PART II
INTERNATIONAL TRADE

International trade used to be obscure and uncontroversial. Governments would negotiate agreements in Geneva and nobody would pay them much attention. International trade has become substantially more controversial during the last fifteen years. The public and civil society now appear increasingly hostile toward trade and toward global trade institutions. Debates have emerged about whether trade and globalization more generally are good things for American workers. Debates have emerged about whether governments should liberalize trade exclusively through the World Trade Organization (WTO) or also through regional arrangements such as the North American Free Trade Agreement. Debates have emerged about whether global trade rules limit the ability of governments to achieve other desirable social objectives such as protecting the environment and safeguarding human and animal health. Part II examines these contemporary debates.

Chapter 2 explores the impact of international trade, and the U.S. trade deficit, on job destruction and job creation. Trade liberalization promotes specialization in production along the lines of comparative advantage. Societies that trade, therefore, should lose jobs in some sectors and create jobs in others. Robert Scott argues here that these labor market dynamics are compounded by the trade deficit the United States has run for more than twenty-five years. Focusing on the U.S.–China bilateral trade deficit, Scott argues that the excess of imports over exports results in net job reduction for the United States. Douglas Irwin challenges Scott's logic. He argues that the net job loss that may be attributed to the trade deficit is offset by net job creation attributable to foreign investment in the United States. For Irwin, therefore, trade, and even the trade deficit, does not affect how many jobs are available in the United States, but rather the kind of jobs available.

Chapter 3 examines how to maintain public support for trade given its impact on people employed in comparatively disadvantaged industries. Because trade eliminates jobs in some areas and creates jobs in others, some people must transition out of their current jobs to new work. In addition, the Stolper–Samuelson theorem tells us that trade has some permanent redistributive consequences: It reduces the return

to society's scarce factor. Hence, some people will earn less than they did previously. How can we best maintain public support for trade in the face of these labor market consequences? Howard Rosen argues that the best approach relies on a variety of instruments that retrain displaced workers and help them find new jobs in expanding sectors. Such Trade Adjustment Assistance offers temporary support for people directly harmed by trade. Kenneth Scheve and Matthew Slaughter argue that Trade Adjustment Assistance is inadequate. Instead of such exclusive reliance on short-term adjustment assistance, they call for permanent redistribution of income from those who clearly gain from trade to those who are made worse off.

Chapter 4 explores the debate over the free flow of people across borders. Whereas governments have greatly liberalized the cross-border flow of goods, services, technology, and capital, they continue to restrict the cross-border flow of people. Philippe LeGrain argues that governments should liberalize flows of people, too. Migrants, he argues, may move to enhance their own position, but they end up providing substantial benefits to their host countries as well. The free flow of people, therefore, is a "win–win" situation. David Goodhart argues that governments should continue to restrict migration. Paying particular attention to the impact of migration to Great Britain from its former colonies, he argues that unfettered migration can weaken a society's cultural, linguistic, and political cohesion. He thereby highlights a tension between liberal commitment to social cohesion on the one hand and multicultural diversity on the other.

Chapter 5 considers the consequences of governments' current enthusiasm for preferential trade arrangements (PTAs). PTAs, which include free trade areas like the North American Free Trade Area and customs unions like the European Union, are trade-liberalizing affairs. Yet debate exists about whether PTAs have a net positive or net negative impact on international trade. Daniel Griswold argues that PTAs are a building block toward a world of global free trade. By this logic, governments will first eliminate all trade barriers within regional PTAs and then eliminate all trade barriers between regional PTAs. Jagdish Bhagwati argues that PTAs are a stumbling block to global free trade. He suggests that the preferential nature of PTAs introduces inefficiencies into the international trade system.

Chapter 6 discusses the impact of international trade and the international trade system on the environment. The central question under consideration is whether governments can restrict trade under current WTO rules in support of domestic regulations that reduce greenhouse gas emissions. Jeffrey Frankel asserts that such trade restrictions are a useful tool to support climate change regulation and are consistent with obligations under the World Trade Organization. Jason Bordoff argues that even if WTO rules allow such trade restrictions in support of global warming regulation, governments should create new non-trade instruments. He argues that allowing trade restrictions opens the door to disguised protectionism under which governments protect uncompetitive firms and justify the action in environmental terms.

for example, should be designed to reduce the fear of free riding, and the symbolic aspects of citizenship should be reinforced; they matter more in a society when tacit understandings and solidarities can no longer be taken for granted. Why not, for example, a British national holiday or a state of the union address?

