Do trading blocks help or hurt the cause of global trade liberalisation?

Support your argument with examples.

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Introduction: Few debates in international economics have attracted as much attention recently as the formation and increased proliferation of trading blocks, commonly known as Free trade agreements (FTA). The profound shift of emphasis away from multilateral trade agreements to FTA’s is fundamentally a new characteristic defining current international trade. It is precisely this development that has spurred vast academic research and debate on whether FTA’s in the words of Bhagwati (2008) ‘building blocks’ or ‘stumbling blocks’ to multilateral free trade. This paper will initially analyse the theoretical debate constructed within the Viner tradition focusing on ‘trade creation’ and ‘trade diversion’. I will supplement this further by providing empirical evidence by Yeats (1998) on MERCOSUR and Burfisher (2001) on NAFTA. Henceforth, the discussion will take an increasing dynamic emphasis concentrating on the ‘new regionalism’ that consists of ‘deep integration’ rather than the ‘shallow integration’ superimposed by the previous discussion, which ignores the essential benefits that FTA’s can bring both to members and non-member nations. The works of Ethier (1998), Burfisher et al (2003), Burfisher (2001), and Pomfret (2007) will be analysed to provide light on this new development in trade theory.

It is important initially to provide a short definition of what global trade liberalisation actually entails, and what it means, in order to distinguish whether FTA’s are aiding or undermining it. At the most basic level global trade liberalisation i.e. ‘globalisation’ entails an increase in international trade but it is also the expansion of FDI, MNCs, integration of capital markets resulting in an increase of financial capital flows. Deardorff & Stern (2001) provide analyse that details the exponential rise in global trade especially after the 1950’s. World trade has risen to unprecedented levels; by 1998 it was more than three times what it had been in 1950. One of the main reasons for this development was the increased policy initiative fostered by the GATT and latter replaced by the WTO, which negotiated lowering tariffs after WW2. Tariff levels of manufactured goods in developed countries were lowered from around 40% to 7%, although tariff levels in underdeveloped nations remained high for longer they too were reduced extensively. It became clear that much of the substantial growth of international trade was due to reduced policy barriers to trade that increased competition, which removed protectionist autarkic policies. This is common with the traditional trade theory developed by Heckscher & Ohlin. Under global free trade countries will relocate their factors of production to products that are consistent with their comparative advantage.

Since the 1980’s there has been a gradual shift in attitudes concerning the role of Free Trade agreements (FTA)[[1]](#footnote--1) with achieving non-discriminatory multilateral free trade. This is in part due to an intellectual shift on trade liberalization by policy makers after the 1950’s. Although, they firmly supported global trade liberalization they seemed to propose that any reduction is trade barriers were good as any other, albeit under PTA’s. The second reason is that the restrictive qualifications built into Article 24 of the GATT were often ignored. The second reason was that although the US were initially against PTA’s, however after the Uruguay round were adjourned before any agreement on further trade negotiations were put into place the US decided to ‘Walk on two legs’[[2]](#footnote-0), which meant that they would pursue both bilateral and multilateral trade negotiations based on the principle of ‘most favoured nation’ (MFA) embodied within the GATT, which means that each member extends the same tariff levels to all members. Soon the US had made bilateral trade agreements with several Caribbean and Latin American countries and with Canada CUSFTA, which became known as NAFTA after the accession of Mexico. NAFTA was seen to be the first between the many PTA’s. There have been many estimates of the current number of FTA’s Bhagwati claims that the total number is difficult to ascertain due to the constant increase, however there are around 350 PTA’s reported to the WTO. Thus it is clear that FTA’s are here to stay they are the defining feature of current international trade thus it entails analyses.

