn't include all tariff and nontariff barriers, especially those on agriculture and services, nor does it take into account the issues posed by anti-dumping laws and countervailing duties, which can serve as a form of protectionism. But even with these caveats noted, trade liberalization on a multilateral basis is clearly one of the success stories of the postwar era.

Since the early 1980s, however, attitudes have changed regarding the balance between preferential trading agreements and multilateral steps toward free trade. The United States had long opposed preferential trading agreements; for example, it had agreed only reluctantly to the Generalized System of Preferences which allow

¹ Even in the third edition of their international economics textbook, Krugman and Obstfeld (1994) devoted less than three pages to preferential trade agreements.

unilateral granting of lower trade barriers for developing countries. However, when a GATT Ministerial meeting in 1982 was adjourned without agreement on a new round of trade negotiations, the U.S. response was to announce that the United States would, henceforth, seek a more open trading system with a “two-track” approach. On one hand, the United States would continue to seek further multilateral liberalization; on the other, it would join in “GATT-plus” arrangements with like-minded countries that were willing to open up their economies to an extent greater than that agreed to under GATT.

The first American departure from multilateralism was to extend certain unilateral trade preferences to some Caribbean countries under the Caribbean Basin Initiative. A free trade agreement with Israel followed. Then in 1986, Canada and the United States began talks that led to the Canada-U.S. Free Trade Agreement (CUSFTA). Although the negotiations were long and complex, little public controversy arose over this agreement, especially in the United States. The long, common border with Canada, the apparent Canadian specialization in exports of primary commodities and U.S. specialization in manufactures, and the fact that the United States already accounted for over 70 percent of Canadian trade while Canada was the largest U.S. trading partner, all seemed to make a Canada-U.S. agreement “natural.”

But when Mexico indicated its desire to join the preferential trading agreement a few years later and negotiations began for a North American Free Trade Agreement (NAFTA), the level of controversy ratcheted up. Mexican trade with the United States and the size of the Mexican economy were each smaller than the comparable magnitudes for Canada, especially if one excluded oil. But attention attracted by Mexican accession was entirely disproportionate to the economic magnitude of the event. Some observers claimed that this happened because NAFTA was the first instance of an arrangement between a developed and a developing country, but this was an exaggeration. In the 1950s, Italian per capita income relative to the richer countries in the original European Common Market was about the same as the Mexico-United States differential in the early 1990s. Also, Spain and Portugal had acceded to the EU in the mid-1980s with per capita incomes relative to the rich EU members not significantly greater than the Mexican relative to the United States at the time of NAFTA.

It soon began to seem that NAFTA was only a first push toward a rising wave of preferential trade agreements. President Bush proposed a Free Trade Area of the Americas initiative, intended to bring all nations of the western hemisphere (except Cuba) into a free trade agreement, and many potential members of such an agreement expressed support for the idea. At around the same time, the dissolution of the Soviet Union and the emergence of independent states in eastern Europe and the former Soviet Union led to a proliferation of preferential trading agreements between those states and countries of Western Europe. The Association of Southeast Asian Nations (ASEAN), which had earlier been a “trade-facilitating” arrangement, decided to become a free trade area.

An Asia-Pacific Economic Cooperation (APEC) grouping was announced, including countries on both sides of the Pacific, which declared its intention to reach free trade by the developed country members by the year 2010 and by the developing country members by the year 2020, although it has never been quite clear whether the free trade goals of APEC were to be achieved preferentially or on a multilateral basis.

Although the concrete actions necessary to bring about a true free trade area either in the western hemisphere or across the Pacific remain to be agreed upon, it is clear that the emphasis of the world trading regime has shifted from one in which trade relations between nations were almost entirely multilateral to one in which the open multilateral system coexists with a series of preferential arrangements. This coexistence of the WTO and an open multilateral system side by side with a proliferation of preferential trading agreements raises a number of important questions. To what extent, or under what conditions, is a proliferation of PTAs compatible with further strengthening and liberalization of the open multilateral trading system? To use the catchphrase that has captured the essence of the problem: are PTAs building blocks or stumbling blocks for the open multilateral system?

There are many ancillary questions. What are the effects of PTAs? Under what conditions are they more or less conducive to welfare improvement of the members of the arrangement and to those that are excluded? Are there significant differences between customs unions and free trade agreements? In the realm of political economy, do preferential trading agreements tend to stimulate further support for multilateral liberalization, either within member countries or within excluded countries, or do they tend to build up new interest groups opposing multilateral liberalization?

