

---

# INTERNATIONAL TRADE DEVELOPMENTS

---

## Preferential Trade Agreements and the Multilateral Trading System

Soamiely Andriamananjara<sup>1</sup>  
soamiely@usitc.gov  
202-205-3252

*Does the current proliferation of preferential trading agreements (PTAs) encourage or impede evolution toward freer global trade? Does it perhaps even increase the likelihood of trade tensions between competing trading blocs? The article presents two models that show how PTAs could affect the multilateral trading system. One model suggests that global free trade may—or may not—be achieved through PTA expansion, depending on a PTA's membership policies. The second model suggests that the greater the degree of preference between the PTA and nonmembers, the less likely PTA members will be willing to undertake multilateral trade liberalization and the more likely nonmembers will be, to support large-scale multilateral liberalization.*

As a guiding principle, the multilateral trading system—organized under the auspices of the World Trade Organization (WTO)—is based upon the concept of “most-favored-nation” and “nondiscriminatory” treatment of all WTO members. During the last two decades, however, a growing number of WTO members have begun to explore alternatives to multilateral trade liberalization—in the form of preferential trading agreements (PTAs).<sup>2</sup> By design, these PTAs grant more favorable conditions to trade with other parties to the agreement than to trade with WTO members. Although PTAs clearly depart from the overarching WTO principle of “nondiscrimination,” they are permitted under specific conditions spelled out in GATT Article XXIV, the so-called 1979 Enabling Clause, and in GATS Article V.

PTAs have flourished all over the world. Nearly all of the 140 WTO members are now party to at least

one agreement.<sup>3</sup> Feeling that progress through WTO talks is too slow, even countries traditionally opposed to the preferential approach are now looking at PTAs as an alternative route to further trade liberalization. For instance, until very recently, Japan has relied completely on the multilateral system, but is now actively pursuing different PTAs with South Korea, Singapore, Mexico, and Canada. South Korea opposed preferential deals in the past, but is negotiating now with New Zealand and Chile as well as Japan.

### The “Regionalism versus Multilateralism” Debate

The inherently discriminatory nature of PTAs—in contrast to multilateral trade liberalization—can be harmful to both member and nonmember nations. Although PTAs can create trade, they can also divert

---

<sup>1</sup> The views and conclusions expressed in this article are those of the author. They are not necessarily the views of the U.S. International Trade Commission as a whole or of any individual Commissioner.

<sup>2</sup> PTAs can take different forms ranging from free-trade areas such as the Latin American Free-Trade Area (LAFTA), or the North American Free-Trade Area (NAFTA); to monetary unions such as the European Union (EU) and customs unions such as the Mercado Común del Sur (Mercosur).

<sup>3</sup> As of May 2000, 127 PTAs have been notified to the GATT/WTO and are in force, of which 100 are under GATT Article XXIV, 17 under the Enabling Clause, and 11 under GATS Article V. See [http://www.wto.org/english/tratop\\_e/region\\_e/region\\_e.htm](http://www.wto.org/english/tratop_e/region_e/region_e.htm).

trade away from lower cost producers in nonmember countries.<sup>4</sup> Although it is possible to reconcile preferential trading with progress toward freer global trade, policy analysts have identified two big dangers: (1) slower or even blocked multilateral liberalization, and (2) leaving aside of the world's poorest countries. It is therefore important that policymakers understand the relationships between PTAs and the multilateral trading system. Does preferential trading encourage evolution toward globally freer trade, or does it place impediments in its way, and perhaps even increase the likelihood of trade wars between competing trading blocs? This forms the nub of the "Regionalism versus Multilateralism" debate.<sup>5</sup>

In parallel to the proliferation of PTAs, the academic literature on the subject has thrived in recent years, focusing in particular on two dimensions of the issue. One dimension pertains to the dynamics of PTA formation and asks whether PTAs have a tendency to expand their memberships or to merge, and whether this tendency will continue until it culminates in global free trade. The second dimension concerns the effects of the establishment of a PTA on the member and non-member countries' incentives for multilateral trade liberalization.

The remainder of this article presents two models that could be useful in thinking respectively about these two dimensions. One model about membership dynamics shows that globally free trade may or may not be achieved through PTA expansion depending on the PTA membership policies. A second model focusing on producers' influence shows that the greater the degree of preference in the PTA, the less is the magnitude of multilateral trade liberalization that PTA members are willing to undertake and the greater is the non-member countries' support for large scale multilateral liberalization.

## The "Dynamics" of PTA Formation: Stagnant or Expanding Membership?

Will PTAs continue to expand and merge until one super PTA encompassing the entire world is left? This process has been termed "domino regionalism" by

<sup>4</sup> The seminal work on the trade-creation/trade-diversion tradeoff is by Jacob Viner, *The Customs Union Issue* (Washington DC: Carnegie Endowment for International Peace, 1950).

