Multilateral Trade Negotiations and Preferential Trading Arrangements

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1994

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I. Introduction

For some years now, there has been a growing feeling in the United States and other major trading countries that their interests are not being well served by reliance on multilateral trade negotiations carried out under the auspices of the General Agreement on Tariffs and Trade (GATT). There has been considerable interest accordingly in seeking the benefits of freer trade by means of preferential bilateral/plurilateral trading arrangements of various kinds. The purpose of this chapter is to investigate these issues.

To put multilateralism and preferential arrangements in historical perspective, it is important to recall that bilateral and plurilateral deals and arrangements have always been an important part of the trade policy environment,[1] and have coexisted with multilateralism from the start. In this connection, we may note that, beginning in 1934, U.S. tariff authority was transferred from the Congress to the Executive Branch in accordance with the Reciprocal Trade Agreements Act (RTAA). As Winters 1990 p. 1289 has remarked, this was done in an effort to offset the detrimental effects of the Smoot-Hawley Act of 1930 that had increased U.S. tariff rates to historic highs and engendered foreign retaliatory actions against U. S. exports. The idea was that foreign markets for U.S. exports might be opened if the United States in turn was ready to make concessions to open its own market. Under the authority of the RTAA, the United States completed twenty bilateral trade agreements between 1934 and 1939. As Winters 1990 p. 1290 notes, the bilaterally negotiated tariff reductions were relatively small. But what was important here was that all the agreements provided for unconditional most-favored-nation (MFN) treatment. This was necessary to insure that an individual negotiating

[1] The scope of bilateral arrangements is in fact much greater than implied here if account is taken of the many "friendship, commerce, and navigation" treaties and the bilateral investment treaties that have been negotiated over a long period of time. In addition, there are numerous sectoral agreements in existence.

country would receive the benefits of whatever further tariff reductions might later be negotiated between the United States and other countries.

Bilateral reciprocity combined with MFN was subsequently adopted as the modus operandi of the GATT, and, as we will discuss below, there have been significant elements of bilateralism in all of the GATT negotiations from 1947 to the present. Thus, while we often think of the GATT as a system based on multilateralism, this may not give due recognition to the role that bilateralism has played in the system. A further manifestation of bilateralism in the GATT was the inclusion of Article XXIV relating to the formation of customs unions and free trade areas. We will note in our later discussion that a substantial number of preferential trading arrangements have in fact been set up within the GATT system, and that Article XXIV has been largely ineffective in overseeing and disciplining these arrangements. What all of this suggests then is that the current world trading system is best described as a coexistence of multilateralism and bilateral/plurilateral arrangements. It is apparent therefore that nations have not opted for a purely multilateral system. The question then is whether this mixture of trading arrangements may be conducive or detrimental to world economic welfare.

The chapter proceeds as follows. We begin in Section 2 with a discussion of the principles of GATT. In Section 3, we present a brief history of the main characteristics of the GATT negotiating rounds and an assessment of their accomplishments. Section 4 is devoted to how preferential trading arrangements are accommodated within Article XXIV of the GATT Articles of Agreement and to a discussion of the characteristics and consequences of existing preferential arrangements. In Section 5, we discuss more generally the advantages and limitations of multilateralism and preferential arrangements. In Section 6, we undertake a theoretical analysis of the welfare effects of the expansion of preferential trading blocs using a comparative advantage framework. We conclude in Section 7 with some implications for the design of trading blocs with the objective of enhancing world economic welfare.

II. The Principles of GATT[2]

The haphazard history of trade policy prior to World War II, including both unilateral protectionism and bilateral deals to undo that protectionism, led after the war to the formation of the GATT. A very strong case can be made that the GATT has had a profound and beneficial influence on the global trading system. Since World War II, the GATT has provided a consensual framework of rules and procedures for the efficient conduct of international trade. In addition, it has served as a negotiating forum in which major reductions in trade barriers have been agreed upon and carried out. The two main pillars or guiding principles of the GATT are well known: *nondiscrimination* and *reciprocity.*

The principle of nondiscrimination means essentially that a nation's trade policies are applied in a uniform and like manner to all of its trading partners. Individual nations or groups of nations are therefore not to be singled out for special preferential or punitive

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[2] There are many excellent discussions of the principles and functioning of the GATT, including Baldwin 1987, Bhagwati 1990a,b, 1991, Finger 1979, Jackson 1989, Jackson and Davey 1986, Patterson 1989, Winters 1990, and Wolf 1987.

treatment as the case might be. For the principle of nondiscrimination to work effectively, nations must act cooperatively and seek to enhance world welfare. This would rule out aggressive or exploitative behavior that is designed to benefit individual nations or groups of nations at the expense of others. In the event of disputes between GATT signatories, the presumption is that there would be impartial adjudication. The interests of small nations especially would therefore be protected against the possibly detrimental actions of larger and more powerful nations.

The principle of reciprocity is more pragmatic in character and arises from the idea that trade liberalization should be viewed in a cooperative context in which countries will exchange concessions on a reciprocal basis. However, the principle of reciprocity does not necessarily rule out unilateral liberalization. Rather, as already noted, reciprocity stems in large measure from the efforts of the United States especially during the 1930s to use reductions in U. S. trade barriers as an inducement to get its trading partners to do likewise. Narrowly conceived, reciprocity implies that concessions will be balanced bilaterally, and this is in fact how trade liberalization was effected during the 1930s. Under the GATT, particularly prior to the Kennedy Round in 1963-67, negotiations were primarily bilateral. But what is crucially important is that the GATT embodies the Most-Favored-Nation (MFN) principle, so that any concessions that may be negotiated bilaterally are then automatically extended to all other GATT member nations. The GATT system can thus be viewed as a multilateral system in which there is nondiscrimination and reductions in trade barriers are made generally available to all countries that adhere to MFN.[3]

The GATT is intended to foster transparency of trade policy measures. This has been most evident in the legal binding of tariff rates by GATT member nations and efforts to reduce these bound rates by negotiation. Transparency has also been an objective with regard to the use of nontariff measures of various kinds. Greater transparency will thus facilitate international transactions by consumers and business firms.

The GATT focus on the reduction and removal of trade barriers and fostering transparency can be achieved most effectively in what Bhagwati 1990b has called a "fix rule trading regime." This means a regime in which trade is guided by a set of rules governing access to markets, that is, rules that permit markets to operate in such a way that the actions of private transactors will serve to enhance economic efficiency and welfare. This is to be distinguished from a "fix quantity rule trading regime," in which trade is managed more directly by government authority establishing quantitative targets for exports and imports without regard necessarily to the effects that managed trade may have on efficiency and welfare.

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[3] Krugman 1991b, 1992a asserts that the GATT is based on what he calls principles of "enlightened mercantilism." He refers to this as "GATT-think" whose basic principles are: (1) exports are good; (2) imports are bad; and (3) other things equal, an equal increase in imports and exports is good. He concludes nonetheless that the trading system has been well served by the principles of GATT-think. The reason is that GATT-think captures important political realities in terms of the way in which the interests of exporting firms are played off as a counterweight against the interests of import-competing firms. Seen in this light, reciprocity and MFN become the "hidden logic" in the GATT system as the prime vehicles for achieving the dismantling of trade restrictions and thus promoting the benefits of freer trade.

III. A Brief History of GATT Negotiating Rounds[4]

As indicated in Table 2.1, there have been eight rounds of GATT negotiations since 1947. In the first GATT round (Geneva 1947), there were 23 participating countries and $10 billion of trade affected by tariff concessions. For the United States in particular, concessions covered 56 percent of total dutiable imports, and, as Finger 1979 p. 423 notes, tariff reductions plus tariff bindings covered 78 percent of total imports. The next two negotiating rounds (Annecy 1949 and Torquay 1951) mainly involved newly acceding countries to the GATT, and in this sense these rounds can be considered as a completion of the first round. Once tariff bindings were effected, the Geneva (1956), Dillon (1960-61), and Kennedy (1963-67) Rounds then focused almost entirely on tariff reductions. There were 48 countries involved in the Kennedy Round and $40 billion of trade covered by tariff concessions. While tariff reductions also figured importantly in the Tokyo Round (1973-79), the primary focus by then was on nontariff measures. The Uruguay Round (1986-?) is the eighth negotiating round and at the time of writing (July 1993) is still in progress. It involves some 100 participating countries and has a large agenda, including negotiations on: trade barriers; sectoral liberalization (e.g., agriculture and textiles and apparel); GATT rules, procedures, and the functioning of the GATT system; and "new" issues (intellectual property rights, trade-related investment measures, and services).

All of these multilateral rounds might suggest that the world shifted abruptly after World War II from bilateral deals to a system of purely multilateral cooperation. Such was not the case, however. As Winters 1990 notes, the negotiations themselves were completely bilateral in the early GATT rounds, and their multilateral implication arose solely from the requirement of MFN. In an effort to deal with problems of free riding, the negotiated concessions were lumped into a single package and were provisional until the overall agreement was completed and signed. This was intended to provide a means of assessing the reciprocity of concessions. In addition, efforts were made to maximize the benefits of the liberalization for the negotiating parties. Finger 1979 refers to this as *internalization,* and it is measured as the imports subject to tariff reductions as a percentage of all dutiable imports on either a bilateral or multilateral basis. In order to maximize the degree of internalization, countries negotiated on a product-by-product, *principal supplier* basis, meaning that concessions were to be exchanged bilaterally on goods for which the two countries were each other's major suppliers. The importance of internalization can be seen in Table 2.1, where it apparently became increasingly difficult to select goods for negotiating purposes in the successive rounds. That is, the import coverage of U.S. tariff reductions decreased from 56 percent in the Geneva Round (1947) to 19 percent in the Dillon Round (1960-61). At the same time, the bilateral internalization ratio in the Dillon Round grew to 69 percent and the multilateral ratio to 96 percent.

Given the obvious limitations of the product-by-product, principal-supplier approach in the Dillon Round, it was decided in the Kennedy Round to adopt an across-the-board form of tariff negotiation whereby tariff rates were to be reduced by a fixed percentage according to an agreed formula, with exemptions to be negotiated for industries that were deemed too sensitive to liberalize. It is evident from Table 2.1 that

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[4] The discussion here draws especially on Finger 1979 and Winters 1990.

the import coverage of U. S. tariff reductions in the Kennedy Round was increased substantially as compared to the Dillon Round, and that the degree of multilateral internalization remained relatively high. This is noteworthy in view of the fact, as Winters 1990 points out, that the tariff negotiations still had a pronounced bilateral orientation. In addition to its tariff negotiations, the Kennedy Round agenda was intended to include negotiations on NTBs and agriculture and to give special attention to developing country exports. It was also decided to forego reciprocal concessions on the part of developing countries. As Winters 1990 and others have noted, the Kennedy Round did not succeed to any important extent in reducing existing NTBs, and the agricultural negotiations failed. It also appeared that the only developing countries to gain significantly in the Kennedy Round were those that did make reciprocal concessions, so that the "special and differential treatment" of developing countries was of questionable value to them.