Lifestyle diversity and high immigration bring cultural and economic dynamism but can erode feelings of mutual obligation, reducing willingness to pay tax and even encouraging a retreat from the public domain. In the decades ahead European politics itself may start to shift on this axis, with left and right being eclipsed by value-based culture wars and movements for and against diversity. Social democratic parties risk being torn apart in such circumstances, partly on class lines: recent British Social Attitudes reports have made clear the middle class and the working class increasingly converge on issues of tax and economic management, but diverge on diversity issues.

The anxieties triggered by the asylum seeker inflow into Britain now seem to be fading. But they are not just a media invention; a sharp economic downturn or a big inflow of east European workers after EU enlargement might easily call them up again. The progressive centre needs to think more clearly about these issues to avoid being engulfed by them. And to that end it must try to develop a new language in which to address the anxieties, one that transcends the thin and abstract language of universal rights on the one hand and the defensive, nativist language of group identity on the other. Too often the language of liberal universalism that dominates public debate ignores the real affinities of place and people. These affinities are not obstacles to be overcome on the road to the good society; they are one of its foundation stones. People will always favor their own families and communities; it is the task of a realistic liberalism to strive for a definition of community that is wide enough to include people from many different backgrounds, without being so wide as to become meaningless.

CHAPTER 5 FREE TRADE AGREEMENTS ARE STEPPING-STONES *v.* FREE TRADE AGREEMENTS ARE STUMBLING BLOCKS

Free Trade Agreements Are Stepping-Stones toward Global Free Trade

Advocate: Daniel T. Griswold

Source: Free-Trade Agreements: Steppingstones to a More Open World, Trade Briefing Paper #18 (Washington, DC: CATO Institute, July 10, 2003)

Free Trade Agreements Are Stumbling Blocks toward Global Free Trade

Advocate: Jagdish Bhagwati

Source: "Why PTAs Are a Pox on the World Trading System," in *Termites in the Trading System: How Preferential Agreements Undermine Free Trade* (New York: Oxford University Press, 2008), 49–88

The last twenty years have seen an explosion of preferential trade agreements (PTAs). PTAs, sometimes referred to as regional trade agreements, are trade agreements that discriminate between members and nonmembers. PTAs come in two basic forms. In a free trade agreement (FTA), governments eliminate tariffs on goods entering their markets from their FTA partners, but each member retains independent tariffs on goods entering from non–FTA members. In a customs union, like the European Union, member governments combine an FTA with a common external tariff for goods entering the union from nonmembers. Although PTAs have been part of the global trade system throughout the postwar period, the number of such agreements accelerated rapidly during the 1990s. Today, approximately 180 PTAs are in force, and all World Trade Organization (WTO) members except Mongolia belong to at least one PTA.[1]

The proliferation of PTAs has thus generated debate concerning their impact on the multilateral trade system. Article 24 of the General Agreement on Tariffs and Trade gives governments the right to create PTAs, so the central

[1] World Trade Organization, "Regionalism: Friends or Rivals?" http://www.wto.org/english/theWTO_e/whatis_e/tif_e/bey1_e.htm.

issue is not really about whether PTAs are consistent with WTO obligations. Instead, the debate focuses on whether PTAs, in spite of their seeming trade-liberalizing consequences, are stepping-stones or stumbling blocks: Do they bring the world closer to or further from free trade?

FREE TRADE AGREEMENTS ARE STEPPING-STONES TOWARD GLOBAL FREE TRADE

Proponents argue that PTAs are stepping-stones to global free trade. Liberalizing trade within the WTO is difficult because negotiations must produce agreements that satisfy more than 150 governments. In this context, a strategy based on PTAs might gradually lead to global free trade. Each successive PTA will eliminate tariffs on trade between some countries. Each PTA that governments negotiate will exert a gravitational pull that attracts new members. Eventually, the global network of PTAs will eliminate tariffs between most countries. Governments thus achieve via PTAs what they cannot achieve as readily via multilateral negotiations within the WTO.

Daniel Griswold, an American economist, develops an argument along these lines. Griswold supports the American policy of negotiating FTAs as a second-best alternative to multilateral negotiations. He recognizes the legal and economic complexities that characterize PTAs: Are they consistent with WTO rules, and do they divert more trade than they create? Yet he argues that on balance the careful construction of FTAs is a useful policy tool that can advance American interests and promote gradual movement toward global free trade.

