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TRADE BLOCS AND MULTILATERAL FREE TRADE

by

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Abstract

This paper takes a cool look at the current movement towards regional trading blocs. It argues this is similar to the unravelling of the first great liberal international economic order of the 19th century, and finds that there is a particular danger of a new form of imperialism, this time to promote Greenery.

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Economists attribute to trading blocs -- whether they be common markets or regional free trade areas -- has been ambivalent. This follows from the classical case for free trade, as modified by the modern theory of trade and welfare (see Corden (1974)). This states in its static version that free trade is in the interest of each country because it expands its feasible set of consumption possibilities, by providing, in effect, an indirect technology for transforming domestic resources into the goods and services which yield current and future utility to consumers. The dynamic version incorporates investment in line with a country's comparative advantage, which minimizes the present value of the resource costs of its future demand. The modern theory, moreover does not necessitate a commitment to laissez faire. Except for the so-called optimum tariff argument (when a country can influence its terms of trade), most arguments for protection can be shown to be arguments to deal with so-called domestic distortions in the working of the price mechanism. They require domestic public interventions, but not in foreign trade. From this perspective -- as the relevance of the optimum tariff argument is likely to be limited (see below) -- the ideal policy for each and every country is to unilaterally adopt free trade in its own self-interest, as Britain did after the repeal of the Corn Laws. The case for trading blocs must therefore at best be a second-best judgment.

Such a case is ultimately based on the judgment that irrespective of the theoretical case in favor of unilateral free trade, most countries are mercantilist, looking upon foreign trade as a zero sum game. The negotiating mechanisms underlying the promotion of multilateral free trade even under GATT are implicitly mercantilist. Mercantilists view trade as a war, and the various GATT rounds with their "concessions" to economic virtue are like multilateral disarmament.[1] If in this contest some countries decide to disarm amongst themselves, and that on balance does not hurt others (that is if the arrangements are net trade creating), then the resulting trading bloc is to be blessed. This in essence is the rationale of GATT's article XXIV allowing exceptions to its most-favored nation (MFN) rule and the principle of non-discrimination which is the cornerstone of the multilateral trading system constructed under its auspices since the Second World War.

Most economists agree that the net effects of the two major trading blocs which are currently emerging -- Europe after the completion of the internal market, and the North American Free Trade Area (NAFTA) -- are likely to be net trade creating (see for example Krueger (1992)). But there are two remaining and serious worries. The first is that rather than being a step towards multilateral free trade such blocs will lead to a retrogression. This arises from the new interest groups created who benefit from the trade diversion which accompanies any discriminatory preferential trading arrangement. They will oppose any further movement to an open multilateral trading system. The second is that the concentration of scarce political capital and energy on promoting regional trading blocs will divert the attention and support of traditional supporters of the global system towards these second-best schemes. Further given the inevitable trade frictions that will arise between large regional trading blocs -- with those left outside, such as the East Asian NIC's and Japan trying to form their own defensive blocs -- the whole multilateral trading system built up since the Second World War could unravel. In this context it is the U.S. endorsement of regionalism which is most worrying. As Martin Wolf notes:

> The shift in U.S. thinking towards FTAs, and more generally toward bilateralism as a principle, rather than a shamefaced expedient, is momentous. As the progenitor and most enthusiastic upholder of the unconditional MFN principle, the U.S. may well doom the GATT system in its present form by its defection.
> (Wolf (1989), p. 93)

But is GATT, particularly its latest Uruguay round worth saving? There has been a considerable amount of silly academic and other scribbling about the defects of GATT, from which it has been ably defended by Bhagwati (1991). More serious is the danger of a trade war between rival trading blocs if the Uruguay round collapses. The World Bank's <u>World Development Report 1991</u>, estimated that this could lead to a loss of 3-4 percent of world output.