<sup>5</sup> For a survey of this literature, Jagdish Bhagwati and Arvind Panagariya, "Preferential Trading Areas and Multilateralism—Strangers, Friends, or Foes?" in J. Bhagwati and A. Panagariya, eds., *The Economics of Preferential Trade Agreement* (Washington DC: American Enterprise Institute Press, 1996).

Richard Baldwin, who uses a political economy model to show how the expansion of a PTA increases the incentives of the outsiders to apply for membership.<sup>6</sup> He argues that the most recent wave of regionalism was caused by two idiosyncratic events (namely, the 1994 North American Free-Trade Agreement or NAFTA, and the European Communities' EC 1992 program), multiplied by a "domino effect." Baldwin's results suggest a continuous expansion of the PTA that will stop only when all remaining outsiders conclude they will incur loss of domestic market share and other costs that more than offset preferential market-access and other gains by becoming members of the PTA. One direct implication of his result is that if membership were open (i.e. member countries cannot prevent non-members from joining), and if noneconomic factors (e.g. security or sovereignty motives) against seeking entry were absent, regionalism would lead to global free trade.

Baldwin's analysis, though insightful, tells one part of the story but it fails to consider the incentives of the PTA members to keep other countries out of the arrangement. After all, the formation and expansion of a trading bloc require a "coincidence of wants" among all interested parties—members and nonmembers. Both nonmembers must want to join the PTA and, at the other end, the members must be willing to accept them as new members. Therefore, a complete analysis of the issue should also look at the incentives of the members to accept or reject new members. Soamieli Andriamananjara investigates the effects of the formation or expansion of a PTA on members, nonmembers, and the world as a whole.<sup>7</sup> He demonstrates that an expansion of a regional grouping always unambiguously hurts those left out (even if the external tariffs of the PTA remain constant). He also shows that the effects of an expansion on a member country are positive for small PTAs, but become negative as the PTA membership grows more numerous.

Consider an outsider country contemplating entry into a trading bloc. Its choice is determined by the trade-off between the costs of opening up one's own market to more foreign competition and the gains from obtaining better, preferential access to the PTA preferential market. In the context of Andriamananjara's model, it can be shown that the market-access gain is

<sup>6</sup> Richard Baldwin, "A Domino Theory of Regionalism," *NBER Working Paper 4364* (NBER: Cambridge MA, 1995).

<sup>7</sup> For more details on the model, see Soamieli Andriamananjara, "On the Size and Number of Regional Integration Arrangements: A Political Economy Model," *World Bank Policy Research Working Paper 2117* (World Bank: Washington DC, 1999).

always larger than the costs of allowing entry, as long as the aggregate size of the PTA market exceeds that of the prospective member. Since the larger the PTA, the more an outsider stands to gain from joining, the incentive of a nonmember country to apply for membership increases with the size of the PTA. Outsider countries that initially had little interest in joining the PTA may become interested when the PTA size becomes large enough. According to this model, an outsider would always want to apply for membership to an existing bloc. Thus, *if the PTA had an open membership policy, it would likely continue to expand until global free trade is achieved.*

Consider next the incentives of the PTA members. If member countries could choose to accept or reject new members, the expansion of the bloc is probably not likely to yield global free trade. In fact, when deciding whether to accept or reject a new member, a PTA member compares the gains from getting preferential access to the new member's market against the losses of having to share its original preferential market with the new member—the pie is getting larger but it also has to be shared by more members. For a small bloc size, the gains are large enough to offset the losses so that the insiders are willing to accept new members. As the bloc expands, however, the insider's incentives for further PTA expansion decrease and eventually go to zero before the PTA encompasses the entire world. Hence, *the expansion of a PTA fails to lead to global free trade when PTA membership is selective* (i.e. a PTA grants membership to a new member if and only if all existing members agree to admit the new member) because it implies a reduction of the PTA members' welfare from the levels that they achieve when only a limited number of countries are members.<sup>8</sup> In fact, at some point, the members will refuse to admit new members as "congestion" characteristics of the PTA start to kick in, whereby bureaucratic rigidities may begin to impose additional costs that hamper gains from expanded market access within the PTA.

So far, the process being considered is one in which only one PTA forms and expands at any given time. One can also look at an alternative process whereby PTAs form more or less symmetrically and merge simultaneously to yield progressively larger blocs. Will this continue so as to yield one single bloc, which is global free trade? In this model, it can be shown that in this simultaneous bloc expansion, the

<sup>8</sup> When the PTA members decide to stop further expansion, the rejected countries have an incentive to form their own PTA. The model demonstrates that the possibility of a second bloc leads the members of the original bloc to preempt the losses associated with the creation and enlargement of a second PTA by choosing a group size larger than the one they would have chosen if only one bloc were allowed to form. Hence, the threat of regionalism by outsiders forming additional blocs in competition would encourage previous blocs toward larger PTAs.