FREE TRADE AGREEMENTS ARE STUMBLING BLOCKS TOWARD GLOBAL FREE TRADE

Critics of PTAs argue that on balance the recent proliferation of such arrangements constitutes a real threat to the global multilateral trade system. On the one hand, critics argue that the logical evolution of a system based on PTAs is to three rival trade blocs, one based in Europe, one based in the Americas, and one based in Asia. These rivals would then engage in trade wars. One bloc might raise tariffs on imports from outside to protect local producers. The other blocs would respond by raising tariffs in return. The resulting trade wars would progressively reduce trade between the blocs and thus push the world toward a regional rather than a multilateral and global trade organization. And even if this worst case scenario does not arise, the negotiation of PTAs necessarily reduces the attention paid to the multilateral WTO. Consequently, PTAs gradually, even if unintentionally, erode support for the WTO-based trade system.

Jagdish Bhagwati is perhaps the most vocal critic of the contemporary proliferation of PTAs. In the extract presented here, Bhagwati criticizes PTAs on

three grounds. First, he asserts that the resulting trade diversion is much larger than commonly recognized. Second, he claims that the proliferation of PTAs has created an extraordinarily complex network of rules that make it impossible *ex ante* to determine which tariff rates apply to a particular product. Finally, PTAs enable the United States to use its power to extract concessions from smaller countries that it could not otherwise obtain. This power asymmetry creates the opportunity to use PTAs to establish "trade unrelated rules" such as common labor and environmental standards and protection of property rights.

POINTS TO PONDER

1. Does the United States, as a hegemon, have a responsibility to pursue liberalization exclusively through the multilateral system?
2. Which of the following do you believe more likely: The threat to liberalize through PTAs will spur WTO negotiations to successful conclusion, or the emergence of PTAs will cause governments to gradually place less emphasis on the WTO?
3. Which do you consider more worrisome: a world in which governments liberalize trade through PTAs rather than the WTO or a world in which they eschew PTAs but are unable to make progress within the WTO? Justify your selection.

Daniel T. Griswold

Free-Trade Agreements: Steppingstones to a More Open World

Introduction

. . . Since final passage of trade promotion authority in 2002, the Bush administration has launched an aggressive campaign to negotiate bilateral and regional free-trade agreements (FTAs). . . . Those agreements already negotiated or in the pipeline are sure to spark the usual debate about free trade versus fair trade, environmental standards and working conditions in poor countries, jobs and wages in the United States, and the other issues that inevitably swirl around any trade agreement before Congress.[1] But bilateral and regional trade agreements also raise a peculiar set of policy issues, economic and noneconomic alike, that are generally neglected when deals are debated and voted on.

Even for supporters of trade expansion, not every bilateral and regional free-trade agreement proposed is necessarily good economic policy. Despite the name, free-trade agreements do not always promote more trade, nor do they necessarily leave parties to the agreement or the rest of the world better off. Beyond the economic ambiguities of FTAs are a number of important strategic and foreign policy considerations that cannot be ignored.

This paper examines the merits of negotiating free-trade agreements. It analyzes both the economic and noneconomic implications of FTAs, weighs the costs and benefits of the specific agreements put forward by the Bush administration in light of those implications, and proposes guidelines for future negotiations to maximize the benefits and minimize the costs to both the U.S. economy and our broader national interests.

On balance, . . . bilateral and regional agreements . . . further our national interests. If crafted properly, those agreements would strengthen the U.S. economy by injecting new import competition into domestic markets and opening markets abroad more widely to U.S. exports. More important, they would encourage economic reform abroad and cement economic and foreign policy ties between the United States and key allies.

The Peculiarities of FTAs

For anyone who supports free trade, support for free-trade agreements would at first glance seem to be automatic. Such agreements by definition lower barriers to trade between participants, and lowering or eliminating barriers altogether has been the aim of the whole trade liberalization movement. Yet

regional and bilateral trade agreements raise legal and economic questions that should be addressed.

Departing from Multilateral Trade

FTAs are an exception to the basic legal principle of nondiscrimination in international trade. Article III of the basic charter [of] the World Trade Organization ([WTO;] the General Agreement on Tariffs and Trade [GATT] 1947 as amended by the 1994 Uruguay Round Agreement) declares as a fundamental principle that market access should be extended to all members on a most-favored-nation, or nondiscriminatory, basis. Specifically, "any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."[2]

Of course, FTAs explicitly deviate from that principle. They grant an advantage (lower or zero tariffs) to parties to an agreement that are not granted to other members of the WTO that are not parties to the agreement. But free-trade agreements and customs unions, when properly crafted, are consistent with GATT rules.