The principle of across-the-board linear reductions of tariff rates with exemptions was continued in the Tokyo Round, again involving a significant element of bilateralism. But the Tokyo Round dealt primarily with the rules of the GATT system, including technical standards, customs valuation, import licensing and quantitative restrictions, safeguards, subsidies and countervailing duties, antidumping, government procurement, and civil aviation. The Tokyo Round constituted therefore a marked departure from earlier rounds in view of its focus on GATT rules and procedures. Since these are "constitutional" matters, they clearly do not lend themselves to quantitative assessment and to bilateral quid pro quo concessions. It also means that it is difficult to achieve consensus on the design and scope of the specific negotiating items, and, accordingly, that the negotiations may be protracted and nettlesome if there are significant disagreements among the major participants.

The United States led an effort to launch the eighth round of GATT negotiations at the GATT Ministerial Meeting in 1982, but this meeting was apparently badly timed in view of the ongoing world recession, and there were important disagreements about the agenda that was tabled. As already noted, the Uruguay Round was subsequently initiated in 1986. It is unquestionably the most far reaching of all the GATT rounds to date. The Uruguay Round has fourteen individual negotiating groups dealing with trade barriers, sectoral issues, GATT rules and procedures, and new issues. As Winters 1990 notes, it has an even stronger orientation towards "constitutional" matters than was the case in the Tokyo Round. It also seeks to address the difficult issues of agricultural subsidy programs, reaffirms the continuation of the special and differential treatment for most developing countries, and leaves the questions of the choice of formulae for reductions in tariffs and NTBs to be decided in the course of the negotiations.

The Uruguay Round was scheduled for completion in December 1990, but the negotiations were suspended because the United States and the Cairns Group of other major agricultural exporting countries considered the offer by the European Community (EC) to reduce its agricultural subsidies to be unacceptably small. The Uruguay Round negotiations have since been resumed, but their completion is still contingent on whether the EC will make agricultural concessions that the major agricultural exporters are willing to accept. This means that the rest of the Uruguay Round negotiating agenda is being held in abeyance.

The experience of the GATT negotiating rounds is instructive with regard to the successes achieved and also the problems that have been encountered. First, it is clear that the tariff rates of the major industrialized countries have been reduced to relatively low levels, and, as a consequence, that tariffs on the whole no longer constitute major barriers to trade for these countries. Even though there has been a distinct bilateral orientation in the tariff negotiations, the degree of multilateralization of the tariff concessions has been substantial. Second, it is also clear that NTBs have not been reduced to any significant extent, although some reductions may be possible if the Uruguay Round can be concluded on a positive note. Third, the Uruguay Round is the first time that issues of agricultural subsidies have been squarely faced on an international level. It comes as no surprise that the depth of domestic opposition to reductions in these subsidies is profound, given that the subsidies have been in place for decades and that agricultural incomes depend heavily on them. It is perhaps regrettable that there are many other important issues being held hostage to the agricultural negotiations, but it is arguable that the stakes in agricultural liberalization may be potentially greater as compared to these other issues. Finally, beginning with the Tokyo Round and continuing in the Uruguay Round, there has been a pronounced shift towards negotiations covering the rules and procedures of the GATT system. Many aspects of these rules and procedures touch directly on domestic policies in the major trading countries/blocs, so that there are bound to be important differences in the design and implementation of these policies and in the role that interest groups may play when it comes to making changes in policies.

The combination of the impasse in the agricultural negotiations and the pronounced shift towards negotiations on "constitutional" issues may be interpreted as testimony to the difficulties associated with multilateralism as efforts are being made to bring about changes in longstanding domestic policies in the major countries/blocs. It is in this light that the prospects for negotiating preferential arrangements seem appealing. In order to be able to evaluate the case to be made for preferential arrangements, it will first be useful to examine how these arrangements are handled within the GATT and to examine the characteristics and consequences of the important arrangements that have been implemented since World War II.

IV. Preferential Trading Arrangements and the GATT

GATT Article XXIV

In drafting the Articles of Agreement of the GATT, some allowance had to be made for preferential arrangements. The presumption was that such arrangements might be welfare enhancing provided certain criteria were met.[5] The details are set out in Article XXIV of

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[5] Bhagwati 1992a suggests a three-fold rationale for inclusion of Article XXIV in the GATT: (1) full integration of trade among a subset of countries would give the bloc a quasi national status that would be consistent with the single-nation MFN obligation towards other GATT members; (2) removal of all barriers would preclude special and more limited preferential arrangements; and (3) the formation of a trading bloc might further the achievement of freer trade on a global basis.

the GATT, which is entitled "Territorial Application-Frontier Traffic-Customs Unions and Free Trade Areas." This Article is reproduced in the Appendix below.

Article XXIV:4 states that:

"The contracting parties recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements. They also recognize that the purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories.

It is further stated in Article XXIV:5(a),(b),(c) that "...the duties and other regulations of commerce...shall not be higher or more restrictive than...prior to the formation..." of the customs union or free-trade area (FTA) and that the arrangement is to be concluded "within a reasonable length of time." The GATT is to be provided (Article XXIV:7(a)) with information pertaining to the arrangement in order that reports and recommendations can be made as deemed appropriate, and compensatory adjustments may be sought if rates of duty are increased (Article XXIV:6). Finally, Article XXIV:8(a)(b) states that "...the duties and other restrictive regulations of commerce...are [to be] eliminated on substantially all the trade between the constituent territories in products originating in such territories."[6]

An indication of the major preferential arrangements that have been implemented between 1947 and 1991 is given in Table 2.2, which is adapted from Whalley 1991. A more detailed list of the 69 preferential agreements of various kinds and subsequent amendments thereto notified to the GATT between 1947 and 1988 is given in Schott 1989, who notes (pp. 24-25) that only four agreements were explicitly deemed to be compatible with Article XXIV and that no agreement was found to be incompatible.[7] This is not to say that criticisms of preferential arrangements have been absent in GATT deliberations. But it appears nonetheless that the GATT member countries have sidestepped whatever discipline might have been justified with respect to particular arrangements that did not meet the criteria of Article XXIV.[8]

Having described the GATT provisions for preferential arrangements and the lack of any effective surveillance of them, it is of interest to consider some characteristics and consequences of some of the most noteworthy existing arrangements.

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[6] See Jackson and Davey 1986 p. 457 for a list of some of the problems of legal interpretation arising from the language of Article XXIV.

[7] See also the listings of regional and preferential trading arrangements in de la Torre and Kelly 1992 pp. 8, 9, 11, and 12 and Fieleke 1992 pp. 4-5.

[8] According to Patterson 1989 p. 361: "The effective destruction of Article XXIV as a serious restraint on FTA and customs unions began in earnest when the European Community was examined and subjected to very extensive debate under these provisions in 1957-58. No agreement was reached as to the legal question of whether the EC satisfied the requirements of Article XXIV. Apart from political considerations, which dictated a tolerant attitude on the part of some, including the United States, the participants in these discussions concluded that the EC was going to go forward as set out in the Treaty of Rome, and if it were formally found to be 'illegal,' the GATT as an institution would be mortally wounded." See also the discussion of the role of GATT in influencing regional arrangements in Bhagwati 1992a and Finger 1992.

Characteristics and Consequences of Preferential Arrangements

A great deal of analytical attention has been devoted over the years to the economic issues posed by preferential arrangements, but it would take us too far afield to review these issues in detail. For our purposes here, a convenient summary of the issues is provided in Wonnacott and Lutz 1989 pp. 69-70, who identify several considerations that relate in particular to the likelihood of trade creation or trade diversion and therefore to whether world economic welfare may be increased or lowered as the result of a preferential arrangement.[9] They note that the ratio of trade creation to trade diversion will depend on whether:

1. The tariffs of outside countries are high and the initial tariffs of member countries are also high. In this case, the formation of a preferential arrangement is not likely to be trade diverting since there would not be a great deal of trade with outside countries. By the same token, the welfare effects of the preferential arrangement would be enhanced if the member-country tariffs on imports from outside countries were subsequently set at low rates.

2. The prospective member countries are already major trading partners and are close geographically.

3. There are important differences in comparative advantage among the member countries.

In addition they argue that a preferential arrangement is most likely to be viable if the member countries are at similar levels of development and the division of gains from the preferential arrangement can be achieved without major economic and political disagreement. In this connection, Schott 1991 pp. 2-3 emphasizes the importance of the sustainability of the trading relationships among the member countries and the compatibility of their laws and regulations governing trade flows among themselves and with third countries.

It is interesting in light of the foregoing considerations to examine Table 2.3, adapted from Wonnacott and Lutz 1989 p. 76, which lists the important preferential arrangements that have been established and the changes in trade patterns that have occurred. The eight arrangements are classified into two groups according to the changes in internal trade prior to and after the arrangement was put in place.[10] Wonnacott and Lutz draw a number of conclusions about the experiences of the preferential arrangements listed:

1. The preferential arrangements in the first group, in which internal trade increased, generally followed an across-the-board approach to the freeing of internal trade, whereas the second group followed primarily a product-by-product approach. In the latter case, except for the ASEAN, there was a decline in external trade. The substantial increases in internal trade and comparatively small declines in the external trade of the European Community (EC) are especially noteworthy.

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[9] See de Melo, Panagariya, and Rodrik 1992 for a review and extension of the pertinent literature dealing with: (1) the welfare effects of trading blocs; (2) the role of economies of scale, factor mobility, and tariff revenues; and (3) institutional considerations. See also de la Torre and Kelly 1992 pp. 3-6 and Saxonhouse 1992.

[10] It will be noted that Table 2.3 does not include the entry of Greece, Portugal, and Spain into the EC, the 1983 Closer Economic Relationship between Australia and New Zealand, and the 1985 U.S.-Israel and 1989 U.S.-Canada FTAs. Also, it does include arrangements that are no longer in force.

2. There is an apparently positive relationship between the expansion of internal trade and the similarity of development and economic structure, which is also suggestive of the fact that similar economies like those in Western Europe tend to be each other's best customers. Geographical proximity does not appear to be a controlling factor in all situations, as suggested particularly in the different experiences of the Central American Common Market and the East African Community.

The conclusions regarding the EC experience coincide with those of Schott 1991, who observes (pp. 4-5) that the "EC has substantially succeeded in promoting the integration of its member economies" and that "intra-EC trade has far outpaced the growth of exports to third markets." Further, he notes (p. 6) that the multilateral system has been able to accommodate the continuing integration of the European market and evolution of a strong regional trading bloc. Schott also examines the emerging North American trading bloc, which was not included in Table 2.3. As he notes, both Canada and Mexico conduct about two-thirds of their export and import trade with the United States as well as being large-scale recipients of U.S. foreign direct investment. While there are many similarities between the Canadian and U. S. economies in terms of their economic structure, level of development, and compatibility of their trade regimes, this is of course much less true in comparison to Mexico. But when account is taken of the far reaching unilateral economic reforms and liberalization achieved by Mexico in recent years and the commitment of the Mexican government to continue its policy reforms, the prospects for a successful North American trading bloc appear to be favorable despite the differences between Mexico and the United States and Canada.[11] Further, Schott judges that a North American Free Trade Area (NAFTA) is likely to be compatible with the multilateral trading system insofar as U.S. trade especially will continue to be directed very substantially to markets outside of North America and all three NAFTA nations will look to the multilateral system to expand their trading opportunities and to provide a framework for governing their trade relations.