There is considerable disagreement on these issues. Some economists have concluded that preferential trading agreements threaten the open multilateral system and should be severely circumscribed, if not proscribed, under the WTO (for example, Bhagwati, 1995). Others argue that such agreements are a step towards multilateral liberalization and inherently strengthen the WTO and international trading system.²

In what follows, a guide to the current state of the debate is presented. The first section gives a rundown of the various types of preferential trading agreements and an indication of their quantitative spread over the past decade. A second section reviews the arguments over the positive and normative effects of various preferential trading agreements. A third section then considers the empirical evidence so far available as to the effects of preferential trade agreements. A final section then provides this author's assessment of whether the spread of preferential trading agreements should be viewed as building blocks or stumbling blocks to the cause of free trade.

² A symposium in the *Economic Journal* with articles by Bhagwati, Greenaway and Panagariya (1998), Ethier (1998) and Bagwell and Staiger (1998) is illustrative of the range of views on the issue.

Types and Numbers of Preferential Trading Agreements

At the end of 1998, the World Trade Organization listed 98 preferential trading agreements in force. Some involved a number of countries, such as the MERCOSUR customs union between Argentina, Brazil, Paraguay and Uruguay, while others were bilateral. Many countries participate in more than one arrangement. Chile, for example, has free trade agreements with Mexico, Canada, MERCOSUR, the European Union, and is seeking similar arrangements with Australia and New Zealand (who have a free trade agreement of their own), Korea, and NAFTA. Richard Snape (1996) has described the current set of trading arrangements as a “spaghetti bowl,” which is what a map with lines drawn between countries with preferential trading agreements looks like.

World trade has increased rapidly in recent years. Over the period 1990 to 1997, world GDP grew at an average annual rate of 2.0 percent, while world merchandise exports grew at an average annual rate of 6.5 percent (WTO, 1998, Table 1). However, the share of world trade happening under preferential trading agreements has increased even faster.³ In 1963, 56.3 percent of exports from the 15 European Union countries were destined for other EU countries, while 51.8 percent of EU imports originated in other nations of the EU-15. By 1997, the comparable figures were 60.8 percent for exports and 67.6 percent for imports. For NAFTA, the relevant figures may be taken from the change during the 1990s. U.S. exports to Canada constituted 21.1 percent of total U.S. exports in 1990 and were 21.7 percent of U.S. exports by 1997, which does not look like a sizeable increase. However, using 1990s as the starting point may underestimate the effect of CUSFTA, since the share of trade with the United States should already have started to increase in the late 1980s as it became clear that CUSFTA was coming into force. U.S. exports to Mexico were 7.1 percent of the total in 1990, and rose to 10.4 percent in 1997. For Mexican and Canadian exports to the United States, the figures are more striking: Mexican exports to the United States rose from 78.8 percent of total exports in 1990 to 85.4 percent in 1997, while Canadian exports to the United States rose from 75.0 percent in 1990 to 82.4 percent in 1997 (WTO, 1998). Intra-PTA trade among the four nations of MERCOSUR—Argentina, Brazil, Paraguay and Uruguay—has grown even more dramatically: from 8.9 percent of total exports in 1990 to 24.4 percent in 1997 for exports and from 14.5 to 20.5 percent for imports over that same period (WTO, 1998, Table 1.9).

In principle, an infinite variety of preferential trading agreements are possible, differing by the level of reduced tariff barriers among members as contrasted with the tariffs faced by nonmembers and according to which subset of goods and services are covered. Although the wording of Article XXIV of GATT, quoted earlier, would seem to rule out PTAs that cover only some goods or reduce tariffs

³ It should also be noted that the share of world GDP that is traded between countries in *different* preferential trading agreements has also increased, because trade as a share of world GDP is rising.

only partially, such agreements still happen; perhaps best known is the U.S.-Canada Auto Pact, which preceded NAFTA. However, since all PTAs that are WTO-consistent have 100 percent reductions of tariffs (at least at the end of the phase-in period), I shall typically assume in the discussion that follows that all PTAs (eventually) entail complete elimination of tariffs on goods between partners.⁴ Moreover, I shall assume throughout the discussion that the relevant trade barriers take the form of tariffs and not of quantitative restrictions on trade. For most countries entering into PTAs, quantitative restrictions on imports among members are either nonexistent or dismantled in forming the PTA.

Trade economists have grouped preferential trading agreements into several categories: free trade agreements, customs unions, common markets, and economic union. A free trade agreement (FTA) describes a preferential arrangement in which tariffs are lowered relative to other members but maintained against the outside world. A customs union is a preferential arrangement in which all tariffs among the members are eliminated, while external tariffs are adjusted to a common level. By GATT/WTO rules, the common external tariff must on average be no higher than the pre-union tariff, and “compensation” is negotiated by nonmember countries when accession of a member “harms” the nonmember. The United States, for example, received compensation when Spain joined the European Union because, *inter alia*, the United States was disadvantaged with respect to wheat exports to Spain. A common market is a customs union which, in addition, permits free movement of factors of production, like labor and capital, among the member countries. Finally, an economic union is a common market which additionally has common economic laws covering issues such as standards across members.⁵ As Viner (1950) presciently pointed out, the more extensive the coverage and the more complete the reduction in trade barriers, the more political pressures there are likely to be to achieve a “level playing field” with respect to tax treatment, government policies (as, for example, with respect to environmental protection), and other issues.