One great paradox of the 1980s is that whereas developing countries are finally coming around to accepting the economists case for the unilateral implementation of free trade, the developed countries which in the past have been the major votaries of multilateral free trade have been gradually turning their backs on their professed principles through various forms of creeping administrative protection such as non-tariff barriers like VER's and anti-dumping actions. Stoeckel et al. (1990) have estimated on the basis of their world trade model that a 50% reduction in these non-tariff barriers and in the much lower current tariff barriers would result in an increase of world income of over 5%. This is the prize offered by multilateral trade liberalization.

But instead the current prospect is of a strengthening of regional trading blocs at the expense of the multilateral trading system (see Lawrence and Schultze (1990), Schott (1989)). This growing impatience with the multilateral trading system is unlikely to lead to the 1930s type collapse of the world trading system as many observers fear. A more likely outcome is by analogy with the gradual erosion of the first liberal trading order established in the second half of the 19th century.

The great Age of Reform began with the repeal of the Corn Laws in 1846, and culminated in Gladstone's 1860 budget, the first of a series which unilaterally freed Britain's trade. Subsequently, with the Cobden-Chevalier Treaty of 1860, and a string of other tariff treaties, all of which for the first time incorporated the MFN principle, the "dream of universal free trade appeared to be approaching reality" (Kenwood and Lougheed (1971), p. 76). The peak of this liberal free trade order was probably 1870. From 1880 onwards there was a revival of protectionism. During this free trade period, along with the international integration that ensued there was also a movement towards national integration through the formation of the Zollverein in Germany in 1834, and the unification of Italy in 1861. World trade boomed, growing at an annual rate of over 4% per annum between 1850-70 (see Rogowski (1989), p. 22).

Similarly in the quarter century after the Second World War, the second great liberal economic order was created under American leadership through successive multilateral GATT trade rounds. Simultaneously, the movement towards European integration paralleled the movement towards national integration in the 19th century. In the peak period of this second Golden Age, world trade grew at an annual average rate of about 9% (Rogowski, op. cit., p. 89) -- twice as fast as in the 19th century's golden age. The OECD countries and those developing countries which adopted relatively outward-oriented trade policies saw dramatic increases in their levels of living. The major problem it seemed was to convince the remaining developing countries to reverse their inward-orientation -- a task on which I have spent much of my professional career. Just as they seem to be coming around, and with the unexpected collapse of the autarkic system of central planning in Communist countries leading to their rushing to be integrated with the world economy, another universal free trade order seemed to be in the cards. But as in the 1880s, a gradual slide towards protectionism gained momentum in the 1980s. However, there were two major differences. Whereas Britain, which had led the 19th century march to free trade, remained constant to its principles, it was the then-newly-industrializing countries (NICS) -- the U.S., Germany and France -- which revived protectionism. Today it is the NICs -- and those who aspire to this status -- who are converts to free trade, whilst it is europe and the U.S. -- the leaders of the post-war free trade movement -- who are turning inwards. Secondly, unlike the 19th century where the instrument of protection was the tariff, today's new protectionists increasingly use various forms of administrative protection whose common feature is a quota. This is more damaging both to their and world economic welfare, as quotas on foreign trade unlike tariffs, break the link between domestic and foreign prices, and effectively prevent the specialization according to a country's emerging comparative advantage, on which its long-run prosperity ultimately depends. The current movement towards regional trading blocs is a culmination of this trend towards what is called "managed" trade.

It could be argued that the trading blocs being formed, in particular the bilateral free trade agreements currently in favor in the U.S., are merely replicating the commercial treaties the U.K. signed to promote free trade in the 19th century. But there is an important difference. Whereas the 19th century treaties all embodied the MFN clause and hence were non-discriminatory, the current FTA's are based on bilateral reciprocity, are discriminatory and go against the GATT MFN rule. To protect the preferences granted to the partners they set out complex rules of origin to prevent non-members shipping goods to partners with high external trade barriers through those with lower ones (see Krueger (1992a) for an analysis of the protectionist content of rules of origin in FTA's). Though it is possible to have FTA's which are GATT plus, and are on a conditional MFN basis (to avoid the problem of "free riders" with the unconditional MFN rule, which has exercised many politicians -- see Schott (989)), the purpose of the FTA route being pursued by the U.S. as Krueger (1989) notes is that they "at best provide assurances to American trading partners that protectionism will go no further with them" (p. 197).