This brief review of existing preferential trading arrangements suggests that the most successful and durable arrangements have been those involving the already advanced industrialized regions in Western Europe and North America.[12] Preferential arrangements among developing countries have in contrast not been particularly successful and often not durable, especially because they have often been designed with import-substitution objectives in mind.[13] It is also noteworthy that Japan and the Asian newly industrializing countries (NICs) are not members of any *de jure* trading bloc. While it is conceivable that an Asian trading bloc might be formed in the future, it seems like a long way off, since, as Schott 1991 p. 14 notes, the countries in the Asia/Pacific region are very widely dispersed geographically, have rather different levels of development and different trade policies and regulatory regimes, and do not have a strong commitment to regionalism. This latter point is most compelling since a great deal of the

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[11] For a computational analysis of a North American Free Trade Agreement, see Brown, Deardorff, and Stern 1992.

[12] This statement should apply as well to the Closer Economic Relationship between Australia and New Zealand.

[13] For more detailed and up-to-date empirical analyses of the experiences of developed and developing countries with preferential trading arrangements, see de Melo, Panagariya, and Rodrik 1992, de la Torre and Kelly 1992, Fieleke 1992, Irwin 1992, Nogues and Quintanilla 1992, Whalley 1992, and Winters 1992.

international trade and investment of Japan and the other Asian countries relates to other parts of the world, especially the United States and Western Europe.

The conclusion that can be drawn from all of this is that the multilateral system has been able to accommodate a series of preferential arrangements over the past three decades, and it is arguable that the arrangements involving the advanced industrialized countries especially have been welfare enhancing on the whole both to the member countries and to the outside world. Further, it is especially noteworthy that there has been a continuing commitment to multilateralism on the part of the same countries that have participated in these preferential arrangements, given that extra-bloc trade has usually remained important to them. This suggests that the powerful trading blocs and individually powerful trading nations have found it in their interest to adhere to an essentially cooperative form of international behavior rather than seeking to achieve benefits through exploiting their market power in trade.

V. The Advantages and Limitations of Multilateralism and Preferential Arrangements[14]

Having briefly examined the experiences of the GATT negotiating rounds and the characteristics and consequences of preferential arrangements within the GATT system, it is interesting next to juxtapose multilateralism and preferential arrangements and seek to identify their respective advantages and limitations. This discussion is not intended to answer which is necessarily better since, as already mentioned, the two are complementary in many respects. We nonetheless hope that our discussion may serve to identify the major elements of choice and compatibility between multilateralism and preferential arrangements and provide a basis for insuring that the international trading system will function to enhance world welfare.

The Case for Multilateralism

Trade liberalization can be undertaken unilaterally, and there are many instances when unilateral liberalization has in fact been carried out. But governments may often feel constrained by domestic interest groups who are opposed to unilateral liberalization. A case can be made accordingly for multilateral liberalization, as Finger 1979 and others have pointed out, on an economy-wide and reciprocal basis. This permits a balancing of the interests of consumers and exporting firms and workers who will benefit from multilateral liberalization against the interests of import-competing firms and workers who may experience displacement.[15] The presumption is that the benefits of liberalization will far outweigh the costs so that it should be possible, at least in principle, to devise a

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[14] The discussion in this section is based especially on Baldwin 1987, Bhagwati 1990a,b, 1992a,b, Finger 1979, Hoekman 1991, Jackson 1989, Krugman 1991b, 1992a,b, Patterson 1989, Nogues 1990, Schott 1989, 1991, Whalley 1991, Winters 1990, Wolf 1987, and Yarbrough and Yarbrough 1986.

[15] This is the "hidden logic" that has made GATT successful according to Krugman 1991b, 1992a in spite of the seeming mercantilistic principles (GATT-think) that he identifies as underlying the GATT.

tax-subsidy arrangement or some other type of income redistribution so that in effect the gainers can compensate the losers.[16]

As already stated, the GATT system is premised on the desirability of cooperative behavior among nations. This is necessary so that the economic benefits derived from multilateral liberalization can be realized. If the system works effectively, there would be political benefits as well, insofar as nations would act in harmony and would avoid the introduction of exploitative trade policy measures and thus forestall possible retaliatory actions by aggrieved trading partners.

In a world of nation states, it is obvious that issues of national sovereignty and national interest will be of great importance. When trade disputes arise, it is inevitable that their reconciliation will require appropriate policy changes by governments. Since individual nations have agreed to certain obligations and have been guaranteed certain rights as a condition of their membership in the GATT, their acceptance of GATT dispute settlements will of necessity lead to overriding the opposition of domestic interest groups. In this way, national autonomy and sovereignty have to be superseded in order to enhance global welfare.

As already noted in our discussion, it is important to recognize that there is leeway in the existing multilateral trading system for nations to take actions or enter into agreements on a bilateral or plurilateral basis insofar as there are situations in which welfare enhancing mutual interests can be pursued on this more limited basis. In evaluating these actions, what is important is whether or not they are detrimental to third countries. Indeed, as we have already noted, Article XXIV of the GATT permits preferential trading arrangements to be carried out, although subject to the qualification that such arrangements should not reduce world welfare. In this respect, the GATT system should be flexible enough to accommodate a variety of trading arrangements, but with the proviso mentioned that such arrangements not be detrimental to world welfare.

Role and Authority of the GATT in a Changing World Economy

Before discussing the litany of criticisms of multilateralism, it is important to realize that the world trading system is in continuous flux, being subjected to a variety of both long- and short-term economic and political influences. Some of these influences affect all nations in common while others will have differential impacts on particular nations and sectors. What this means is that the role and authority of an institution like the GATT must be able to cope with changing conditions.

Since the GATT is premised on a consensual framework, its ability to function and exercise authority is derived from the support that its members provide to it. The United States has played the central leadership role in the GATT since its inception, championing the cause of multilateralism and providing the initiative and momentum for the convening and completion of the successive GATT negotiating rounds. U. S. influence has waned in recent years, however, as the EC and Japan especially and some of the major developing countries have become economically more important and

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[16] Finger 1979 characterizes multilateral liberalization as a public good since it has the properties of being nonexclusive and nonrival. That is, because of MFN, access to markets is available to all foreign exporters (nonexclusion), and there is no limit on the amount of goods that any foreign supplier(s) or nation(s) can export (nonrivalness).

powerful in the global trading system. Some observers believe that a watershed in U.S. influence dates especially from the failed GATT Ministerial Meeting in 1982 when the U.S.-designed agenda for a new round of negotiations was rebuffed. In retrospect, the call for a new GATT round at a time when the world was experiencing the most severe recession since the 1930s may have been ill advised.

In any case, the rhetoric of U. S. trade policy has since been changed, with an expressed readiness to consider and actually carry to conclusion bilateral and plurilateral negotiating options at the same time that the multilateral option is also to be pursued. Indeed, there appears to be both a carrot and a stick at work here, insofar as the United States is saying that it will pursue the more limited negotiating options unless other major trading countries/blocs show a greater willingness to support multilateral liberalization. To date, neither the EC nor Japan has been willing to assume a leadership role in global negotiations, and the smaller industrialized countries are not important enough to make their influence felt. Some of the major developing countries have become more vocal and involved in the GATT, but these countries have been reluctant, at least formally, to give up whatever advantages they believe to have been derived from special and differential treatment in the past.[17]

The position of the United States in the global trading system during the 1980s was also markedly affected by the macroeconomic imbalance and associated deficits on trade and current account that occurred with dollar appreciation. Given the increased import penetration and problems with exporting that were experienced and the inability to achieve fiscal tightening, pressures in the U.S. Congress grew substantially for import protectionism to ward off allegedly "unfair trade" actions and for activism backed by threats of import restrictions designed to open foreign markets. Japan in particular has been singled out because of its substantial and enduring bilateral trade surplus with the United States. This has reinforced the notion that Japanese policies and domestic institutions are different than those in the other major countries and that Japan does not abide by the same rules and practices of its trading partners. Richardson 1991 has remarked that these interventionist pressures seem to have abated somewhat in the early 1990s, although it is possible that they could reemerge.

Our point is that the support for multilateralism and the GATT system was strongest when the United States played the dominant leadership role. This now seems to have changed, and other major countries/blocs have thus far been slow to fill the void.[18] Moreover, it appears to be especially difficult to effect multilateral trade liberalization at a time when major countries are experiencing significant macroeconomic imbalances.

Criticisms of Multilateralism and Advantages of Preferential Arrangements

Having discussed the case for multilateralism and the international economic environment in which the GATT must function, we can now consider a number of

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[17] This could be changing though, especially in the light of the often far reaching unilateral liberalization that has been carried out in many countries.

[18] Of course, it may not be absolutely necessary to have a single country or regional bloc to serve a hegemonic role, but our reading of historical experience suggests that it can indeed make an important difference in the effectiveness of the trading system.

important criticisms that have been levied against multilateralism and the GATT. They include:

   1. The more countries that are involved in a multilateral negotiation, the more difficult and time consuming it will be to draw up a negotiating agenda and to conduct and conclude a negotiation.[19] In view of the numerous parties involved in a GATT negotiation and the size and complexity of the negotiating agenda, individual countries/blocs may find themselves less able to focus on issues that concern them directly. It is possible furthermore that there may be foot dragging and a tendency for negotiating results to reflect the "lowest common denominator" of the countries participating in the negotiation. These difficulties can presumably be avoided in negotiating preferential arrangements in which fewer countries are involved and the negotiating agenda can be more readily agreed upon.

   2. Because of MFN, concessions may be granted to individual countries without there being any quid pro quo. Free riding may thus occur, unless steps are taken to make concessions conditional as, for example, was done with certain Tokyo Round codes that apply only to signatory nations. The problem is all the more serious because special and differential treatment was extended to developing countries beginning in the 1960s, with the consequence that these countries were exempted from making reciprocal concessions. Bilateral/plurilateral arrangements may therefore be appealing as a way of limiting free riding.

   3. The GATT system of dispute settlement has not worked well, especially since an effective enforcement mechanism is lacking. Furthermore, the GATT rules are inadequate in important respects. For example, it has proven difficult to resist the introduction of nontariff restrictive measures of various kinds and to effectively constrain the use of domestic and export subsidies that impact directly on trade.

   4. The GATT has also been too narrowly focused on trade in goods and has not dealt effectively with issues that lie outside the Articles of Agreement. Examples here include the "new" issues of services and trade related intellectual property rights and investment measures that were belatedly placed on the agenda of the Uruguay Round negotiations, and environmental issues that promise to become increasingly important. This suggests that bilateral or plurilateral negotiations can be more focused and tailored to specific circumstances.