Analysis is complicated by the fact that actual preferential trading agreements normally contain elements of more than one of these forms. For example, NAFTA is primarily a free trade agreement, but it also provides for mobility of capital, which is typically considered part of a common market, and sets common standards for some products, which is part of an economic union. But even though the categories are not divided by bright lines, the separate categories of free trade agreement,

⁴ In fact, it is relatively straightforward to show that, starting from uniform external tariffs, the mutual reduction of tariffs between two countries is likely to be welfare-increasing as tariffs start falling, but that welfare gains—given the constant and unchanged tariffs against countries not part of the union—will peak at some level of tariff reduction less than 100 percent. See Bhagwati, Greenaway and Venables (1998) or Frankel, Stein and Wei (1998, pp. 105–109) for the argument.

⁵ The “common standard” may result either from literal harmonization of standards, or by a “mutual recognition” that each country will accept, say, the health and safety standards of the other. The European Union uses a “mutual recognition” standard, which is more liberalizing and probably politically much easier than attempts at outright harmonization of standards.

customs union, common market, and economic union prove helpful for exposing the current state of thinking with respect to PTAs.

The spate of new preferential trading agreements in recent years has consisted almost entirely of free trade agreements, rather than customs unions (although this pattern will shift to some extent when or if the countries in eastern Europe accede to the European Union). The essential difference between a customs union and a free trade agreement is that in an FTA, the members may differ in the trade barriers that they impose on those outside the agreement. As a result, negotiating a free trade agreement requires an additional negotiating step before it can be implemented; that is, measures are taken to avoid “trade deflection,” which occurs when imports shift to enter the countries of the free trade agreement through the lowest-tariff FTA member. To avoid importation of all goods through the lower-tariff country, rules of origin are negotiated: these stipulate the conditions under which goods entering a member country will be deemed to have “origin” in the partner country.

In NAFTA, for example, origin is not conferred on NAFTA-made garments unless there is “triple transformation” within NAFTA: the raw materials, the fiber, the cloth, and the apparel must all have been processed within the FTA. While rules of origin also are sometimes present in customs unions, as was evident in the dispute over whether Japanese cars assembled in the United Kingdom were entitled to duty-free entry into continental Europe, they assume a smaller role.

Rules of origin can lead to significant controversy. Under the CUSFTA (prior to NAFTA), a major dispute arose between the United States and Canada over the interpretation of the rules of origin regarding automobiles: the Canadian assembler had imported engines produced in the United States, and treated those engines as CUSFTA-made. The United States insisted that a sizable number of engine *parts* had been imported from outside CUSFTA, and that the autos were therefore not eligible for CUSFTA duty-free treatment. The enforcement and implementation of rules of origin also imposes costs and can thus constitute a trade barrier. A study undertaken by the European Free Trade Association estimated that the cost to EFTA members of documenting origin to receive duty-free entry into the EU averaged 3–5 percent of the price (Herin, 1986).

Negotiations over rules of origin offer an opportunity for producers to lobby for restrictive rules of origin for goods of concern to them. The final sticking points in the NAFTA agreement were automobiles and garments. In both cases, the U.S. negotiators wanted more stringent rules of origin than did their Mexican counterparts. From the viewpoint of those seeking protection, rules of origin are excellent instruments for two reasons. First, they are not transparent. It is impossible for the average person to know what, for example, the “triple transformation rule” in NAFTA costs. The final NAFTA agreement contains over 200 pages of rules of origin, including some that exclude commodities altogether. Cheese, for example, is conferred origin *unless* it is made of dairy products (Palmer, 1993). Moreover, rules of origin can differ across agreements and for different purposes. For example, while the United States uses “substantial transformation” as a general standard

for rules of origin, actual rules of origin are different under the Caribbean Basin Initiative than they were under CUSFTA, which in turn differed from those for Generalized System of Preferences, and differed yet again for purposes of labeling rules (Palmer, p. 338). Rules of origin can be based on process used, on percentage of value added, on change in tariff heading, or on substantial transformation. When value added is used, questions must still be addressed as to the treatment of raw materials, interest costs, accounting for overhead, and so on.⁶

A second way in which rules of origin are well-suited to serve as a tool of protectionism occurs when such rules help producers of higher cost intermediate goods (such as auto parts) gain access to the PTA-partner's market in preference to lower cost sources of such goods outside the PTA. Use of higher cost parts from within the PTA will mean that the final assembled products are subject to zero tariffs when shipped within the PTA; in contrast, using lower cost parts from outside the PTA means that the final assembled product will fall afoul of rules of origin restrictions and face duties when shipped within the PTA (Krueger, 1999).