So why given the unprecedented prosperity that the multilateral liberal international economic order has delivered to its participants, are the major architects of the order turning their backs on it? There are a complex web of reasons, and only a few can be highlighted.

The first is that:

> Historically, FTA's have been the economic policy of the uncompetitive and the foreign policy of the weak. The shift of the U.K. to a full blown policy of imperial preferences in the 1930s was an admission of both political and economic decline. Equally, the discriminatory policies of the EEC have their roots not only in fear of competition (initially from the U.S., now from the Far East), but also in the limited number of instruments of foreign policy available to it. Should one interpret the movement of the U.S. in the 1980s toward a trade policy based more on discrimination as a tacit admission of its relative economic and political decline? The answer, unfortunately, is yes.
> (Wolf (1989), p. 92)

The second, is that historically, largely due to the interactions of its factor endowments and mass democracy, the U.S. is naturally protectionist. From the Stolper-Samuelson theorem we would expect protection to be in the interest of the scarce factor of production. In the U.S. this is unskilled and semi-skilled labor. In a mass democracy however, labor is likely to have a disproportionate influence on the polity, if for no other reason than raw labor is the factor of production most evenly distributed amongst the voting public, and hence its interests will tend to be reflected in public policy.[2] The surprising fact therefore is not the U.S.'s current lurch to protectionism, but the nearly three decades after the Second World War when it was a free trader (see Rogowski (1989)).

The third reason is that with the integration of world capital markets, trade imbalances are now the other side of the coin of imbalances on the capital account. As is well known, the U.S. trade deficit is the mirror image of the surplus on its capital account, which in turn reflects the imbalance between domestic investment and savings. This imbalance has been aggravated by the burgeoning fiscal deficit, in turn caused by an expansion of age-related middle class social entitlements (see Lal and Wolf (1986)). The constant trade friction with Japan, because of its trade surplus, cannot be cured through trade-related measures, because this surplus is merely the counterpart of the deficit on capital account due to the Japanese proclivity to save more than they invest. It is also ironic that Japan bashers whilst railing at unfair Japanese trade practices,[3] fail to note that indirectly it is Japan which has financed both investment and the social entitlements that the Americans are unwilling to pay for themselves.

Last but not least are the academic scribblers who in the 1980s have tried to construct a so-called "new" trade theory, which seeks to justify selective protection and industrial policy.[4] Here again there are parallels with the 1880s. In the free traders Black Book, to the names of List, Hamilton and Carey must be added those of Krugman, Helpman and Grossman and others of their ilk! It has been known since John Stuart Mill that a country with some monopoly or monopsony power in its foreign trade could (in the absence of foreign retaliation) garner more of the potential cosmopolitan gains from trade for itself by levying the optimum tariff to improve its terms of trade. With foreign retaliation the welfare outcome is uncertain for the country initiating the trade war, though the cosmopolitan gains will naturally shrink (see Johnson (1958)). The "new" trade theory has provided a sophisticated variant of this optimum tariff type argument, whereby a country can through a "strategic" trade policy cause profits in oligopolistic world markets for certain high-tech commodities, to be shifted from foreign to home producers (see Baldwin (1992)). Though theoretically valid, as is the classical terms of trade argument for protection, its practical relevance is equally limited, largely because of the threat of retaliation, as well as (till recently) the altruistic concern in the OECD for the welfare of poor developing countries. Thus Whalley (1985) estimated that the optimum tariff for both the U.S. and EEC, assuming no retaliation is 150%. However, if the world's trading blocs simultaneously imposed their optimum tariffs, all would lose and world GNP would fall by over 3%.