regionalism process fails to converge into a single bloc except when the external tariff happens to be low enough. This is an example of open regionalism, based on low external tariffs, leading to multilateral free trade. One direct implication of this is that *global free trade can be achieved through bloc expansion if trading blocs lower their external tariffs, as well as lower and eliminate their own internal tariffs.*

## PTAs and Incentives for Multilateralism

The second dimension in the "Regionalism versus Multilateralism" debate is to study the effects of the establishment of the PTA incentives for nondiscriminatory trade liberalization. This is particularly relevant given that preferential trade policies alter the balance of gains and losses that members and nonmembers experience from multilateral trade liberalization. In a recent contribution to the literature, Pravin Krishna uses a three-country model to show that a PTA between two countries reduces the incentives to liberalize tariffs reciprocally with the third country. He also demonstrates that, given sufficient trade is diverted away from nonmembers, multilateral liberalization that was feasible before the PTA formed ceases to be so afterwards.<sup>9</sup>

One can use a simple model to study the effects of regional integration on the incentives of PTA members and nonmembers to undertake multilateral trade liberalization (i.e. reciprocal trade liberalization among members and nonmembers).<sup>10</sup> Consider a world with three countries, two of which are potential PTA members. Assume that the producers' profits play a decisive role in determining a country's trade policies; that is, the gains and losses of domestic producers drive decisions regarding trade liberalization.<sup>11</sup>

Consider a representative firm in one of the potential PTA members. In this model, multilateral trade liberalization has two opposing effects on the profits of that firm: (i) it decreases the profits it makes in the local market as reduced domestic protection produces more competition from abroad, and (ii) it increases the profits it makes abroad (in both other members' and nonmembers' markets) as it gets better access to other

<sup>9</sup> When the PTA members decide to stop further expansion, the rejected countries have an incentive to form their own PTA. The model demonstrates that the possibility of a second bloc leads the members of the original bloc to preempt the losses associated with the creation and enlargement of a second PTA by choosing a group size larger than the one they would have chosen if only one bloc were allowed to form. Hence, the threat of additional competition from a second bloc would encourage the first bloc to expand.

<sup>10</sup> Pravin Krishna, "Regionalism and Multilateralism: A Political Economy Approach," *Quarterly Journal of Economics*, vol. 113, No. 1 (1998) pp. 227-251.

<sup>11</sup> Other political economy models may include consumer welfare or tariff revenues as determinants of trade policy.

countries' markets. As the degree of preference rises, it can be shown that the domestic profit loss from multilateral liberalization increases (i.e. the first effect is strengthened) and the profit gain in the other member countries decreases (i.e. the second effect is weakened).<sup>12</sup> This makes the insiders more reluctant to undertake larger scale multilateral liberalization: the more preference an insider gives and gets from other insiders, the less market access it is willing to give up in exchange for that received from outsiders. The simple model therefore offers an example of how *an increase in the degree of preference in the PTA can reduce a PTA member's willingness to undertake larger scale multilateral trade liberalization.*

Consider next the changes in the incentives of a representative firm in the excluded or "outsider" country. Multilateral trade liberalization increases the firm's profits in the PTA market, but decreases those made in its own domestic market. An increase in the level of discrimination that it faces (that is, the level of preference between the PTA members and outsiders) leaves domestic profits unchanged but decreases its profits in the PTA market due to trade diversion from nonmember to member countries. Given these different effects, it can be analytically shown that *the larger the level of preference enjoyed by PTA members, the larger is the excluded country's support for larger scale multilateral liberalization.* Small tariff cuts are not enough to offset the excluded country's profit losses from the trade diversionary effects of the PTA.

## Conclusion

The models summarized and discussed in this article are theoretical in nature, based admittedly on

<sup>12</sup> The term "degree of preference" refers here to the difference between tariffs charged to PTA members and those charged to nonmembers.

stylized assumptions. In practice, incentives vary from country to country, as well as among different types of PTAs. Moreover, some PTAs have been established for political reasons that extend beyond solely economic reasons.

Keeping these limitations in mind, the foregoing discussion could still be useful in thinking about the incentives of members and nonmembers and the implications of the recent proliferation of PTAs on the global trading system. Does preferential trading encourage or impede evolution toward globally freer trade, perhaps even increasing the likelihood of trade tensions or "trade wars" between competing trading blocs? Although it is beyond the scope of this article to offer any specific policy implications, a number of general conclusions emerge from the discussion that could be useful in designing future preferential trade initiatives.

- S If a PTA has an open membership policy, it may well continue to expand until global free trade is reached.
- S If PTA membership is selective, global free trade is unlikely to be achieved through PTA expansion.
- S In a world where more than one PTA forms simultaneously, global free trade can be reached through sequential PTA mergers if (and only if) the trading blocs' external tariffs are not too high.
- S The greater the degree of preference in the PTA, the lesser is the magnitude of multilateral trade liberalization that PTA members are willing to undertake.
- S The greater the degree of preference in the PTA, the greater is the nonmember countries' support for large scale multilateral liberalization.