The theoretical objection to PTA’s was initially announced with the influential work of Viner (1950) ‘The customs union issue’, which still finds itself at the heart of the debate. In this framework the welfare impact of FTA’s are determined by a few simple variables; changes in commodity trade in the countries within the PTA are ‘trade creation’ effects, changes in trade between the PTA and the rest of the world is ‘trade diversion’ effects and the changes in international prices facing the countries are ‘terms of trade’ effects. Trade creation and terms of trade gains are welfare enhancing, trade diversion and terms of trade loss have a detrimental effect. One of the profound adherents to the Vinerian approach is Bhagwati, who specifically claims that PTA’s on the whole are trade diverting, they divert trade from the cost efficient non-member to relatively inefficient member countries. This has a negative effect both on member countries due to terms of trade loss more has to be paid or exported to buy the same amount of goods but it essentially damages the non-discriminatory multilateral trade negotiations that were developed to increase welfare because it fosters protectionist policies, which will be discussed using empirical studies below.

*‘Acting like termites, PTA’s are eating away at the multilateral trading system relentlessly and progressively… PTA’s are leading us inexorably to what might be aptly described as a trade wreck.[[3]](#footnote-1)*

The case of trade diversion has to be equated with trade creation; it may be possible that member countries gain terms of trade, consume relatively cheaper goods than those that were available before the PTA was formed. Bhagwati claims that due to the very nature that defines PTA’s this is extremely rare they are essentially protectionist. He provides several considerations. Article 24 within the GATT requires that the external tariffs not to be raised when the PTA is formed not to harm other non-members. However the stipulated multilateral free trade tariff is bound at higher levels than the actual tariff levels. Bhagwati gives the example of the Mexican peso crisis of 1994 when external tariffs were raised on 502 items, were tariffs previously had been around 20% to over 35%, while tariff reductions continued among members. A more significant issue is the ‘rules of origin’, which stipulates preferential treatment if adhered to by PTA members, this can essentially be a tool for protectionist policies. The empirical work conducted by Burfisher et al (2001) comments on this by looking at the effects that NAFTA has had on the textiles industry. World trade in textiles is currently regulated by the Agreement on Textiles and Apparel, which superseded the Multi-Fibre agreement under the WTO, NAFTA eliminated all quotas this has shifted US trade with other non-members in favour of Mexico.

*Analyse of bilateral trade data shows that US imports of textiles and apparel from Mexico have increased while those from Asia have declined since NAFTA…in 1993, 14.5% of US textile exports went to Asia while 13.4% went to Mexico. By 1999 textile exports to Asia have decline to 10.3% and the share to Mexican had grown to 31.0%.*

It is clear that the strong ‘rules of origin’ embodied within NAFTA has within the textile industry led to trade diversion not only because there has been an increase in trade with Mexico per se but that there has been a shift from an efficient producer whose products do not consist of US content were as in Mexico it does, this is why rule of origin are highly effective in maintaining protectionist policies. Looking at the static trade effects of MERCOSUR[[4]](#footnote-2), the effects of trade diversion are also evident. Yeats (1998) identifies that inter-trade prior to MERCOSUR were very low but after the accession one witnesses a dramatic increase in trade volume although this alone does not cause concern for multilateral free trade nevertheless, the nature of trade is highly problematic. Yeats shows that the rapidly growing products of inter-trade are goods in which members do not have comparative advantage hence they were not able to export these products competitively to non-member countries. MERCOSUR’s discriminatory tariffs against non-members were five to six times higher than other CU’s such as the EU, which is likely, the cause. For example in 1994 about 63% of MERCOSUR’s inter-trade was within manufactured goods, this is far higher than what it had been previously around 51%. The shift came about in particular industries because tariffs were set accordingly to protect and preserve these dynamic products within MERCOSUR ‘this would suggest the MERCOSUR’s trade barriers affected the reorientation of exports’.[[5]](#footnote-3) Yeats concludes that member countries would have been better of with the trade policies that existed prior to MERCOSUR the uncompetitive capital intensive production would not have existed, they would have maintained a more efficient import structure, paying less for the same amount of goods and maximising utility by buying more. He suggests that there is ‘*convincing evidence that regional preferences can affect trading patterns strongly and detrimentally for both member and non-member countries. The changing trade patterns suggest the MERCOSUR was not internationally competitive in sectors where inter-trade grew more rapidly. Domestic producers reorientated exports to local markets…to charge the higher prices associated with the most restrictive trade barriers’.[[6]](#footnote-4)*