When the GATT was originally signed in 1947, its founding members carved out an exception for free-trade areas. Article XXIV of the GATT allows customs unions or free-trade agreements between members,[3] recognizing "the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries [party] to such agreements."[4] Such agreements are allowed provided they (1) do not result in higher trade barriers overall for WTO members outside the agreement,[5] (2) eliminate "duties and other restrictive regulations of commerce" on "substantially all the trade between the constituent territories . . . in products originating in such territories,"[6] and (3) do so "within a reasonable length of time."[7] Article XXIV can be waived entirely by a two-thirds vote of WTO members.[8]

The most obvious exception under Article XXIV has been the European Union, which began in the 1950s as the six-member European Economic Community. Other well-known FTAs or customs unions among WTO members are the European Free Trade Association, the North American Free Trade Agreement, the Southern Common Market, the Association of Southeast Asian Nations Free Trade Area, and the Common Market of Eastern and Southern Africa.

In fact, free-trade agreements have been proliferating among WTO members. Today more than 150 such agreements are in effect, and the trend has been accelerating in the last decade. In the first 46 years of the GATT, between 1948 and 1994, 124 such agreements were signed (many of which

have since expired), an average of 2.7 per year. Since 1995 the WTO has been notified of 130 such agreements, an average of more than 15 per year.[9] Today an estimated 43 percent of international trade occurs under free-trade agreements, and that share would reach 55 percent if agreements currently being negotiated worldwide were to be implemented.[10]

Despite Article I, free-trade agreements are a legal fact of life in international trade. More and more WTO members are choosing to negotiate FTAs. The question for U.S. trade policy is whether we should join or resist the trend.

The Messy Economics of FTAs

The economics of FTAs is more ambiguous than the legalities. Even though FTAs by definition result in lower trade barriers between member countries, they do not necessarily result in economic gains for all members or the world as a whole.

Economists have been investigating this phenomenon since 1950, when Jacob Viner published his seminal study, *The Customs Union Issue*.[11] Viner noted that customs unions can promote new trade among members, but they can also divert trade from more efficient producers outside the agreement.

If signed with a low-cost foreign producer, an agreement can result in *trade creation* by allowing the low-cost producer to enter the domestic market tariff free, reducing domestic prices, and displacing higher-cost *domestic* producers. But if signed with a relatively high-cost foreign producer, an agreement can result merely in *trade diversion* by allowing the higher-cost importer to displace lower-cost *foreign* importers simply because producers in the new FTA partner can import tariff free. As Viner concluded, customs unions are likely to yield more economic benefit than harm when "they are between sizeable countries which practice substantial protection of substantially similar [that is, competing] industries."[12]

To maximize trade creation, FTAs should unleash real competition in previously protected markets. From an economic perspective, the essential purpose and principal payoff of international trade is expanded competition within the domestic economy and expanded markets abroad for domestic producers. Increased import competition results in lower prices for consuming households and businesses, more product choice, higher quality, and increased innovation. By stimulating more efficient production, import competition increases the productivity of workers, real wages, living standards, and the long-run growth of the economy.

If an FTA does not result in lower prices for the importing country but merely reshuffles imports from the rest of the world to FTA partners, the importing country can suffer a welfare loss. Its government loses tariff revenue, but its consumers do not reap any gain from lower prices. In effect, the importing country's treasury subsidizes less efficient production in the partner country. If global prices outside the FTA fall because of the diverted demand, then the rest of the world loses from lost producer surplus.

To minimize trade diversion, the best FTAs allow a large and competitive foreign producer to displace domestic producers in a large and protected domestic market, thus delivering lower prices and higher real incomes to workers and families. The worst allow less competitive foreign producers to replace more competitive foreign producers in a large and protected domestic market, costing the treasury tariff revenue without delivering lower domestic prices or more efficient domestic production.

Free-trade economists argue among themselves about whether trade creation or trade diversion usually predominates under free-trade agreements. Settling that dispute definitively is beyond the scope of this paper.[13] But we do know that the evidence is mixed and that the short-term, static economic impact of a free-trade agreement is only one factor in deciding whether a particular FTA meets the test of good public policy. The possibility of trade diversion is not sufficient reason to reject the Bush administration's policy of pursuing FTAs.

How FTAs Advance Trade Liberalization

Even if trade diversion occurs, free-trade agreements can advance the goals of expanding free markets, individual liberty, and more peaceful cooperation among nations. In addition to their short-term economic effects, free-trade agreements can advance American interests in several ways.