   5. Asymmetries exist with respect to the influence of large as compared to medium size and small countries. Large countries may believe that the GATT system ties their hands because of the nondiscrimination and MFN principles, and, accordingly, that their national economic and political interests would be better served in bilateral or plurilateral negotiations that are designed to protect their domestic firms and/or to open foreign markets to their exporters. Medium size and small countries, on the other hand, while recognizing the benefits of MFN, if their trade is predominantly with a single large trading country or bloc, may believe that they can get better and more assured access to its market by means of preferential trading arrangements rather than through multilateral negotiations.[20]

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[19] See Table 2.1 for details on country participation and the length of time of the individual negotiating rounds.

[20] We should note that a word of clarification is in order here, lest the foregoing remarks be interpreted to the effect that bilateral/plurilateral negotiations need be harmful particularly to nonmember countries. This

Criticisms of Preferential Trading Arrangements

Having articulated the various criticisms of multilateralism and arguments in support of preferential trading arrangements, we now call attention to a number of limitations of preferential arrangements, as follows:

      1. Perhaps the chief concern over preferential trading arrangements is that they may be detrimental to world welfare because of the trade diverting effects that may result and because of the exploitative tariff behavior that the formation of large trading blocs may engender. However, as we have already indicated, there is no presumption that preferential arrangements need be welfare reducing. Indeed, we will show in our theoretical discussion below that the expansion of preferential arrangements may well constitute a move toward freer trade in some circumstances. Also, the formation of trading blocs need not in itself lead to exploitative behavior if there is a strong sense of commitment to international cooperation among governments in the design and implementation of trade policies and to the removal of trade barriers.[21] Of course, nothing can be guaranteed one way or the other. It will depend on the circumstances. Nonetheless, it might be argued that this agnostic conclusion is fraught with danger. That is, there is a case to be made that the world needs a strong multilateral system with effective rules and discipline to avoid the formation of welfare reducing trading blocs and to constrain their potentially exploitative behavior.

2. Critics of multilateralism have pointed to the slowness and cumbersomeness of GATT negotiations and thus to the greater comparative ease of bilateral/plurilateral negotiations. This favorable view of preferential arrangements has been questioned, however, by a number of proponents of multilateralism. For example, Schott 1989 argues that, while the GATT rounds typically last for several years, the serious and definitive negotiations are concentrated within a relatively short period of time. Also, most of the actual negotiations involve a limited number of the major trading countries/blocs. In contrast, Schott cites some specific drawbacks of preferential arrangements, including: (a) an inability or unwillingness to address NTBs and other problems more related to the multilateral system (e.g., subsidies); (b) difficulties in reconciling quid pro quo demands; (c) identifying which sectors are to be liberalized at a faster or slower pace than others or not at all; (d) elaborating detailed and potentially costly rules of origin; and (e) the need in any event to cover in detail the same issues as in a multilateral negotiation and to reconcile possible divergences of rights and obligations between multilateral and preferential arrangements. Further, if existing preferential arrangements are to be extended to additional countries, a whole new set of negotiations may be required each time another member is to be admitted. A case can be made therefore that it is misleading and even false to believe that it may be relatively easy to negotiate preferential trading arrangements.

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will not be the case when bilateral/plurilateral negotiations succeed in achieving greater liberalization than would be possible in a multilateral negotiation and nonmembers are able to share in the benefits.

[21] Using a political economy framework, Krugman 1992b argues that a small number of large regional blocs may actually enhance global welfare by facilitating the bargaining process internationally, promoting greater liberalization within individual blocs, eliminating the need for a hegemon, and accommodating institutional differences. For criticism of Krugman's views, see especially Bergsten 1991 and Bhagwati 1992a.

3. We mentioned above that the United States appears to have used the prospect of its entering into preferential arrangements as a means of inducing other major trading countries/blocs to pursue the multilateral option. It is not at all clear, however, whether this can be a successful strategy. The argument is especially problematic if the United States were in fact to enter into such preferential agreements. In that event, this could be interpreted by other countries as a signal that the United States was abandoning its unqualified support and preference for multilateral liberalization. Support for multilateralism might also be eroded in any case if a large part of the available negotiating effort and expertise were shifted to the preferential option. Furthermore, once a preferential arrangement is created, it may become dominated by vested interests who feel threatened by, and will thus oppose, multilateral liberalization. It is possible, finally, that the creation of a number of separate trading blocs could heighten international policy conflicts and frictions .

VI. Theoretical Analysis of the Welfare Effects of the Expansion of Trading Blocs

Having set out the advantages and limitations of both multilateralism and preferential arrangements, suppose now that the proliferation of preferential trading arrangements, in the form of FTAs or something similar, is inevitable. Is there anything that we can say theoretically about what this may portend for the welfare of the world?

There are many issues to be considered here, but we will confine our attention to only one: Is a world of a small number of trading blocs significantly inferior to a world of free trade? We say "significantly inferior" because it seems safe to assume that a world of perfectly free trade will never be reached by any mechanism. Experience suggests that multilateral negotiations can at best reduce trade barriers to low levels, but they cannot eliminate them. Since FTAs by definition reduce external barriers to zero within the included countries and do not presumably maintain or introduce intra-bloc barriers, it is potentially the case that a world of trading blocs, with each bloc forming an FTA, could raise world welfare closer to its free trade level than multilateral negotiations. In that case the world of blocs would not look altogether bad.

To illustrate this possibility in simple terms, imagine that we could measure welfare of a country or the world as a function of the size of trading blocs. Suppose, as we will discuss below, that world welfare rises rapidly as bloc size rises at first, then levels off and approaches the free trade level, W^F, as bloc size approaches the world as a whole, as drawn in Figure 2.1. Then if multilateral negotiations can only achieve a level of welfare somewhere short of the free trade level, as at W^M in Figure 2.1, there is a point beyond which blocs are large enough to yield a higher welfare than multilateral negotiations. Of course, it remains to be seen whether the effect of bloc size on welfare shown in Figure 2.1 can be correct.[22]

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[22] The assumption in Figure 2.1 is that the time path of welfare is monotonic as trading blocs increase in size. Krugman 1991a and Bhagwati 1992a suggest that there could be other paths in which world welfare would not consistently rise.

The Krugman Argument

Krugman 1991a,b, 1992b has addressed this question directly.[23] He examines a model of a large number of countries, each of which produces a distinctive good and each of which initially levies its optimal tariff on all imports. He then computes world welfare as these countries are combined into various numbers of equal sized trading blocs, each with zero tariffs internally, and each revising their external tariffs to remain optimal against goods from outside the bloc. While no general result can be obtained from this model, Krugman finds computationally that world welfare declines as the number of blocs decreases (and countries are therefore combined into ever larger FTAs) until the number of blocs reaches three. World welfare then increases as the number of blocs is reduced still further to two, and it increases even more with the move to worldwide free trade in a single bloc. That is, world welfare is at a minimum when the number of blocs is three. Krugman therefore concludes in the context of his model that bilateralism is generally undesirable, since the formation of FTAs would reduce world welfare at almost every stage.

This is an ingenious argument. It is based, however, on a model that stacks the cards against bilateralism. In an alternative framework one might easily conclude that the formation of FTA trading blocs would be beneficial and that a world of a small number of blocs, even three, might be about as good as one could ask for.

A distinctive feature of Krugman's model is that the firms in each country are assumed to produce goods that are distinct from those produced by all other firms. This product differentiation allows him the simplicity of a single-sector monopolistic-competition model, and thus the kind of clean and simple theorizing that one has learned to expect from Krugman. However, the assumption also means that the countries of Krugman's model are subject to something very like the Armington assumption, which is that each country's products are imperfect substitutes for those of all other countries. This, we believe, is largely responsible for Krugman's results.

The Armington assumption has a long history in the construction of computable general equilibrium models of international trade.[24] However for some purposes, and especially for modeling the welfare effects of trade barriers, it has become increasingly recognized that the Armington assumption places an idiosyncratic stamp upon results.[25] In the context of FTAs and trading blocs, the Armington assumption seems especially likely to yield peculiar implications.

First, the Armington assumption makes it important for any country to import from every other country, since each has something unique to provide. This means that an

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[23] There is of course a large and venerable literature on the welfare effects of customs unions and free trade areas, including what determines whether particular combinations of countries forming trading blocs will raise or lower welfare. In addition to extensive discussions of trade creation and trade diversion, perhaps the most notable contribution is Kemp and Wan's 1976 demonstration that any grouping of countries into a customs union can be welfare improving, both for them and for the world as a whole, given a suitable selection of their common external tariff. None of this literature, however, seems to bear directly on the issue here of the welfare effects of the size of trading blocs. For a recent analytical survey of pertinent theory relating to the welfare effects of trading blocs, see especially de Melo, Panagariya, and Rodrik 1992. See also Kennan and Riezman 1990 and Kowalczyk 1989, 1990, 1992.

[24] See, for example, Whalley 1985 and subsequent work based on Whalley's model by Harrison and Rustrom 1991 and Nguyen, Perroni, and Wigle 1991.

[25] Brown 1987 in particular has analyzed critically the implications of relying on the Armington assumption.

extreme form of trading blocs in which blocs do not trade at all with each other would be welfare disasters. That is, depending on the functional form of the utility function, welfare would be either very low or infinitely low. This is not necessarily wrong, of course, but we find it rather implausible that each country's welfare should depend so sensitively on access to the products of each and every other country in the world.

Second, the Armington assumption increases the importance of trade diversion, as compared to trade creation, and therefore increases the likelihood that a preferential arrangement will be welfare reducing. Since this may be counter intuitive, the point requires some explanation.

As usually explained, trade diversion might seem to be impossible in a world of differentiated products. The classic description of trade diversion is the switch away from a low-cost external supplier of a good to a higher-cost supplier of the same good within an FTA. Since with differentiated products the same good is not available from different countries, this simple form of trade diversion is not possible. In addition, Krugman's model does not have differences in costs, and this too would seem to rule out trade diversion as usually described.

However, a more general definition of trade diversion would not involve identical products, and it would not require any particular differences in costs. Any time there is substitution away from one good in favor of another as a result of distorted price signals that incorrectly reflect costs, there will tend to be a welfare reduction.[26] If the two goods are both imported, then this substitution may usefully be labeled as trade diversion, for the welfare loss is from the same source as in the simpler, more familiar example.

Product differentiation in Krugman's model assures that any expansion of an FTA, short of subsuming the entire world, will involve such trade diversion. As long as any countries remain outside the union, there will be substitution away from their products when the FTA lowers the consumer prices of the products produced by new members of the FTA. Since the products of these two groups of countries previously faced the same tariffs, their relative prices within the FTA had been undistorted, and they become distorted by the FTA. Thus trade diversion necessarily occurs in Krugman's model, no matter how large the FTA becomes.

There is trade creation too, of course, as substitution also occurs away from previously protected domestic goods and towards imports from new members of the FTA. However it is easy in Krugman's model for trade diversion to dominate trade creation.