Little has been done analytically or empirically to evaluate the efficiency costs of having different areas of an FTA confronted by different prices of intermediate products. To the extent that, say, an otherwise lower cost location in Canada is eschewed because Mexico has a lower tariff on an input imported from a non-FTA-partner country, it seems evident that an additional source of economic inefficiency might arise under free trade agreements that would not arise under customs unions, when goods prices are uniform across the members. However, one can imagine counterexamples when rules of origin discourage trade diversion that would otherwise have occurred purely because of tariff differences. In the world of second- (or third-) best, generalizations as to economic efficiency effects are difficult.

A final question regarding the structure of free trade agreements concerns the differential effects on "center" and "spoke" countries, where a "center" country enters into bilateral free trade agreements with a significant number of other countries, which are the "spokes."⁷ Wonnacott was the first to point out that a "center" country with multiple bilateral FTAs might achieve an artificial locational advantage because more inputs would be available without duties than in one of the "spoke" countries. Of course, any such advantage could be offset by unilateral reduction of external tariffs on the part of the affected "spoke" countries.

Positive and Normative Effects of PTAs

There are two important sets of questions about the effects of preferential trade agreements. The first set of questions involves how such agreements alter

⁶ It should be noted that a low-tariff country could, in principle, have to raise its tariffs to join a customs union, whereas it could retain its existing (low) tariff levels under a free trade agreement. Such a possibility is presumably ruled out by the provisions of Article XXIV.

⁷ See the essays in Schott (1989).

trade, production, and consumption patterns of the partner countries and the rest of the world. The second set of questions addresses how the formation of preferential trade agreements affects the open multilateral trading system and, in particular, whether it hinders or advances further multilateral trade liberalization.

The two sets of questions are connected. A long-run breakdown of the open multilateral trading system could have a large negative impact on members of preferential trade agreements, as well as the international economy generally. Under those circumstances, even a PTA which offered large short-term gains could result in a long-run deterioration of its members' welfare if its existence resulted in the tipping of the balance away from multilateralism and toward regionalism. Conversely, if formation of PTAs were a stepping-stone on the way to further multilateral liberalization, even a PTA which resulted in short-term welfare losses for its members and the rest of the world might provide dynamic gains.

Most international economists, taking a long-term view, would see the second set of questions, concerning the impact of PTAs on prospects for further multilateral trade liberalization, as being the more central issue. However, identifying the mechanisms through which the presence of PTAs would impact long-term trends is difficult. As a matter of practice, considerably more work has concentrated on the first set of issues than the second, and analysts have generally addressed the two sets of questions separately. That same approach is followed here.

Individual Country Effects of PTAs

There are good surveys of the determinants of the effects of preferential trading agreements on trade patterns and welfare (Baldwin and Venables, 1996; Bhagwati and Panagariya, 1996), and the results can be briefly summarized here. Most of the literature has focused on customs unions, although in recent years some attention has also been given to the differences in effects between customs unions and other forms of PTAs.

Analysis often starts by assuming that the average level of external tariffs is the same after the formation of the union as it was before. This assumption can be justified by the requirement of the WTO (and formerly the requirement of the GATT) that when PTAs are formed, external trade barriers should be on the whole no higher than before the agreement. But even if that requirement were not present, it is analytically useful to separate the issue of preferential alteration of trade barriers from whether those barriers are growing or shrinking.

The usual starting point remains the trade-diversion and trade-creation categories first pointed out by Viner (1950). By reducing barriers to trade within the countries of the preferential trade agreement, such agreements can create new opportunities for gains from trade.⁸ However, not all increases in trade flows within a preferential trading agreement should be counted as a gain from the agreement. If the increase in trade within the agreement comes at the expense of trade

⁸ As noted earlier in footnote 4, reducing tariffs to some extent within the preferential trade agreement typically provides welfare gains, but reducing tariffs within agreement to zero is not typically optimal.

formerly with third countries now outside the agreement, then the outside countries suffer, unless the countries comprising the newly formed PTA were sufficiently small in the international economy so as not to affect world prices of their traded commodities regardless of their behavior. Moreover, the welfare effects for the countries within the preferential agreement are ambiguous. When countries within the agreement end up buying from higher cost sources within the agreement, solely because of their tariff advantage over the lower cost sources outside the agreement, then consumers benefit. The reduced tariff means that the price they pay is lower, but the national treasury suffers because it has lost the tariffs that would have been charged and instead pays the higher cost of the imports. If gains to consumers outweigh the added amount paid to producers in the (high cost) partner country, the result can be a net welfare gain for the country; otherwise, the result can be a net welfare loss for the country within the preferential trading agreement.⁹