Nor are the arguments for a type of infant industry protection being made on the basis of the "new" trade theory any more cogent. It is argued that countries can create a comparative advantage in high-tech industries which purportedly have high fixed costs due to initial research and development expenditures, dynamic scale economies due to learning-by-doing, and technological externalities. But as with the more traditional Hamilton-List arguments for protection to deal with domestic distortions, the first best policy for this case is also some domestic tax-subsidy scheme, as the modern theory of trade and welfare has shown.[5]

Hence, the "new" trade theory does not in my view provide sufficient reasons for the U.S. or EEC adopting industrial policies and various forms of selective protection. Nor does it provide a case against the traditional multilateral trading system and in favor of bilateralism and regional trading blocs. Nevertheless, with theorists of this ilk filling influential posts in the Clinton administration, it would not be surprising if they gave intellectual succor to the growing protectionism in the U.S.

If there is every likelihood that the world is moving towards regional trading blocs, what are likely to be the effects on world trade, and in particular on the welfare of developing countries?

Again analogies with the late 19th century are instructive. Kenwood and Lougheed (1971) note that the effects of protectionism were offset by many other trade creating forces, such as the continuing decline in the costs of transportation, so that world trade continued to grow "steadily between 1870 and 1914, averaging some 3.4 percent annually over the entire period, and was growing faster than total world production which averaged 2.1 percent per annum" (p. 86). Krueger (1992) reaches a similar judgment about the protectionist prospects for world trade in the near future. The protectionist pressures have so far been offset by declining costs of transport and communications, and increased specialization in intra-industry trade, in effecting world trade, which has continued to grow faster than world GNP. The real long run danger is that increasing trade frictions between rival trading blocs could lead to an intensification of trade barriers between them, which could over time erode the multilateral trading system. As Krueger notes, "It would not be the case that any major country decided to abandon open, multilateral trade in favor of its own trading bloc, the shift would happen gradually in response to increased trade frictions" (p. 16).

Finally, there is a more ominous parallel with the late 19th century of particular concern to developing countries. The slow unravelling of the 19th century liberal economic order was also accompanied from the 1880s with a fresh burst of imperialist expansion. Africa was carved up by the European powers, the U.S. seized the Philippines, and intervened politically in numerous Central and Latin American countries, the British added burma and Malaya to their eastern empire. The reasons for this imperialist expansion are too complex to adumbrate, and remain controversial (see Roberts (1990), pp. 754-55 for a succinct summary). But one aspect was the idealism of those who say themselves as the custodians of a superior civilization and sought to transfer it to more benighted lands and climes. Kipling's famous poetic exhortation to the Americans captures this spirit:

"Take up the White Man's burden-
Send forth the best ye breed-
Go, bind your sons to exile
To serve your captives' need;
To wait in heavy harness
On fluttered folk and wild-
Your new-caught, sullen peoples,
Half-devil and half-child."

There is a contemporary movement of idealists in the West -- the global environmentalists -- who might trigger another round of imperialism in the name of saving Spaceship Earth. Already the North American Free Trade Area agreement has come under attack because of the supposedly lax environmental controls in place in one of the partners -- Mexico. Austria recently banned imports of hardwood in order to save the rainforests, but had to reverse course when Malaysia and thailand threatened a trade war. Environmentalists are reportedly lobbying in Washington against the confirmation of a Clinton appointee, who as Chief Economist of the World Bank had the temerity to make the obvious economic point, that countries differed in the extent of their local pollution and absorptive capacity of their environment, hence some might have a comparative advantage in producing "polluting" goods. The desire of the Greens to green GATT by setting up global environmental standards for the production of all commodities is resonant of past attempts to legislate universal labor standards, by putting tariffs on goods produced by labor which did not meet them (see Lal (1981) for a critique of this pauper labor argument). These attempts to discriminate against goods because of the way they are produced is completely at variance with the principle of comparative advantage and the multilateral trading system which embodies it. The Greens in America worried that imports of goods produced in countries with lower environmental standards will undermine the domestic standards in their own countries, "are building a formidable popular coalition around the argument that the removal of trade barriers prevents the United States from pursuing whatever environmental policies it deems appropriate" (The Economist (1993), p. 25). A U.S. trading bloc whose rules could be more readily dictated by the Greens would presumably be more favorably viewed by them than promoting multilateral free trade under GATT.