The discussion thus far has examined the static trade effects that assume only shallow integration of PTA’s they are commonly treated exogenously to the global free trade movement, although in defence of Yeats this point is made explicitly in his introduction. However more recently the traditional perspective dedicated to the Viner tradition has increasingly come under scrutiny. Burfisher et al (2003) claim that the traditional model misses many of the impacts associated with ‘new regionalism’, which typically involves deep integration. New regionalism is characterised as moving just beyond efficiency gains in trade but also increases in FDI, liberalising movement of labour, harmonising macroeconomic policies to achieve a common stable environment. These issues are systematically ignored according to Burfisher et al who criticise Bhagwati static analyses of the Mexican peso crisis. They suggest that on the contrary due to 90% of Mexico’s trade is with the US, NAFTA had effectively prevented Mexico from pursuing a protectionist response to the foreign exchange crisis. *‘NAFTA by locking in Mexico’s policy reforms of the 19980’s was widely considered to have been a major factor in maintaining investor confidence and initiating a macro recovery’.*[[7]](#footnote-5) So NAFTA actually prevented Mexico from closing in and being defensive rather it enabled the opposite to happen, although the precise effects that NAFTA had on the crisis is still contentious.

The important work of Ethier (1998) also reinforces the suggestion that regional integration far from being threatening to global free trade it is actually a direct consequence of the success of past multilateralism and an added guarantee for its survival. Ethier acknowledges the fact that becoming a member of a PTA means relatively small gains for small countries in terms of trade opportunity however the gains are principally in attracting FDI. FDI has been steadily increasing since the 1980’s reforming nations anxious to have a piece of the pie in global trade, attracting FDI is seen to be the necessary step. Being part of a PTA is viewed to be beneficial due to accessibility of large markets. ‘*The regional arrangements, by in effect internalising a critical externality, help spread the benefits of the multilateral trading system around the globe and enhance its value to all participants, thereby reinforcing rather than undermining support for multilateralism’.*[[8]](#footnote-6)However it is important to mention that in Ethier work trade diversion is totally absent because it is simply not factored in, so there may be a downside to FTA’s but this is not in the model. His reasoning is that due to the change in international trade between 1950’s and the 1990’s the importance of trade diversion is minimal. It may be the case that trade diversion is at its peak in comparative terms this however has little welfare effects than it would have had prior to the 1950’s.

The Burfisher et al study I have mentioned previously for a critique of NAFTA, however overall the study concludes that trade creation is far larger thus it overweighs the negative impact of trade diversion. They also note that other studies which have used different tools to assess the impact of NAFTA upon the members conclude that NAFTA was net trade creating and would benefit all three countries, with Mexico being the largest beneficiary. This is demonstrated by looking at the agriculture sector. Prior to NAFTA being enacted there was a fear of what it might do to the Mexican agricultural sector as it was heavily protected and subsidised by the state there were fears of huge migration to urban centres and to the US. However this did not transpire primarily because the agricultural sector quickly started to reform before the extended phase in period. The agricultural policy was not constrained by NAFTA but had gained credibility by it. ‘*Mexico has committed itself to free trade and has looked into such policies via NAFTA’*.[[9]](#footnote-7) The benefits of regional agreement is also evident in the US and Canada. The US imports of agricultural produce from other NAFTA members had increased around 14% annually although this was comparatively small to the overall US agricultural sector it had a appositive effect. Burfisher notes that the domestic reforms within the three countries had a bigger impact on employment and agricultural output than NAFTA has but it was through being a member of NAFTA that gave them a strong emphasis for change especially for Mexico.