To see why, suppose that the welfare effects depend only on the number of goods for which there is trade creation and trade diversion. In a world of many countries, when only two of these form an FTA, there is creation of trade for the goods produced by the partners, but diversion of trade away from all of the goods produced by all other countries. Since the number of the latter countries, and therefore goods, is much larger than the number of countries and goods in the FTA, it is not surprising that diversion outweighs creation. Then, as the FTA is made larger and larger, the number of countries inside the FTA – and hence the amount of trade creation – grows, while the number of countries still outside the FTA shrinks. But even when one enlarges the FTA to include one third of the world (the three-bloc case), there are still two thirds of the world's

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[26] Although this is not certain, just as trade diversion by the narrower definition is not necessarily welfare worsening. See Kowalczyk 1990 for a recapitulation of this argument.

products from which trade is being diverted, and only one third for which trade is being created. Again, then, it is not surprising that each enlargement of the FTA up to this point lowers welfare and that the three-bloc case is the worst possible. Only when the goods and countries included in a bloc become as numerous as the goods and countries outside does trade creation finally have a reasonable chance of dominating trade diversion, and only then does the FTA raise welfare.

As this explanation is intended to suggest, then, the assumptions of complete product differentiation and the consequent exaggerated importance of each country and each country's goods for every other country's consumers may introduce a bias against the possibility that an FTA will be beneficial.

One other feature of the Krugman model should also be mentioned, since it may well contribute to his results even if it does not drive them. In his first paper on this subject, Krugman 1991a assumes that trading blocs maintain optimal tariffs against the rest of the world at all times. In part because of the high degree of product differentiation just discussed, these optimal tariffs tend to rise as bloc size increases, contributing to the welfare loss for the world as a whole. In a more recent analysis however, he questions the usefulness of this assumption and replaces it with a constant external tariff in his calculations. The conclusion that world welfare is minimized with either three or two blocs survives. Therefore, while the assumption of an optimal tariff may have exacerbated the welfare losses in the earlier analysis, it seems not to have caused them. The assumption of product differentiation instead seems to play the more important role.[27]

A Comparative Advantage Approach

As an alternative, suppose that trade among countries conforms more to the traditional model of comparative advantage. That is, all countries are capable of producing the same list of goods, but they differ in their abilities to do so either because of differences in technology or differences in factor endowments.[28] The effect of an FTA on world welfare then depends, we will argue first, on the differences among countries that join to form the FTA. Furthermore, as long as countries choose as partners others with whom enough differences in comparative advantage exist, they will tend to capture for themselves a significant portion of the gains from trade that would be available from a move to complete free trade by the world. In such cases it may well be that the majority of the gains from trade that would be possible with worldwide free trade can be captured by a group of trading blocs. The blocs would only need to be large enough and to include countries with a sufficiently divergent variety of comparative advantages.[29]

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[27] It is also noteworthy that Krugman 1991a,b, 1992b qualifies his analysis by noting that trade diversion may be lessened if the trading blocs consist of countries that are "natural" trading partners who would trade to a very large extent with each other in the absence of the formation of a trading bloc. While there may be some merit to this point, we have noted above that geographic proximity may not necessarily be a controlling factor. Bhagwati 1992a makes a similar point and also notes that relatively high substitution elasticities between nonmember and member country goods could prove detrimental to welfare.

[28] We abstract from considerations of imperfect competition and increasing returns to scale. More will be said on this below.

[29] The welfare gains would thus come mainly from an expansion of interindustry trade, and there would be presumably (transitional) costs of adjustment.

Unfortunately, we are not able to make these points with any great generality. However, we can illustrate them by means of simple examples, and that will be our approach.

A Four-Country Example

Consider first a four country version of the simple two-good Ricardian trade model that has been used for two centuries to illustrate the concept of comparative advantage.[30] Let the countries have identical preferences and labor endowments, and let unit labor requirements for producing the two goods, *X* and *Y*, be also the same in countries 1 and 2 and in countries 3 and 4, but differ between the two pairs of countries. That is, let countries 1 and 2 have a comparative advantage in good *X* relative to countries 3 and 4. We will consider only the extremes of free trade and autarky to make our point. Suppose that prohibitive tariffs initially exist in all four countries, and that we now consider opening pairs of the four countries to free trade, thus forming trading blocs. It makes a great difference which pairs of countries we choose to form a bloc. If countries 1 and 2 were to form an FTA, they would not in fact trade with each other since their autarky prices are the same. They would gain nothing from trade. If countries 1 and 3 were to form an FTA, however, they would indeed trade and gain from trade exactly as in the traditional 2-country model. Thus it is only if countries with different comparative advantages join in an FTA that there can be trade creation, and only then are there gains from formation of the FTA.[31]

This example also illustrates our other point that worldwide free trade may not be necessary. In this example, with identical preferences and labor endowments and only two different sets of technologies, the worldwide free trade equilibrium is identical to the equilibrium that will be attained if any pair of countries with different technologies form an FTA, save only for size. That is, the equilibrium world price with free trade is also the equilibrium price within an FTA formed by, say, countries 1 and 3, and the quantities produced and consumed within each country are also the same. Only the total outputs are different, being twice for four countries what they are for two.

Thus, in this very special case, all of the gains from trade that can be achieved with worldwide free trade can also be achieved in two completely separate trading blocs, so long as each bloc includes countries with different technologies. This illustrates the point that trading blocs can in principle approximate (and in this case equal) the welfare levels of complete free trade.

In a more general model, one would not expect to find blocs equaling the welfare of free trade, but a tendency in this direction does seem likely. It seems plausible that blocs would in general achieve levels of welfare that are between autarky and free trade, being closer to the latter the larger are the blocs and the more diverse in terms of technologies represented. With only four countries we cannot capture much of this, but we can capture a part of it – and also foreshadow our next examples – by looking at blocs in terms of expected values.

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[30] The example works just as well with Heckscher-Ohlin assumptions.
[31] We assume here and in what follows that there are zero domestic barriers within any given country that would inhibit intra-bloc trade.

Suppose in the four-country model that we are to form two blocs of two countries each, but that the composition of the blocs is to be decided randomly. What are the levels of welfare associated with two blocs in this sense, and how do they compare to autarky and complete free trade? The answer depends on what random mechanism is used for selecting blocs.

Let each possible pattern of blocs be equally likely. There are three such patterns: (1,2)(3,4), (1,3)(2,4), and (1,4)(2,3). Of these only the first has the countries staying at autarky levels of welfare, while the other two have the countries attaining free trade levels. Thus the formation of two random blocs yields an expected gain in welfare that is two-thirds that of free trade.

To be a bit more formal in preparation for the next example, assume there are two types of countries in this four-country case. Let countries 1 and 2 be type A and countries 3 and 4 be type B. Let the welfare attained by a country of type i when it trades in an FTA including countries of types $j,k,l,...$ be denoted w^i_{jkl}. Thus w^A_A is the autarky welfare of a country of type A, w^A_{AB} is the welfare of a country of type A in an FTA with a country of type B, and so on.

Now let $W(I)$ be the level of expected world welfare associated with an equal number of blocs of size I. In the four-country example, the only possibilities are $I=1$ (autarky), 2 (two blocs) and 4 (free trade). Adding up over the four countries one can obtain world autarky welfare as

$$W(1) = 2w^A_A + 2w^B_B$$

and free trade welfare as

$$W^F = W(4) = 2w^A_{AB} + 2w^B_{BA}$$

The world gains from free trade are then

$$G^F = G(4) = W(4) - W(1) = 2\left(w^A_{AB} - w^A_A\right) + 2\left(w^B_{BA} - w^B_B\right)$$

The expected welfare for a country of type A from two randomly chosen blocs is $(1/3)w^A_A + (2/3)w^A_{AB}$ and there is a similar expression for a country of type B. Therefore expected world welfare with two blocs is

$$W(2) = 2\left[(1/3)w^A_A + (2/3)w^A_{AB}\right] + 2\left[(1/3)w^B_B + (2/3)w^B_{BA}\right]$$

Comparing to $W(1)$, the expected gain in world welfare from two blocs is then

$$\begin{aligned}G(2) &= W(2) - W(1) \\ &= 2\left[(1/3)w^A_A + (2/3)w^A_{AB}\right] + 2\left[(1/3)w^B_B + (2/3)w^B_{BA}\right] - 2w^A_A - 2w^B_B \\ &= (2/3)G^F\end{aligned}$$

What this says is that the expected gain from forming two trading blocs, with the composition of the blocs randomly selected, is two-thirds of the gain that would arise from a single bloc, or free trade. That is, trading blocs do, on average, generate more than half of the gains from free trade.

A Six-Country Example

To allow for a slightly richer array of possibilities than the four-country model, now consider six. Again let there be just two goods and two technologies, so that the countries are of only two types, *A* and *B,* now with three of each. In addition to the extremes of autarky and free trade, there are now the possibilities of three blocs with two countries each, and of two blocs with three countries each. The two-country blocs have the same possibilities for welfare as before, but the three-country blocs do not: a country can join with zero, one, or two other countries of the same type as itself.

Levels of world welfare under autarky and free trade are the same as before, except that there are now six countries instead of three:

$$W(1) = 3w_A^A + 3w_B^B$$
$$W^F = W(6) = 3w_{AB}^A + 3w_{AB}^B$$

This gives a world gain from free trade of

$$G^F = G(6) = 3\left[w_{AB}^A + w_{AB}^B - w_A^A - w_B^B\right]$$

With blocs of two countries, there are fifteen ways that the six countries can be distributed across three blocs. In only six of these do all three blocs have one country of each type, so that they all attain the same welfare as under free trade. In the remaining nine, one bloc has two type-*A* countries, one has two type-*B,* and one has one of each. This leads to an expected world welfare of

$$W(2) = (2/5)\left[3w_{AB}^A + 3w_{AB}^B\right] + (3/5)\left[2w_A^A + 2w_B^B + w_{AB}^A + w_{AB}^B\right]$$

and an expected gain from trade of

$$G(2) = (3/5)G^F$$

Thus with more countries, blocs of two countries still produce more than half the benefit of free trade, but the expected gain is somewhat smaller than in the four-country case.

With two blocs of three countries there are ten ways that the six countries can be distributed across the blocs. One of those ways has all three type-*A* countries in one bloc and all three type-*B* in the other, leading to autarky levels of welfare in both. In the nine other ways that the two blocs can appear, each bloc has two countries from one type and one from the other. Expected welfare is therefore

$$W(3) = (1/10)\left[3w_A^A + 3w_B^B\right] + (9/10)\left[2w_{AAB}^A + w_{AAB}^B + w_{ABB}^A + w_{ABB}^B\right]$$

Interpretation of this expression does not lead to anything as simple as the other cases, and we will not try to carry it further here. It seems likely, though we have not been able to prove it, that it involves higher expected welfare than $W(2)$.

      This example has one additional feature that would appear in a more general case but did not appear in the four-country case. It is quite possible for a country to achieve a level of welfare higher than world-wide free trade by joining an FTA. Consider a country of type A in an FTA with two other countries of type B, an "ABB" FTA in the notation used above. In a competitive model without increasing returns to scale, the free-trade equilibrium price in any group of countries is a weighted average of the autarky prices of the separate countries, the weights depending on the sizes of the countries. Thus the equilibrium price in an ABB FTA will be closer to the autarky price of the type B countries than will the equilibrium price under free trade where there are equal numbers of countries of the two types. Since the welfare of any country increases with the difference between the equilibrium price and its own autarky price, it follows that the type-A country is better off in the ABB FTA than it would be under free trade:

$$w_{ABB}^A > w_{AB}^A$$

A Many-Country Case

As our final example we consider a many-country case where comparative advantage is more generally defined in terms of relative autarky prices and may therefore reflect differences in technologies and/or factor endowments.