More ominous is the Greens desire to dictate environmental policy to the rest of the world. This currently is based on attempts to ban trade in goods which harm the so-called global commons, or promote global warming and the depletion of the ozone layer -- which supposedly threaten life itself.[6] It is this last factor which could in time provide a pretext for direct or indirect imperialism. If developing countries do not adopt the requisite policies (despite trade bans) to control their noxious emissions, continue to degrade their eco-systems, and fail to control their burgeoning populations, what are the bets on the emergence of a green variant of the 19th century's white man's burden?

These are still straws in the wind. But the diversion of intellectual and political support from GATT towards the creation and strengthening of regional trading blocs, makes it harder to fight this growing dirigisme, and incipient green imperialism. Therefore, though I have no doubt the rise of regional trading blocs will give a journal specialized in their study a longer lease of life, I for one cannot (for the reasons set out in this essay) join in the celebrations of this birth anniversary, by wishing it many happy returns!

FOOTNOTES

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[1]See Ludema (1991) for a game-theoretic analysis which shows that despite the free rider problem, the GATT bargaining techniques and procedures based on the MFN rule, will, if side payments are allowed, result in free trade.

[2]This alludes to the theory of endogenous tariff determination, which marries the so-called specific factors model of trade theory with the median voter type theorem of political scientists. See Mayer (1984), Findlay (1990), and Lal (1989).

[3]It is a common misperception that Japan is more closed than the U.S. or the EEC. Rogowski (1989) notes:

> No less than an authority than the U.S. International Trade Commission has concluded that Japan's average tariff level is lower than that of either the United States or the European Community. In 1982, Japanese non-tariff barriers in manufacturing industry were estimated as between 5 and 7 percent; those of the European Community were 20% of the United States 34%. ... Protection continues in a few sectors deemed to be strategically or politically essential, e.g., advanced electronics and rice, but it is consistently overrated by Western politicians and journalists. (n. 60, p. 106)

[4]There have been three intellectual protectionist waves since the Second World War. I have discussed the first two in Lal (1983, 1985). The latest is discussed in Lal (1992, 1993).

[5]In Lal (1993) I also deal with the industrial policies of the Far Eastern super growth performers, which have mesmerized various observers. I argue that these were meant to deal with the agency problem in capital intensive industries when there was insufficient agglomeration of private wealth, to allow for a small group of shareholders in each capital intensive firm to hold sufficient shares to monitor the management. Keeping an outward-orientation whilst promoting certain industries through credit subsidies to firms which met their export targets, was a way to create wealthy industrial groups who would have a personal stake in monitoring the management of their firms. The outward-orientation and export targets implied that the firms would be efficient -- because exports cannot be willed by governments. This allowed the effectuation of their emerging comparative advantage in relatively capital intensive industries, as they moved up the ladder of comparative advantage.

[6]The scientific basis of the fears surrounding global warming and the ozone hole is controversial to say the least. I have surveyed the available evidence in Lal (1990), whilst Lal (1992a) takes a cool look at green imperialism!

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TradeBlock is the world's leading provider of institutional trading tools for digital currencies.Â If you believe you've reached this page in error, please let us know at support@tradeblock.com. Need Help? Contact us at support@tradeblock.com with any questions and we will assist you shortly. Multilateral free trade has taken on increasing global importance with the passage of such agreements as the NAFTA, the EU, the GATT, and the recent transformation of the latter into the WTO. The underlying principle of each is progressive trade liberalization in all fields of economic activity, including those which are more prone to protectionist forces such as agriculture, financial services, and foreign direct investment.Â Regional trading blocks. As a preliminary discussion, it is enlightening to briefly examine GATT XXIV which provides the legal basis for NAFTA and the EU. In this debate, trade blocs are stumbling blocks if they prevent or slow multilateral tariff cutting, while they are building blocs if they accelerate or at least do not hinder multilateralism. Numerous mechanisms have been presented to suggest that one or the other position is feasible/likely. These include Reizman (1985), Kennan and Reizman (1990), Krishna (1998), Freund (2000), LimÃ£o (2006), and Levy (1997).