A Safety Valve for the Multilateral System

One, FTAs provide an important safety valve if multilateral negotiations become stuck—an all-too-real possibility. Multilateral negotiations through the GATT and now the WTO can be long, tortuous, and uncertain. Since the Kennedy Round concluded in 1967, only two other comprehensive multilateral agreements have been reached—the Tokyo Round Agreement in 1979 and the Uruguay Round Agreement in 1994. And because of the need for consensus, it takes only one of the 146 nations in the WTO to scuttle a new agreement.

To cite one plausible scenario, the French government could prevent completion of a Doha Round Agreement because of its long-standing objections to liberalization of agricultural trade. Negotiators have already missed a March 31, 2003, deadline for preliminary agreements on agriculture, and doubt is widespread that the round will be concluded by 2005 as agreed in the 2001 agreement that launched it. The Uruguay Round, it should be remembered, almost foundered on the subject of agriculture. Given the history of multilateral negotiations, it would be unwise to put all of our tradable eggs in the Doha Round basket.

FTAs provide institutional competition to keep multilateral talks on track. If other WTO members become intransigent, the United States should have the option of pursuing agreements with a "coalition of the willing" in pursuit of trade liberalization. Negotiating FTAs, or at least retaining the option to do so, can send a signal to other WTO members that, if they are unwilling to negotiate seriously to reduce trade barriers, we retain the right to find bilateral and regional partners who will. Knowing that WTO members, including the United States, can pursue FTAs outside the multilateral process can focus the minds and wills of negotiators to reach an agreement.

Fears that FTAs could divert attention from the multilateral track are unfounded. Most WTO members that have pursued regional and bilateral FTAs have not abandoned their commitment to multilateral negotiations. The U.S. government signed agreements with Israel, Canada, and Mexico during the Uruguay Round negotiations from 1986 to 1994 without reducing its commitment to a final multilateral agreement. And there is no evidence that pursuit of FTAs today has distracted the Bush administration from the ongoing Doha Round of WTO negotiations. Indeed, U.S. Trade Representative Robert Zoellick has been leading the charge in the Doha Round with aggressive proposals to liberalize global trade in manufactured goods, agricultural products, and services.

A Level Playing Field for U.S. Exporters

Two, FTAs can level the playing field for U.S. exporters who have been put at a disadvantage by free-trade agreements that do not include the United States. The United States is party to only 3 of the 150 or so FTAs currently in force around the world—NAFTA [North American Free Trade Agreement] and bilateral agreements with Israel and Jordan. Even though American producers may be the most efficient in the world in a certain sector, our exporters may not be able to overcome the advantage of rival foreign producers who can export tariff free to countries with which their governments have signed an FTA.

In Chile, for example, U.S. exporters encounter a uniform 6 percent tariff. Competing exporters in the European Union, Canada, and Brazil, in contrast, sell duty-free in the same market because their governments have signed free-trade agreements with Chile. According to the National Association of Manufacturers, U.S. exporters have lost market share in Chile since its government began to aggressively pursue free-trade agreements with its non-U.S. trading partners in 1997. Especially hard-hit by the tariff differential have been U.S. exports to Chile of wheat, soybeans, corn, paper products, plastics, fertilizers, paints and dyes, and heating and construction equipment.[14] All those sectors have seen their market share drop significantly in the absence of a U.S.–Chile free-trade agreement.

Institutionalizing Reforms Abroad

Three, FTAs can help less-developed countries lock in and institutionalize ongoing economic reforms. A signed agreement prevents nations from backsliding in times of economic or political duress. Agreements assure foreign investors that reforms mark a permanent commitment to liberalization. For example, when Mexico suffered its peso crisis in 1994–95, its NAFTA commitments kept its market open to U.S. exports. The assurance of an FTA also works the other way, guaranteeing that exporters in the partner country will enjoy duty-free access to the large American market. By signing an FTA with the United States, less-developed countries signal to the rest of the world that they are serious about embracing global competition. That signal, combined with access to the U.S. market, can help to attract foreign investment and spur faster development.

Blazing a Trail for Broader Negotiations

Four, FTAs can provide useful templates for broader negotiations. As the members of the WTO grow in number and diversity, reaching consensus among all 146 members becomes more difficult. Negotiators can be forced to consider only the lowest common denominator acceptable to all members. Negotiating with only one country or a small group of like-minded countries can allow more meaningful liberalization in areas such as sanitary and phytosanitary (i.e., animal and plant) regulations, technical barriers to trade, service trade and investment, electronic commerce, customs facilitation, labor and environmental standards, dispute settlement, and market access for politically sensitive sectors.