When imperfect competition prevails, the welfare consequences of preferential trading agreements can become more complex. The rents accruing to imperfectly competitive industries may shift as a consequence of the PTA, and losses of tariff revenues to the government may also represent losses of rents. In addition, the integrated market of a preferential trade agreement may permit economies of scale to arise in domestic production and/or allow an increased variety of goods available to consumers that enable a change in production volumes (Baldwin and Venables, 1996). These gains and losses arise because of the ability of firms to serve larger markets and thus to spread their fixed costs over a larger number of consumers with the entry of each new member into the preferential trading agreement. The degree of competition confronting individual producers may also be affected by integration, which may create gains from a procompetitive push for greater efficiency and innovation.

Formation of preferential trade agreements can affect the flow of foreign capital in many of the same ways that trade flows are affected, that is, investment may be created as a consequence of market integration or it may be diverted from a lower cost location outside the PTA to a location within it. The returns on investment may be affected through any of the routes that affect trade flows under perfect or imperfect competition.

There is no logical necessity that the welfare impact of a preferential trading agreement is of the same sign for all members. There is, however, some presumption that the terms of trade for members of the PTA will not deteriorate and might

⁹ There are a number of additional contributions to the literature on preferential trading agreements. Perhaps the best known is that of Kemp and Wan (1976) who showed that a preferential trade agreement could always be formed which would leave the rest of the world no worse off and PTA members better off. Such a PTA would have the property that the vector of external tariffs were set such that trade vectors, element for element, equaled or exceeded their pre-PTA level. One can question whether in practice one could ever either determine what such a tariff vector would be, or how one would know that trade levels exceeded their pre-PTA levels element for element. See Bhagwati, Greenaway and Panagariya (1998) for a discussion.

improve, vis-à-vis the rest of the world, which would represent a welfare gain for the PTA members and a welfare loss for the rest of the world.¹⁰

Efforts to translate these arguments into firm rules about when PTAs are more or less likely to lead to welfare improvement have been only partially successful. Even for a given trade arrangement, such as a 100 percent reduction in tariffs among members, the effects will vary depending on the levels of tariffs prevailing prior to the preferential trading agreement, as well as the pattern of trade among members and the rest of the world: the same set of external tariffs, when reduced in different PTAs, could result in very different welfare effects depending on economic structures and patterns of trade among members and between members and the rest of the world.

For example, in the hypothetical situation where factor prices after the preferential trade agreement are those that would prevail in a world of free trade, then the PTA union must be welfare-increasing for countries inside the agreement, and no worse than welfare-neutral outside it. Likewise, if factor prices after a preferential trade arrangement diverge farther from world prices than they did before the preferential agreement was in place, there is a presumption that the PTA reduced the welfare of its members. When the share of trade between two countries is already high before they seek out a preferential trade agreement—as, for example, between Canada and the United States—there is something of a presumption that a PTA is more likely to be welfare-enhancing, in part because the scope for trade diversion is smaller.¹¹ When tariffs to the external world are very high, then a preferential trade agreement seems more likely to cause trade creation because the volume of external trade was already small. There may be some presumption that a PTA between a developed and a developing country is more likely to improve welfare, because of the substantial underlying difference in factor endowments, than an agreement between two developing or two developed countries, which will have more similar factor endowments.

A related question arises with respect to the formation of geographically contiguous trading groups. Early in the discussion regarding CUSFTA and NAFTA, Paul Krugman (1991b) and Larry Summers (1991) independently suggested that the welfare effects of a preferential trading agreement among regional groupings were likely to be positive because neighbors were “natural” trading partners. As a general statement, this assertion seems implausible. Neighbors by definition have closer proximity, but their factor endowments and production structures may be quite similar, as in the case of the United States and Canada, or quite different, as

¹⁰ However, Krugman (1991a) elsewhere attempted to assess the effects on world welfare of division into an increasingly small number of trading blocks, in a model in which the mechanism is one of altering the terms of trade vis-à-vis nonpartner countries. He found that world welfare was minimized at three trading blocks.

¹¹ But, as Bhagwati, Greenaway and Panagariya (1998) note, shares of trade are averages and what is important is the marginal supplier. It could happen that trading partners had highly priced inelastic supplies of their exports within a neighborhood of actual pre-PTA exports. In that case, the presumption would not apply.

in the case of the United States and Mexico. When neighbors can be similar, it is hard to conclude that trade between neighbors will necessarily be “natural” in some way. An extreme case would be a PTA between two labor-abundant developing countries that had both provided heavy protection for their (same) capital-intensive import-competing industries, while exporting the same commodity bundle of raw materials, so that when they agree to a PTA, all the increment in trade was in goods previously imported from developed countries.