It is commonly declared within the Viner tradition that there is an exponential rise in preferential trade agreements huge numbers are presented to give weight to the argument Bhagwati (2008) the term used to express the current problem is the spaghetti bowl effect. Each nation has PTA’s with other nations they further have other PTA’s and so forth until the trade picture becomes intertwined and chaotic each having different rules of origin hence different tariffs on a multitude of different goods creating a spaghetti effect. Pomfret (2007) specifically examines the number of FTA’s reported to the GATT/WTO between 1948 and 2006. Pomfret claims that the ‘WTO counts overstate the current situation because they do not exclude abrogated RTA’s’.[[10]](#footnote-8) This means that the impressive numbers commonly stated as a sign of regionalism is actually misleading. An example given is the recent enlargement of the EU up to 65 PTA’s were incorporated within the EU so there were minus 65 PTA’s in 2004 this is commonly not reported. Another problem for using PTA numbers is that they all seem to carry the same weight but this is also misleading because most are either unsuccessful or unimportant, for example the EU enlargement is significant however the PTA between Moldova and Bosnia is relatively insignificant in world trade.

The argument presented by Pomfret is important and I agree that the numbers have to be looked at carefully, nevertheless it is clear that given the need to abrogate certain PTA’s there is still comparatively a large increase in PTA’s. I assume for Bhagwati the issue is beyond just the numbers rather it is an ideological shift that has come to manifest itself on international trade that is slowly reversing multilateral free trade that dominated prior to the 1950’s. Since then the dominant idea has been to focus solely on tariff reduction and if this is going to be achieved with regional agreements then so be it. Nevertheless this process has led to policy inconsistency with the original purpose of GATT/WTO. As identified with the work of Yeats on MERCOSUR the high tariff rates on non-members actually has diverted trade and reduced overall welfare. The rules of origin and the weakening of article 24 embodied within the GATT has exacerbated and aided trade diversion has led to hurting global trade liberalisation. Having said this I also agree that the dynamic and deep integration that PTA’s afford its members is important as Pomfret notes that CUSTA (the regional agreement between US and Canada) had a minor effect on trade flows because the member countries had relatively low tariffs prior to CUSTA. The important reason why CUSTA existed was to lock each country to multilateral free trade so it acted like insurance against protectionist policies that the other country may pursue similar to the concept behind game theory although the gains in the short run may be higher to pursue protectionist policies nevertheless in the long run through CUSTA the welfare gains are higher for everyone. The overall effect that FTA’s may have on multilateral free trade ultimately depends on ones perspective but research, which ignores the trade aspect totally like Ethier (1998) provides a peripheral account that can only be misleading. The work of Burfisher et al analysing the impact of NAFTA is much more illuminating and provides a wider scope that covers both angles the Viner tradition and new regionalism the debate needs more rigorous research as this.

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1. FTA’s consist of Preferential Trading Agreements (PTA) and Customs Union (CU) Members within a PTA establish a common tariff they apply to each other, which is essentially lower than those applied to non-member countries. The important fact that differentiates PTA’s from CU’s is that each member has the power to apply different tariffs to non-members. CU has to set a uniform tariff both with members and non-member countries so it entails a longer period of negotiations [↑](#footnote-ref--1)
2. Bhagwati (2008: 29) [↑](#footnote-ref-0)
3. Bhagwati (2008: xii) [↑](#footnote-ref-1)
4. MERCOSUR was established under the Treaty of Asuncion, signed in 1991 by Argentina, Brazil, Paraguay, and Uruguay. MERCOSUR is a Customs Union. [↑](#footnote-ref-2)
5. A. Yeats (1998:20) [↑](#footnote-ref-3)
6. A. Yeats (1998:25) [↑](#footnote-ref-4)
7. M E. Burfisher (2003:14) [↑](#footnote-ref-5)
8. W J. Ethier (1998:1242) [↑](#footnote-ref-6)
9. M E. Burfisher et al (2001:135) [↑](#footnote-ref-7)
10. R. Pomfret (2007:926) [↑](#footnote-ref-8)