Those agreements, in turn, can blaze a trail for wider regional and multilateral negotiations. The U.S.–Chile FTA provides an example of how to incorporate labor and environmental standards into the text of an agreement without threatening to hold trade hostage to rich-country demands for higher standards in less-developed countries. FTAs can provide creative solutions to sticky political problems that can then be adapted in other agreements.

Internal Competition and Integration

Five, FTAs can spur internal reform and consolidation within member states, enhancing economic growth and support for more liberalization. By encouraging regional integration, FTAs hasten the consolidation of production within the FTA, increase economies of scale, and create a more integrated production process. Consolidation may be most pronounced in more heavily protected service sectors such as telecommunications, financial services, and transportation. More efficient industries and infrastructure can yield dynamic gains year after year, boosting growth,

investment, and demand for imports from FTA partners as well as the rest of the world.

For all those reasons, the Bush administration's agenda of negotiating free-trade agreements is worth pursuing. Under the right conditions, FTAs can inject new competition into our domestic economy, lowering prices for consumers and shifting factors of production to more efficient uses, while leveling the playing field for U.S. exporters. Beyond those immediate benefits, FTAs can provide institutional competition for multilateral talks, spurring integration among FTA countries and liberalization abroad and blazing a trail through difficult areas for broader negotiations in the future. As a foreign policy tool, FTAs can cement ties with allies and encourage countries to stay on the trail of political and economic reform.

Conclusion

As a tool for expanding freedom and prosperity, regional and bilateral free-trade agreements are useful if less than ideal. They complicate the international trading system by deviating from the most-favored-nation principle of nondiscrimination, and they can blunt the benefits of international trade by diverting it from the most efficient foreign producers to those that are favored but less efficient. But FTAs can produce compensating benefits by opening domestic markets to fresh competition, encouraging economic liberalization abroad, cementing important foreign policy and security ties, integrating regional economies, opening markets to U.S. exports, and providing healthy institutional competition for multilateral negotiations.

To maximize the economic benefits of free-trade agreements, the U.S. government should focus its efforts on negotiations with countries that provide new opportunities for U.S. exporters and whose producers would be most likely to enhance competition in our own market. That approach requires that U.S. negotiators not duck politically sensitive sectors through long phase-in periods for or exemptions from liberalization. Instead, they should tout the immediate liberalization of those sectors as offering the best opportunities to reap the benefits of trade.

As a broader foreign policy tool, free-trade agreements should reward and solidify market and political reform abroad. If FTA partners are not major export markets or significant producers of goods that compete in our domestic market, they should be moving decisively toward free markets and representative government. They should be reform leaders in regions of the world where models of successful reform are most needed. In this way, free-trade agreements can serve as carrots to encourage the spread of political and economic freedom abroad.

Despite their peculiarities and incremental nature, free-trade agreements can serve the cause of freedom and development by breaking down barriers

to trade between nations. If crafted according to sound principles, free-trade agreements can serve America's economic and foreign policy interests.

Endnotes

1. For articles and studies on those more general trade issues, see previous materials published by the Cato Institute's Center for Trade Policy Studies available at www.freetrade.org.
2. General Agreement on Tariffs and Trade 1947, Part I, Article I, Section 1, www.wto.org/english/docs_e/legal_e/gatt47_01_e.htm.
3. Members of a customs union adopt a common external trade policy with uniform tariffs applying to imports of all members. Members of a free-trade agreement retain independent external trade policies while eliminating barriers among themselves.
4. General Agreement on Tariffs and Trade 1947, Part III, Article XXIV, Section 4.
5. Ibid., Part III, Article XXIV, Section 5 (a) and (b).
6. Ibid., Part III, Article XXIV, Section 8(a)i.
7. Ibid., Part III, Article XXIV, Section 5(c).
8. Ibid., Part III, Article XXIV, Section 10.
9. World Trade Organization, "Regional Trade Agreements: Facts and Figures," www.wto.org/english/tratop_e/region_e/regfac_e.htm.
10. Organization for Economic Cooperation and Development, "Regional Trade Agreements and the Multilateral Trading System," November 20, 2002, p. 12.
11. Jacob Viner, *The Customs Union Issue* (New York: Carnegie Endowment for International Peace, 1950).
12. Ibid., p. 135.
13. For a favorable assessment of free-trade agreements, see Robert Z. Lawrence, "Emerging Regional Arrangements: Building Blocks or Stumbling Blocks?" in *International Political Economy: Perspectives on Global Power and Wealth,* ed. Jeffry A. Frieden and David A. Lake, 3d ed. (New York: Routledge, 1995), pp. 407–15; and Lawrence H. Summers, "Regionalism and the World Trading System," in *Trading Blocs: Alternative Approaches to Analyzing Preferential Trade Agreements,* ed. Jagdish Bhagwati, Pravin Krishna, and Arvind Panagariya (Cambridge, Mass.: MIT Press, 1999), pp. 561–66. For a negative assessment, see Jagdish Bhagwati and Arvind Panagariya, *The Economics of Preferential Trade Agreements* (Washington: AEI Press, 1996), especially pp. 1–78.
14. National Association of Manufacturers, "Absence of Chilean Trade Agreement Costing U.S. over $1 Billion per Year," Washington, February 4, 2003, www.nam.org/Docs/ITIA/25837_ABSENCEOFCHILEANTRADEAGREEMENT.pdf.