Finally, concerns have been raised that a sequence of free trade agreements, especially when they overlap between different countries, may induce repeated relocation of footloose industries, with subsequent dislocation of economic activity and wasted sunk costs. There were newspaper reports of plants migrating from the Caribbean (where tariff-free entry into the United States had been granted under the Caribbean Basin Initiative) to Mexico when NAFTA came into force.

Building Blocks or Stumbling Blocks?

Trade liberalization during the quarter century following World War II made a significant contribution to rapid global economic growth. Of course, the fact that growth was rapid also facilitated further trade liberalization. But during this time, there was little move toward regional integration except for the European Common Market, and even that integration took place in the context of a rapid global reduction in trade barriers and tariffs.

While economists have reached general agreement about the appropriate framework for analysis in studying the effects of PTAs on their members and on the rest of the world (although disagreements remain with respect to the verdicts on individual PTAs), economists differ dramatically in their thinking about how PTAs will affect the open multilateral trading system. Some believe that PTAs are a facilitating intermediate step on the path to greater global trade liberalization. Others provide models that reach the opposite conclusion.

Those who consider PTAs “building blocks” to further trade liberalization have put forward several lines of reasoning. First, they point to the empirical evidence that PTAs are predominantly, if not overwhelmingly, trade-creating (discussed further in the next section). Then, they use these findings to argue that PTAs provide support for further multilateral liberalization. As a matter of political economy, this claim is a delicate one. Additional exports among PTA partners may create interests that would fear losing sales outside of the trade agreement if multilateral liberalization were to succeed, and thus would probably oppose it. For example, Caribbean nations who had received unilateral preferences from the United States in the Caribbean Basin Initiative typically opposed Mexican accession to NAFTA because of concern over trade and investment shifting from the Caribbean to Mexico. Mexican exporters to the United States may oppose further multilateral liberalization out of concern that they would lose their preferences relative to, say, Brazilian competitors.

However, the evident success of the European Union provides a counterexample, since it was a successful customs union whose internal trade was liberalized

as external opening also took place. The key difference here is whether the new trade within the preferential trading block is opened up between globally low cost producers, in which case they need not fear additional multilateral competition, or whether it is an attempt to protect high cost suppliers within the trade agreement from outside competition. The presumption behind the “natural trading blocks” argument of Krugman (1991) and Summers (1991), mentioned earlier, is that preferential agreements work well when they match countries which should “naturally,” because of proximity, be economically intertwined with each other.

A second argument, closely related, is that regional trading arrangements arise out of the success of multilateral liberalization among developed countries, as developing countries try to “lock in” their trade reforms and induce trade and investment flows from large countries. Ethier (1998) offers a strong version of this argument. Ethier recognizes that trade diversion and protectionist pressures will constitute threats, but he views preferential regional arrangements as typically consisting of a large country linking with one or more small countries, with the latter motivated to lock in their liberalized trade regimes. Seen in this light, PTAs are a symptom of the success of the open multilateral system and are fully compatible with further multilateral liberalization.

A third line of argument has focused on the effects of preferential trading agreements on producer lobbies in member countries that have tariffs above those in their partners. When those tariffs are placed on intermediate goods, the increased competition with producers in the low input tariff country can lead producers to lobby for lower tariffs in their country. There is anecdotal evidence of this occurring in Canada in response to NAFTA and in New Zealand under the Australia-New Zealand preferential trade agreement. This argument also explains one reason a free trade agreement may do a better job of encouraging multilateral trade liberalization; in a customs union, all producers face the same external tariffs, but in an FTA, where they face differential external tariffs, producer pressure will arise to lower multilateral tariff levels to the level of the PTA partner.

A fourth argument suggests the use of preferential trading agreements as a bargaining threat to encourage multilateral trade agreements. When the Uruguay Round was finally completed, for example, some analysts claimed that Europeans had been motivated to reach an agreement out of concern that they would face a trading block emerging out of APEC or in the western hemisphere. However, this argument could cut either way, depending on circumstances; for example, a nation that belonged to a number of preferential trade agreements might feel less need to help make multilateral trade talks reach a successful conclusion.

Finally, there is the argument that was originally enunciated by American officials in accepting preferential trade agreements as part of official American trade policy in 1982, which is that a PTA permits member countries to liberalize beyond the extent that can take place multilaterally. When negotiations on further multilateral liberalization are blocked, countries can use preferential trade agreements to go further and provide a demonstration of the benefits, which may in turn induce other countries to soften their resistance to multilateral liberalization. A related argument, suggested by

Levy (1998), focuses on the possible learning about the benefits from open trade that may come about from preferential trading agreements when voters are (erroneously) frightened of opening up their markets.¹²

On the other side, an equally vocal group of economists argues that the spread of preferential trading agreements is likely to damage the multilateral trading system. In the extreme, they foresee the possibility of a world of trading blocks with relatively high barriers between them, in which trade diversion becomes the norm and outright trade war is always a possibility.