      Suppose the world consists of $M+1$ countries, numbered $i = 0,1,...,M$. Let these countries have, in general, different autarky prices but be otherwise identical in the following sense: each produces and consumes two goods, and their excess supplies of good one are

$$ES^i(p) = p - q^i$$

where p is the price of good one in terms of the numeraire good two, and q^i is the only parameter of this excess supply function that we allow to differ across countries. Since in autarky $ES^i = 0$, q^i is the autarky price of good one in country i.[32]

      In addition to the autarky prices, one can also derive the world free-trade equilibrium price, p^F, from

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[32] Note the assumption that price, p, appears in this function with a coefficient of one. What is important here is that each country have the same coefficient, indicating that behavior of both producers and consumers at the margin is identical across countries, and also that countries are in some sense equal in size (else a large country would have a much larger quantity response to a change in price than a small country). It is not important that the common coefficient happens to be one, which could always be assured by appropriate choice of units. A somewhat more general formulation would permit a different coefficient on p for each country. This would add complexity, and would also invalidate the result to be derived, without some additional assumption. Such an additional assumption will be suggested in a footnote below.

$$\sum_{i=0}^{M} ES^i(p^F) = 0$$

as

$$p^F = \frac{1}{M+1}\sum_{i=0}^{M} q^i$$

which is simply the average of the autarky prices.[33]

Suppose that country 0 were to contemplate joining a trading bloc of some N other countries in addition to itself. If those N countries were $i = 1,..., N,$ then the resulting equilibrium bloc price, $p^{0,N}$, would be

$$p^{0,N} = \frac{1}{N+1}\sum_{i=0}^{N} q^i = \frac{1}{N+1}q^0 + \frac{N}{N+1}p^N \tag{1}$$

where p^N is the equilibrium bloc price for countries 1, ...,N (without country zero). That is, if country 0 joins the bloc it will face an equilibrium price that is a weighted average of its own autarky price and that of the bloc excluding itself, the weight on the latter being larger the more countries are in the bloc. But suppose that, instead of the participants in the bloc being known, country 0 will join a bloc with N other randomly selected countries. In that case its equilibrium bloc price will still be given by equation (1), but the equilibrium price of the N-bloc, p^N, will be random. Since (1) is linear, the expected equilibrium price for the bloc of $N+1$ countries will be given in terms of the expected equilibrium price for the N-bloc:

$$Ep^{0,N} = \frac{1}{N+1}q^0 + \frac{N}{N+1}Ep^N \tag{2}$$

To calculate Ep^N, let $c(N)$ be the number of possible N-country blocs that can be formed out of the M countries 1,...,M. If each is equally likely, then

$$Ep^N = \frac{1}{c(N)}\sum_{j=1}^{c(N)} p^{N^j}$$

$$= \frac{1}{c(N)}\sum_{j=1}^{c(N)}\frac{1}{N}\sum_{i=1}^{N} q^{h^{ji}}$$

where p^{N^j} is the equilibrium bloc price for the jth possible bloc of size $N,$ and h^{ji} is the index of the ith country in that j^{th} bloc. This is a simple average of all the autarky prices $q^1,...,q^M,$ with each one repeated by the number of blocs in which it appears. Since each

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[33] If countries have different coefficients on price in their excess supply functions, then this becomes a weighted average with those coefficients serving as weights.

bloc is equally likely and all possible blocs are represented in this summation, each autarky price q^i for $i = 1, ..., M$ must appear the same number of times in this summation, and thus have equal weight. Thus

$$Ep^N = \frac{1}{M} \sum_{i=1}^{M} q^i = p^M$$

which is just the equilibrium bloc price for the bloc of all M countries other than country zero. That is, the expected equilibrium price for a bloc of N countries chosen randomly from a larger group of M countries is just the equilibrium price for the M countries themselves as a bloc.[34] Substituting this into equation (2), the result for a randomly selected bloc of size $N+1$ including country zero is therefore

$$Ep^{0,N} = \frac{1}{N+1} q^0 + \frac{N}{N+1} p^M \qquad (3)$$

This result is illustrated in the top panel of Figure 2.2. The horizontal axis measures the number of countries in a bloc in addition to country zero, while the vertical axis measures various prices. The autarky price in country zero, q^0, is shown as lower than the equilibrium bloc price for all countries excluding zero, p^M. As the above equation indicates, the expected equilibrium bloc price for a bloc of country zero plus N other randomly selected countries rises to half way between q^0 and p^M for $N=1$ and continues thereafter to approach p^M. The graph stops at $N=M$, where the free trade price p^F is reached just short of p^M.

The bottom panel of Figure 2.2 gives information about the welfare of country zero in these various circumstances. The welfare of a country is given by its indirect utility function, which in this case takes the simple form[35]

$$V^i(p) = (p - q^i)^2$$

Letting $G^0(N)$ be the expected gain in welfare of country zero from entering into a bloc with N other randomly selected countries,

$$G^0(N) = EV^0(p^{0,N}) \geq V^0(Ep^{0,N}) = (Ep^{0,N} - q^0)^2 \equiv \overline{G}^0(N) \qquad (4)$$

---

[34] This is the result we need, and it was in order to get it that we assumed the countries to be identical in such a strong way. If countries instead have different coefficients on price in their excess supply functions, it will not in general be true. (To see this, simply consider $N=1$ and $M=2$, with one country having a much larger coefficient and hence a large influence on the equilibrium price. The expected price in a one-country randomly chosen bloc is half way between their two autarky prices, while the equilibrium price for the two together is much closer to the autarky price of the high-coefficient country.) The result can nonetheless be salvaged if the coefficients are uncorrelated with the autarky prices.

[35] This is obtained by integrating the excess supply function above, and normalizing on a level of welfare of zero in autarky.

using the convexity of $V(\cdot)$. Thus the bottom panel of Figure 2.2 graphs $\overline{G}^0(N) = V^0(Ep^{0,N})$ as a function of *N*, taking $Ep^{0,N}$ as given by (3) from the top panel. From the inequality in (4), this graph provides a lower bound on the gain to country zero from entering into blocs of various sizes. This graph illustrates the conclusion discussed throughout this section of the chapter: that much of the gains from free trade can be achieved, in this case for an individual country, by entering into FTA trading blocs of larger and larger size.

The curve $\overline{G}^0(N)$ in Figure 2.2 provides only a lower bound for the expected gains from entering into blocs of various sizes for a particular country. We are not able to place an upper bound on this gain, which could extend well above the curve and even above the level of welfare in free trade. Indeed, one can easily find cases where the expected welfare for a country from entering into a bloc that includes only part of the world will be higher than its welfare from free trade. Suppose in a world of many countries that one of them has an autarky price equal to the free-trade price. Then it has nothing to gain from free trade at all. But by entering into trading blocs with only part of the world, it is quite likely to meet a bloc price that differs from its autarky price, and therefore enjoy greater welfare. Thus for a particular country it is quite possible that trading blocs are better than free trade.

This cannot be the case for the world as a whole, however. We know from the literature on the gains from trade that world welfare cannot be larger with trade barriers than without, and will usually be smaller. Therefore the upper bound on world welfare is given by free trade. Since the lower bound can be obtained by adding together vertically curves like $\overline{G}^0(N)$ in Figure 2.2, the world expected gains from trading blocs of various sizes are indeed constrained to lie between a curve like *W*(*N*) in Figure 2.1 and the horizontal line shown for free trade, just as we surmised earlier.

Tariffs

Our discussion in this section has assumed that tariffs were always either prohibitive or zero. This may seem to be an important limitation in a world where actual tariffs are mostly neither of these. Furthermore, by excluding non-zero, non-prohibitive tariffs we have ruled out any possibility of trade diversion: with previously prohibitive tariffs there was no trade to be diverted by the formation of an FTA. Finally, this assumption has also made it unnecessary for us to consider the distinction between an FTA and a customs union: our FTAs continue to charge prohibitive tariffs against the rest of the world, and it therefore does not matter whether those tariffs are the same or not.

All of this seems to suggest that our analysis cannot be of much relevance. However, we would argue that our main result of the potential desirability of trading blocs can only be enhanced by now allowing for trade to occur over nonzero tariffs. As long as FTAs continue to involve zero tariffs internally, the presence of some trade externally can only raise welfare as compared to what it would have been in the prohibitive tariff case that we examined. Since we argued that expected welfare rises with the size of trading blocs and approaches the free-trade level as the blocs become large,

the even higher welfare of blocs that do trade externally must have at least the second of these properties as well.[36]

Extensions and Caveats

The analysis here has included only three very simple examples. There are many directions in which it would be desirable to go with this, and it is premature to suggest that we know what such extensions would yield. However, these results do seem sufficient to at least raise the possibility that trading blocs may be welfare improving, and even that they may approach the level of welfare that could have been attained by free trade.

However, the examples here are at the opposite extreme from the model of Krugman, in the sense that they stack the cards in favor of trading blocs just as his model stacks them against. This suggests that an important consideration is whether in fact most trade is driven by differences in comparative advantage, as in the examples here, or by other considerations such as the product differentiation that drives Krugman's model. In a world where comparative advantage dominates and countries act cooperatively rather than noncooperatively in their trade policies, trading blocs of diverse countries may not be so bad.

Similarly, the examples here have assumed constant returns to scale and perfect competition. If instead there are increasing returns to scale and/or imperfect competition of various sorts, the argument here would have to be modified and possibly weakened. As long as trading blocs are too small to permit minimum efficient scale in many industries, or too small to permit a reasonable amount of competition, enlarging the blocs will increase welfare more than in the case considered here for these additional reasons. If this process can be completed while the blocs still encompass only a fraction of the world, then these effects strengthen our argument, since welfare will rise with bloc size even more rapidly when blocs are still small. On the other hand, if the entire world market is needed to surpass minimum efficient scale in many industries, or to permit a satisfactory level of competition, then these effects could conceivably turn our concave function into a convex one. In that case, any division of the world into trading blocs could fall well short of free trade in terms of welfare.

Note, finally, that the conclusion of our theoretical discussion is that a group of trading blocs, if they are large enough, can approximate the level of welfare that may be feasibly attainable from a multilateral system. However, it is also clear that if such blocs are too small and if the trade between them is too limited, then the gains we have described will not be achieved. In terms of our Figure 2.1, blocs must be sufficiently large to bring us up the curve to the free trade level, or else barriers to trade will be detrimental to world welfare. Therefore, our analysis argues in favor of trading blocs only if they are sufficiently large and only if they collectively encompass the entire world.