Jagdish Bhagwati

Why PTAs Are a Pox on the World Trading System

The worries over PTAs [preferential trade agreements] have increased dramatically in the past two decades as PTAs have proliferated. What exactly are the downsides of this phenomenon, which has gathered speed and become an addiction of the politicians, even as economists (with few exceptions) have expressed alarm at the development? What exactly are they worried about?

Trade Diversion

The traditional objection to PTAs was simply that . . . they could divert trade from the cost-efficient nonmember countries to the relatively inefficient member countries. The reason, of course, is that the nonmembers continue to pay the pre-PTA tariffs, whereas the higher cost member countries no longer have to.

It is easy to see that such a shift in production to a higher cost member country must sabotage the efficient allocation among countries and thus undermine what economists call "world welfare," or, in more palatable language, "cosmopolitan advantage." Recall that Jacob Viner was the first to draw attention to the possibility of trade diversion arising with discriminatory reduction of trade barriers in PTAs. He had focused mainly on PTAs' impact on cosmopolitan advantage, but it was pretty obvious to economists that such trade discrimination could hurt the liberalizing country itself. Why? Because when a country (call it the "home" country) shifts to a higher cost within-the-PTA supplier, it is buying its imports more expensively, incurring what economists call a "terms of trade" loss.

Trade diversion is not a slam-dunk argument against PTAs, for offsetting the loss from trade diversion can be a gain if trade creation takes place. Trade may grow because consumers in the home country now pay lower prices in their own markets; the higher cost supply from the member country is still cheaper than what the domestic consumers had to pay before the PTA was formed. Again, the import-competing producers in the home country will reduce their own inefficient production as the domestic price of imports falls after the PTA comes into operation; this also leads to welfare-enhancing trade creation. Therefore, whether a specific trade-diverting PTA brings loss or gain to a country depends on the relative strengths of the trade diversion and trade creation effects.[1]

The really important implication of the "trade diversion" analysis, however, was that informed economists could no longer pretend that it did not matter how one liberalized trade, that preferential trade liberalization was possibly a two-edged sword on which one could impale oneself. Thus, when some policy makers said that all trade liberalization was good, whether it was through bilateralism, plurilateralism, or multilateralism, they were really flying in the face of science. . . .

As it happens, the proponents of PTAs are too complacent about the phenomenon of trade diversion. Consider seven principal arguments.

1. There is evidence of fierce competition in many products and sectors today, with few managing to escape with "thick" margins of competitive advantage that provide comforting buffers against loss of comparative advantage.[2] Thus, even small tariffs are compatible with trade diversion as tariffs are removed from members of a PTA while they remain in place on nonmembers.
2. The thinness of comparative advantage also implies that today we have what I have called kaleidoscopic comparative advantage, or what in jargon we economists call "knife-edge" comparative advantage. Countries can easily lose comparative advantage to some "close" rivals, who may be from any number of foreign suppliers. So even if preferences today do not lead to trade diversion, the menu of products where you develop comparative advantage in a world of volatility and rapidly shifting comparative advantage will be forever changing, and any given preferences may lead to trade diversion in the near future, if not today.
3. While Article 24 requires that the external tariffs not be raised when the PTA is formed so as not to harm nonmembers,[3] the fact is that they can be raised when the external (MFN [most favored nation]) tariffs are bound at higher levels than the actual tariffs. In these cases, a member of the PTA is free to raise the external MFN tariffs up to the bound levels, whereas typically the scheduled tariff reductions in the PTA, when a hegemonic power is involved, will be hard to suspend.[4] This is in fact what happened during the Mexican peso crisis of 1994, when external tariffs were raised on 502 items from 20 percent or less to as much as 35 percent, while the NAFTA [North American Free Trade Agreement]-defined reductions in Mexican tariffs on U.S. and Canadian goods continued. So the prospect of trade diversion actually increased, despite the intent of those who drafted Article 24.
4. Article 24 freezes only external tariffs when the PTA is formed, with no increase in the external tariff allowed. But it does not address the modern reality that "administered protection" (i.e., antidumping and other actions by the executive) . . . can be used and abused more or less freely

in practice. Once you take into account the fact that trade barriers can take the form of antidumping measures, . . . initially welfare-enhancing trade creation can be transformed into harmful trade diversion through antidumping actions taken against nonmembers. . . .