One argument for this position holds that as within-block trade increases under a preferential trading agreement—as it has within NAFTA, the European Union, MERCOSUR, and others—countries within preferential trading agreements become more likely to raise barriers against parties outside the agreement. Bhagwati (1995), for example, has stressed the extent to which trade diversion happens even when tariffs are low, through such means as anti-dumping findings against east Asian countries when American imports from Mexico increase. Further plausibility is given to this view when it is also noted that the Mexican authorities responded to the financial crisis at the end of 1994 and to the sharp drop in oil prices in late 1998 by raising their tariffs against imports from other countries, thus increasing discrimination against non-NAFTA members.

A second line of argument focuses on the proposition that multilateral free trade is an optimal policy in most situations, and asks why formation of a preferential trade agreement is possible while unilateral liberalization is not. It is possible that protectionists will accept PTAs to avoid further multilateral liberalization. Moreover, when trade diversion takes place as a result of PTAs, those benefiting from diversion will tend to oppose further multilateral liberalization, as they would lose their newly-found markets to lower cost producers. Levy (1997) has shown that in a standard trade model, bilateral trade agreements can never increase support for multilateral free trade and are likely to generate the most opposition when the factor endowments of the partner countries are similar. Even export interests will provide less political support for multilateral liberalization, once they have already gained access to additional markets within a preferential trading agreement.

A third line of argument points to the fact that resources in trade ministries are limited, and suggests that use of those resources to concentrate on formation of preferential trade agreements may distract attention from multilateral liberalization. Thus, it was argued that during the NAFTA negotiations, U.S. officials were fully absorbed in that activity and thus did not support multilateral efforts as much as they would otherwise have done.

¹² The argument that PTAs can serve as learning devices with respect to multilateral liberalization has also been made in another context: proponents of incorporating labor standards and/or environmental standards into the WTO have pointed to the existence of those side agreements within NAFTA as setting a useful precedent. Those concerned that labor standards will in fact be protectionist against imports of labor-intensive goods from developing countries or that environmental standards will be used by protectionists to achieve their ends make, of course, the opposite argument, further opposing PTAs because of their susceptibility to protectionist influence in these regards.

It seems evident that, in theory, preferential trade agreements can be either building blocks or stumbling blocks to further multilateral liberalization. As empirical evidence mounts as to their effects, it may be possible to delineate those conditions under which the “building block” outcome is the more likely. Given existing knowledge, there can be no strong presumption in either direction, although there are clearly grounds for concern over the potential for PTAs to weaken the momentum toward multilateral liberalization.

Empirical Evidence Regarding the Impact of PTAs

Separating the effects of preferential trade agreements from everything else that is happening in the world economy poses some difficult empirical challenges. In the case of the European Union, for example, rapid economic growth and multilateral liberalization have both been proceeding while intra-European integration has occurred.¹³ Moreover, many empirical studies have been prospective, when interest in the effects of a proposed PTA is at its height, rather than retrospectively looking back at what actually happened. Since interest in PTAs and their effects revived in the 1990s, attention has tended to focus on NAFTA and more recently-formed PTAs. But these newer agreements only have data for a few years. Moreover, these are often transition years where changes are being phased in; in NAFTA, for example, tariff reductions were scheduled to phase in over periods ranging up to 15 years.

There is considerable evidence that preferential trade agreements have increased intra-regional trade among their members, as noted earlier. However, the evidence that trade is tending to become more concentrated in PTAs does not prove anything about the extent of trade diversion or trade creation.

Most of the research on the effects of NAFTA and the newer regional trade agreements has been done within the context of a computable general equilibrium framework. All of these studies show trade creation greatly exceeding trade diversion. Robinson and Thierfelder (1999, p. 16) recently surveyed these studies and summarized their conclusions:

Trade creation greatly exceeds trade diversion in virtually all the RTAs [Regional Trading Agreements] studied. In general, welfare for all members increases. Furthermore, welfare for old members increases as new members join the RTA, suggesting that there are gains from expanding the RTA.

Features from new trade theory such as imperfect competition, increasing returns to scale, trade externalities, or dynamics generate big welfare gains, compared to models incorporating only neoclassical production structures.

¹³ Interested readers can consult Balassa (1977) and Winters (1987) for assessments of the effects of the EU. Baldwin and Venables (1995) provide a survey of the contemporaneous estimates of the impact on Europe in 1992. Winters (1992) contains a number of papers representing different approaches.

Domestic policy reforms in conjunction with an RTA provide additional welfare gains.