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[36] Haveman 1992 has developed a model of trading blocs that encompasses comparative advantage and positive (optimal) tariffs that apparently negates this conclusion and reinforces Krugman's conclusion that the formation of trading blocs will be detrimental to world welfare as the number of blocs increases to two rather than three as in Krugman's model. In Haveman's model, however, this result does depend on the assumption that external tariffs are levied optimally at each stage.

It is quite possible that a multilateral system of controls would be needed to assure that blocs do achieve this size and comprehensiveness, as well as to prevent the blocs from increasing levels of protection among themselves. Thus, as we will elaborate further in the concluding section, we do not view this simple theoretical analysis as undermining the case for GATT or for multilateral oversight of trade policy. We would only suggest on the basis of this analysis that trading blocs might have a legitimate place in a multilateral system, and that their presence should not be taken as necessary evidence that the gains from multilateral trade are being foregone.

VII. Implications for the Design of Trading Blocs to Enhance World Welfare

From our institutional and historical discussion, it appears that preferential arrangements are an inevitable part of the world trading system. From our theoretical discussion, it appears that such arrangements are not necessarily the economic disasters that they have sometimes been supposed to be. It remains therefore to examine how the multilateral trading system should accommodate preferential arrangements, since it evidently must, in order to assure that their presence does not undermine other desirable features of the multilateral system and in order if possible to assure that they yield the greatest benefits and the fewest costs for the world as a whole. In this concluding section, therefore, we make several suggestions for how the multilateral trading system should be structured to this end.[37]

1. The GATT should recognize bilateral arrangements as an intrinsic part of any multilateral system, and not treat them as exceptions to the rule only to be tolerated. At present, in spite of Article XXIV, there is a tendency to regard new preferential arrangements as undermining the legitimacy of the GATT, and as long as they are treated that way they will indeed have that effect. Instead, much as the IMF came to accommodate the existence of flexible exchange rates in the 1970s, the GATT must accommodate preferential arrangements so that their presence will be seen as contributing to the system rather than tearing it apart.

2. The requirement, already embodied in Article XXIV, that new preferential arrangements should not lead to an increase in the level of protection, must be strengthened and enforced. In fact, the evidence does not suggest that such arrangements have historically added significantly to the level of protection, so it should not be too difficult to enforce such a requirement. But, where cases can be brought to the GATT of violations of Article XXIV, they should be encouraged. That will not only serve in a minor way to restrain protectionism. But it will serve in a more major way to enhance the role of the GATT vis-a-vis such preferential arrangements and make it clear that the two can and should coexist.[38]

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[37] See also Bhagwati 1992a,b and Whalley 1991 for related suggestions concerning the role and treatment of preferential arrangements within the multilateral system.

[38] It is essential here, as Bhagwati 1992a,b and others have stressed, that measures be taken to constrain the use of antidumping measures and voluntary export restraints. The limitation of these measures is of course desirable in its own right and is ostensibly being dealt with in the Uruguay Round negotiations. The improvements here would then presumably carry over to the enforcement of Article XXIV.

3. Language should be added to the GATT encouraging the formation of preferential arrangements where they are most likely to be beneficial to the countries involved and to the world. On the basis of comparative advantage, the GATT should favor arrangements that combine countries with large, rather than small, differences in factor endowments and technologies. In particular, the GATT should encourage the inclusion of less developed countries within preferential arrangements, not involving only other developing countries like themselves, but involving also developed countries with whom they can benefit the most from trade.

4. Finally, and perhaps most importantly, the GATT should insist that preferential arrangements should have ways of accommodating new members, and that all countries (or at least all GATT members) should have access to joining some trading bloc, somewhere in the world. It will indeed be a disaster, politically as well as economically, if the formation of preferential trading arrangements leads not to an entire world of trading blocs, but rather to a world of blocs that include only the rich countries and a handful of their favored neighbors. Developments so far in Europe and America suggest a surprising and encouraging willingness to extend preferential treatment beyond the borders of the developed world. It remains to be seen whether this willingness will cease once the developed countries have acquired a comfortable buffer between themselves and the rest of the third world. The GATT could and should play an important role in preventing this from happening.

Appendix

General Agreement on Tariffs and Trade

Article XXIV

Territorial Application–Frontier Traffic–Customs Unions and Free Trade Areas

1. The provisions of this Agreement shall apply to the metropolitan customs territories of the contracting parties and to any other customs territories in respect of which this Agreement has been accepted under Article XXVI or is being applied under Article XXXIII or pursuant to the Protocol of Provisional Application. Each such customs territory shall, exclusively for the purposes of the territorial application of this Agreement, be treated as though it were a contracting party; *Provided* that the provisions of this paragraph shall not be construed to create any rights or obligations as between two or more customs territories in respect of which this Agreement has been accepted under Article XXVI or is being applied under Article XXXIII or pursuant to the Protocol of Provisional Application by a single contracting party.

2. For the purposes of this Agreement a customs territory shall be understood to mean any territory with respect to which separate tariffs or other regulations of commerce are maintained for a substantial part of the trade of such territory with other territories.

3. The provisions of this Agreement shall not be construed to prevent:

(a) Advantages accorded by any contracting party to adjacent countries in order to facilitate frontier traffic;

(b) Advantages accorded to the trade with the Free Territory of Trieste by countries contiguous to that territory, provided that such advantages are not in conflict with the Treaties of Peace arising out of the Second World War.

4. The contracting parties recognize the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements. They also recognize that the purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories.

5. Accordingly, the provisions of this Agreement shall not prevent, as between the territories of contracting parties, the formation of a customs union or of a free-trade area or the adoption of an interim agreement necessary for the formation of a customs union or of a free-trade area; *Provided* that:

(a) with respect to a customs union, or an interim agreement leading to the formation of a customs union, the duties and other regulations of commerce imposed at the institution of any such union or interim agreement in respect of trade with contracting parties not parties to such union or agreement shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union or the adoption of such interim agreement, as the case may be;

(b) with respect to a free-trade area, or an interim agreement leading to the formation of a free-trade area, the duties and other regulations of commerce maintained in each of the constituent territories and applicable at the formation of such free-trade area or the adoption of such interim agreement to the trade of contracting parties not included in such area or not parties to such agreement shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free-trade area, or interim agreement, as the case may be, and not to raise barriers to the trade of other contracting parties with such territories.

(c) any interim agreement referred to in sub-paragraphs (a) and (b) shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time.

6. If, in fulfilling the requirements of sub-paragraph 5(a), a contracting party proposes to increase any rate of duty inconsistently with the provisions of Article II, the procedure set forth in Article XXVIII shall apply. In providing for compensatory adjustment, due

account shall be taken of the compensation already afforded by the reductions brought about in the corresponding duty of the other constituents of the union.

7. (a) Any contracting party deciding to enter into a customs union or free-trade area, or an interim agreement leading to the formation of such a union or area, shall promptly notify the CONTRACTING PARTIES and shall make available to them such information regarding the proposed union or area as will enable them to make such reports and recommendations to contracting parties as they may deem appropriate.

(b) If, after having studied the plan and schedule included in an interim agreement referred to in paragraph 5 in consultation with the parties to that agreement and taking due account of the information made available in accordance with the provisions of sub-paragraph (a)*,* the CONTRACTING PARTIES find that such agreement is not likely to result in the formation of a customs union or of a free-trade area within the period contemplated by the parties to the agreement or that such period is not a reasonable one, the CONTRACTING PARTIES shall make recommendations to the parties to the agreement. The parties shall not maintain or put into force, as the case may be, such agreement if they are not prepared to modify it in accordance with these recommendations.

(c) Any substantial change in the plan or schedule referred to in paragraph 5(c) shall be communicated to the CONTRACTING PARTIES, which may request the contracting parties concerned to consult with them if the change seems likely to jeopardize or delay unduly the formation of the customs union or of the free-trade area.

8. For the purposes of this Agreement:

(a) A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that

(i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and,

(ii) subject to the provisions of paragraph 9, substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union;

(b) A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories.

9. The preferences referred to in paragraph 2 of Article I shall not be affected by the formation of a customs union or of a free-trade area but may be eliminated or adjusted by means of negotiations with contracting parties affected. This procedure of negotiations with affected contracting parties shall, in particular, apply to the elimination of preferences required to conform with the provisions of paragraph 8(a)(i) and paragraph 8(b).

10. The CONTRACTING PARTIES may by a two-thirds majority approve proposals which do not fully comply with the requirements of paragraphs 5 to 9 inclusive, provided that such proposals lead to the formation of a customs union or a free-trade area in the sense of this Article.

11. Taking into account the exceptional circumstances arising out of the establishment of India and Pakistan as independent States and recognizing the fact that they have long constituted an economic unit, the contracting parties agree that the provisions of this Agreement shall not prevent the two countries from entering into special arrangements with respect to the trade between them, pending the establishment of their mutual trade relations on a definitive basis.

12. Each contracting party shall take such reasonable measures as may be available to it to ensure observance of the provisions of this Agreement by the regional and local governments and authorities within its territory.

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TABLE 2.1. GATT Negotiating Rounds

| | | | | | -------------------------- U.S. Tariff Reductions-------------------------- | | |
| | | | | | | --- Internalization Ratio --- | |
	GATT Round	Countries Participating	Trade Affected (Billions of $)	Average Depth of Cut[a]	Import Coverage[b]	Bilateral[c]	Multilateral[d]
1.	Geneva, 1947	23	$10.0	35%	56%	n.a. %	84%
2.	Annecy, 1949	33	n.a.	37	6	35	39
3.	Torquay, 1951	34	n.a.	26	15	58	64
4.	Geneva, 1956	22	2.5	15	20	74	89
5.	Dillon, 1960-61	45	4.9	20	19	69	96
6.	Kennedy, 1964-67	48	40.0	44	64	n.a.	91
7.	Tokyo, 1973-79	99	155.0	34[e]	n.a.	n.a.	n.a.
8.	Uruguay, 1986-?	100	n.a.	n.a.	n.a.	n.a.	n.a.

[a]Weighted by dutiable imports.
[b]Imports subject to tariff reductions as a percentage of total dutiable imports.
[c]Share of imports subject to a tariff reduction coming from the individual country receiving that concession.
[d]Share of imports subject to a tariff reduction coming from all countries participating in the negotiating round.
[e]Weighted by total imports.

Source: Adapted from Finger 1979 pp. 424-25, Jackson and Davey 1986 pp. 324-25, Deardorff and Stern 1986 p. 49, and Winters 1990 p. 1291.

Table 2.2. Major Preferential Trading Arrangements, 1947-91

1947	Article XXIV included in GATT. Allows formation of customs unions and free trade areas under certain conditions.
1957	Treaty of Rome established the European Economic Community. A customs union involving Belgium, Luxembourg, France, the Netherlands, Germany, and Italy. Treaty went into force 1 January 1958.
1959	Stockholm Convention established the European Free Trade Association (EFTA) to go into effect 1 July 1960. Members included Austria, Denmark, Norway, Portugal, Sweden, Switzerland, and the United Kingdom.
1960	Montevideo Treaty established the Latin American Free Trade Association (LAFTA) comprising Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, and Uruguay.
1960	Central American Common Market (CACM) formed. Included Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua.
1963	Yaoundé Convention between the EEC and former French, Belgian, and Italian colonies in Africa. Gives these countries preferential access to the EC and set up the European Development Fund.
1965	Australia and New Zealand formed a free trade area.
1965	Canada and the United States sign Automobile Products Trade Agreement (Auto Pact).
1967	East African Community formed. Included Kenya, Tanzania, and Uganda.
1967	ASEAN formed. Included Brunei, Indonesia, Malaysia, Philippines, Singapore, and Thailand.
1969	Andean Pact formed. Included Bolivia, Chile, CQlombia, Ecuador, Peru, and Venezuela.
1969	Yaoundé Convention extended.
1973	European Community enlarged to include Britain, Ireland, and Denmark.
1975	Yaoundé Convention superseded by Lome Convention. Extended preferential arrangements to include former colonies of Britain and widened to include countries in the Caribbean and Pacific.

1983	Australia and New Zealand formed Closer Economic Relationship to provide for a free trade agreement.
1984	United States implements Caribbean Basic Economic Recovery Act to extend duty-free treatment to 21 beneficiary countries in the region for 12 years.
1985	United States-Israel Free Trade Area Agreement enters into force. Over a 10-year period, all tariffs between the two countries to be eliminated.
1986	Portugal and Spain join the European Community. Single European Act signed to provide for full European integration in 1992.
1989	Canada-U.S. Free Trade Agreement enters into force. Under agreement all items should be traded duty-free between the two countries by 1998.
1990	EC and EFTA undertake discussions on a European Economic Area which would provide for freer movement of goods, services, capital, and people between the two associations.
1990	United States announces "Enterprise for the Americas" initiative to explore a hemisphere-wide free trade zone involving countries of North, Central, and South America.
1991	United States, Mexico, and Canada enter discussions on a North American free trade area.

Source: Adapted from Whalley 1991.

Table 2.3. Trade Patterns of Preferential Trading Blocs (Percentage of Combined GDP of Member Nations)

Association and time period[a]	Internal trade			External trade			Total trade		
	Base	Later	Change	Base	Later	Change	Base	Later	Change
Readily apparent increases in internal trade									
Central American Common Market (CACM)[b] 1957-60 1966-70	1.8	10.0	8.2	33.4	33.2	-0.2	35.2	43.2	8.0
European Community (EC6)[c] 1953-57 / 1963-67	8.1	13.1	5.0	20.0	17.9	-2.1	28.1	31.0	2.9
1953-57 / 1968-72	8.1	17.2	9.1	20.0	18.3	-1.7	28.1	35.5	7.4
European Community (EC9)[d] 1968-72 / 1978-82	17.6	24.3	6.7	17.9	24.0	6.1	35.5	48.3	12.8
European Free Trade Association (EFTA)[e] 1955-59 / 1965-69	6.9	8.7	1.8	30.1	27.4	-2.7	37.0	36.1	-0.9
Andean Pact[f] 1964-68 / 1974-78	0.9	2.4	1.5	30.5	38.2	7.7	31.4	40.6	9.2
No obvious effect on internal trade									
Association of Southeast Asian Nations (ASEAN)[g] 1967-71 / 1972-76	7.0	7.8	0.8	37.5	49.9	12.4	44.5	57.7	13.2
New Zealand-Australia FTA 1961-65 / 1971-75	1.7	1.8	0.1	28.6	24.8	-3.8	30.3	26.6	-37
Latin American Free Trade Area (LAFTA)[h]	1.6	1.6	0.0	19.0	13.1	-5.9	20.6	14.7	-5.9
East African Community (EAC)[i] 1968-72 / 1973-77	6.3	3.9	-2.4	35.6	34.5	-1.1	41.9	38.4	-3.5

[a]Except for EAC and ASEAN, the base period precedes establishment of the regional association. For EAC and ASEAN (both established in 1967), bilateral trade data from the period preceding establishment are not available.
[b]Members include: Costa Rica; El Salvador; Guatemala; Honduras; and Nicaragua.
[c]Members include: Belgium, France, W. Germany, Italy, Luxembourg, and the Netherlands.
[d]Members include: EC6 plus Denmark, Ireland, and United Kingdom.
[e]Members include: Austria, Denmark, Finland, Norway, Sweden, Switzerland, and United Kingdom.
[f]Members include: Bolivia, Chile, Colombia, Ecuador, Peru, and Venezuela.
[g]Members include: Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand.
[h]Members include: Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, and Uruguay.
[i]Members include: Kenya, Tanzania, and Uganda. EAC effectively came to an end in 1977.
Source: Adapted from Wonnacott and Lutz 1989 p. 76 and based on IMF, *Direction of Trade*.
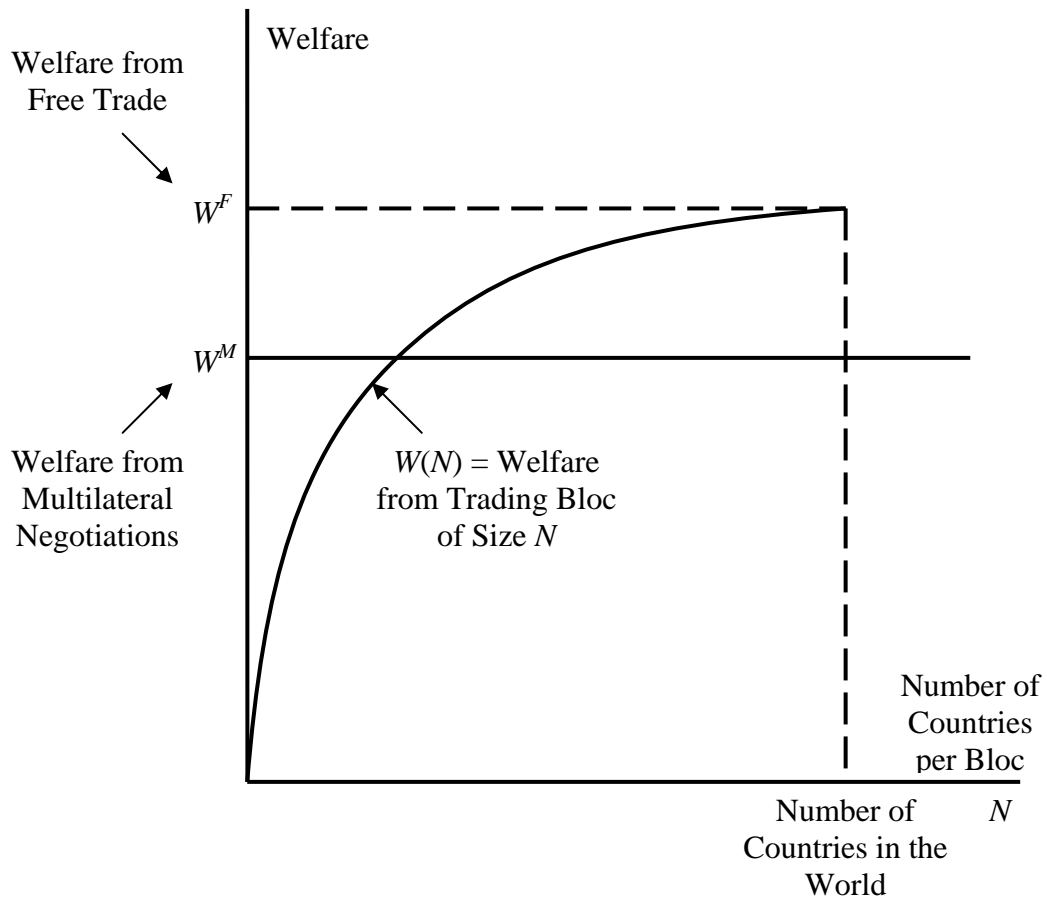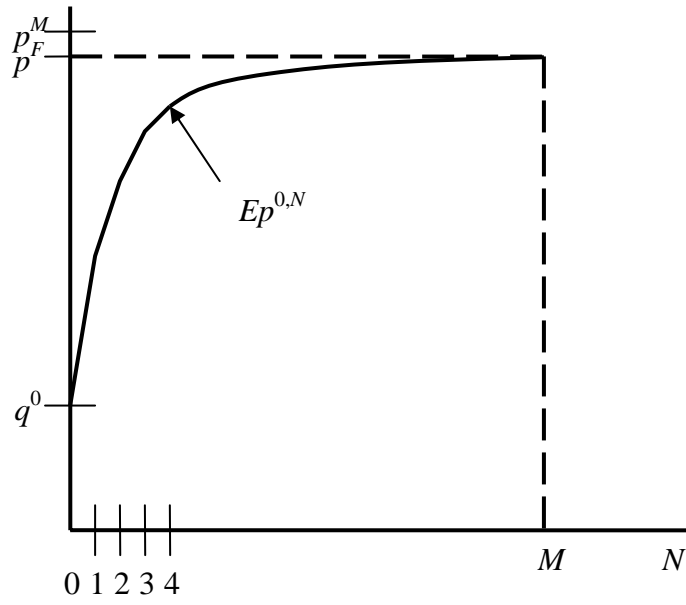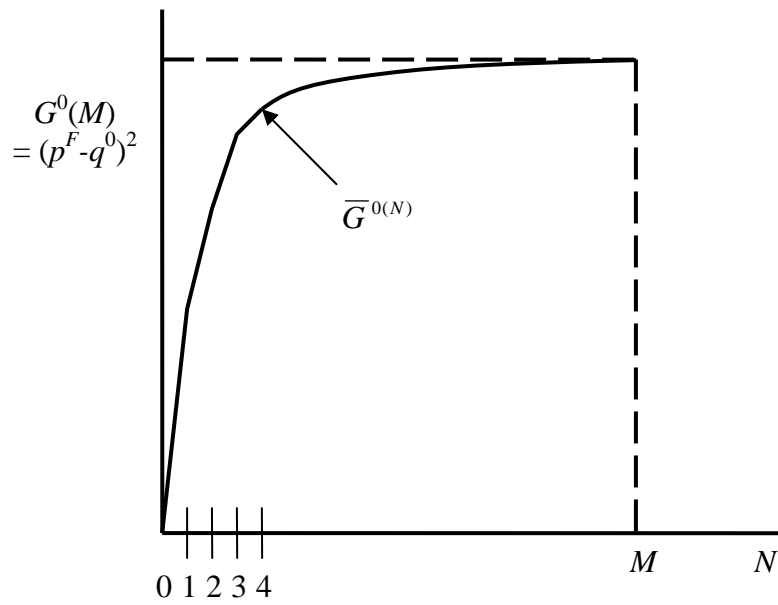
Welfare from
Free Trade

Welfare from
Multilateral
Negotiations

W^F

W^M

Welfare

$W(N)$ = Welfare
from Trading Bloc
of Size N

Number of
Countries
per Bloc

Number of
Countries in the
World

N

Figure 2.1 World Welfare with Trading Blocs
and Multilateral Negotiations

a) *Bloc Price*

b) *Country Welfare*

Figure 2.2 Expected Bloc Price and Country
Welfare with Trading Blocs