While these findings are encouraging, it should be stressed that they are based on computable general equilibrium models and, as suggested by the finding with regard to the importance of imperfect competition, the results depend on the way in which the system is modeled. It is to be hoped that there will shortly be sufficient data for econometric studies to complement the computable general equilibrium analyses.

Few other studies to date shed much light on the effects of NAFTA or other recently formed preferential trade agreements. One exception pertains to MERCOSUR, where Yates (1996) examined the productive efficiency of the change in trade patterns over the period 1988 to 1994—a period during which trade patterns shifted dramatically toward more intra-MERCOSUR trade. Yates concluded that most of the increase in intra-MERCOSUR trade resulted from trade diversion from more low cost sources outside of MERCOSUR to higher cost intra-MERCOSUR sources. Yates also noted that MERCOSUR appeared to have significantly higher external tariff barriers than has been the case in those PTAs which appeared to have had more trade creation relative to trade diversion.¹⁴ He concluded (p. 25): “The findings of this study appear to constitute convincing evidence that regional preferences can affect trading patterns strongly and detrimentally for both member and nonmember countries. The changing trade patterns suggest that MERCOSUR was not internationally competitive in sectors where intratrade grew most rapidly.”

In the next few years, additional data will become available with which to examine the changes brought about by preferential trade agreements. Given the importance of the issues, and the inability of theory to provide definitive answers as to their effects, it is to be hoped that empirical examination and analysis of outcomes will expand greatly in the next few years.

Conclusions

Not all preferential trading agreements are created equal. The European Union has flourished for 40 years, during which time the multilateral trading system was greatly liberalized and strengthened. Conversely, MERCOSUR in Latin America appears to have much greater potential for trade diversion and for negatively affecting the welfare of its members. The Australia-New Zealand Closer External Relations Agreement (CER) appears to have provided an impetus for

¹⁴ These results were criticized by Robinson and Thierfelder (1999) on the grounds that they were obtained by “partial equilibrium methods.” However, there is always a trade-off between the more detailed data that can be used in partial equilibrium analysis and the greater simplification of structures that must be used in computable general equilibrium models. See Baldwin and Venables (1995) for a discussion. To this author, the production efficiency results are not seriously cast in doubt by the fact that they are partial equilibrium—especially in light of the height of external MERCOSUR tariffs—but further work is clearly called for.

further trade liberalization and both countries have remained strong supporters of the open multilateral trading system.

There is little point in advocating that the WTO should seek to outlaw preferential trading agreements: PTAs are here to stay. Rather, the useful questions would seek to find ways to make PTAs more compatible with further multilateral liberalization. Many authors have pointed to the weakness of the GATT/WTO rules on PTAs, and suggested amendments of one sort or another.¹⁵ However, the impact of many of the proposed amendments strikes me as uncertain, because in the present state of knowledge, we lack sufficient understanding of the conditions under which PTAs will be stepping-stones or stumbling blocks to a broader pattern of free trade. On Ethier's (1998) arguments, they are almost certainly stepping-stones; on Bhagwati's (1995) arguments, they are almost certainly stumbling blocks. The truth lies somewhere in between.

Additional empirical evidence will accumulate, based on the effects of the many recently formed preferential trade agreements, which will help to specify what sorts of PTAs are conducive to further multilateral liberalization and what sorts are not. One potentially interesting line of research will focus on the motivation for PTAs: in the European case, the motive was largely political, at least initially. Canada was seeking to avoid the side effects of American protectionism (Hart, 1994). By contrast, in MERCOSUR's case, much of the motivation arose from a desire to achieve more bargaining power in dealing with North America.

Another line of research will focus on how preferential trade agreements have affected the height of preexisting tariffs against third countries. Lower tariffs vis-à-vis third countries will always reduce the potential for trade diversion under a preferential trading agreement and will generally increase welfare, but how important that factor is in driving the overall extent of trade creation and diversion is not clear.

Yet another question that arises is concern with the form of preferential trade agreements. It is possible that the most common motives for adopting FTAs, as contrasted with customs unions, may be protectionist—that is, to keep one's own tariffs against third countries. If so, that raises questions as to whether WTO rules should act to discourage FTAs, while still allowing customs unions. For example, the WTO might seek to discourage the use of FTAs as an outlet for protectionism by specifying that rules of origin can only be imposed in a certain way (say, according to a percentage value added criterion) or that accession of new parties to an existing agreement might become more automatic, as long as the new parties meet certain prespecified conditions.

At present, however, the existing state of knowledge only specifies the reasons why the formation of a preferential trade agreement can either facilitate further multilateral trade liberalization or hinder it. Much more needs to be learned about the conditions that will determine the direction and magnitude of the outcome.

¹⁵ See WTO (1995, Ch. 5) for the suggestions made by members of the WTO secretariat.

However, there are sufficient grounds to justify a serious concern that the rise of preferential trading agreements may pose a threat to the open multilateral system.

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