5. There is plenty of evidence that trade diversion can occur through content requirements placed on member countries to establish "origin" so as to qualify for the preferential duties. . . . To qualify for the preferential tariffs in PTAs that include the United States, one must satisfy requirements such as that the imports of raw materials and components . . . come from the United States. For example, if apparel exports to the United States are accorded preferential tariffs, they must be made with U.S. textiles. This naturally diverts trade in textiles from efficient nonmember suppliers to inefficient U.S. textile producers.
6. Many analysts do not understand the distinction between trade diversion and trade creation and simply take all trade increase as welfare-enhancing. However, some recent analysts who are familiar with the phenomenon of trade diversion have tried to estimate it using what is called the "gravity model." Dating back some decades, this equation simply explains trade between two countries as a function of income and distance. Adapting this simple equation to their use, the economists Jeffrey Frankel and Shang-Jin Wei, who pioneered the use of gravity analysis to estimate trade creation and trade diversion, estimated total bilateral trade between any pair of countries as a function of their income and per capita incomes, with bilateral distance accounted for by statistical procedures.[5] If the countries belonged to, say, the Western hemisphere and they traded more with each other than with a random pair of countries located outside the region, that would mean that the PTA between countries in the Western hemisphere had led to trade creation. . . . The real problem with the analysis is that more trade between partners in a PTA can take place with *both* trade creation and trade diversion, so that one simply cannot infer trade creation alone from this procedure. Hence, the recent estimates based on gravity equations . . . which sometimes (but not always) suggest that PTAs in practice have led to more trade creation than diversion, cannot be treated as reliable guides to the problem of determining whether or not a PTA has led to trade diversion.[6]
7. Several economists have suggested that we need not worry about trade diversion and that beneficial effects will prevail if PTAs are undertaken with "natural trading partners." The initial proponents of this idea, Paul Wonnacott and Mark Lutz, declared creation is likely to be great and trade diversion small if the prospective members of an FTA [free trade agreement] are "natural trading partner."[7] One criterion proposed for

saying that PTA partners are natural trading partners is the volume of trade already between them; the other is geographic proximity. Neither really works.[8]

. . . There is no evidence that pairs of contiguous countries or countries with common borders have larger volumes of trade with each other than do pairs that are not so situated, or that trade volumes of pairs of countries arranged by distance between the countries in the pair will also show distance to be inversely related to trade volumes.[9] . . .

The "Spaghetti Bowl": A Systemic Concern

. . . The systemic problem from discriminatory trade liberalization under PTAs arises in two ways. First, when a country enters into multiple FTAs, it is evident that the same commodity will be subjected to different tariff rates if, as is almost always the case, the trajectories of tariff reduction vary for different FTAs. Second, and much more important, is the . . . fact that . . . tariffs on specific commodities must depend on where a product . . . originates (requiring inherently arbitrary "rules of origin").

With PTAs proliferating, the trading system can then be expected to become chaotic. Crisscrossing PTAs, where a nation had multiple PTAs with other nations, each of which then had its own PTAs with yet other nations, was inevitable. Indeed, if one only mapped the phenomenon, it would remind one of a child scrawling a number of chaotic lines on a sketch pad. . . .

. . . Crisscrossing PTAs, causing in turn the mish-mash of preferential trade barriers, prompted me to christen them the "spaghetti bowl" phenomenon and problem. . . . The phrase has caught on famously. . . . Then again, in the Far East, and in the context of Asian PTAs, it is now referred to as the "noodle bowl," and each PTA that contributes to the chaos is called a "noodle."[10] Of course, Marco Polo is reputed to have brought noodles, eaten since the Han Dynasty, back from China, giving us the Italian spaghetti. So perhaps this Asian shift of terminology from spaghetti to noodles is only a matter of extended reciprocity spanning two millennia.

The chaos resulting from arbitrary rules of origin, designed to establish which product is whose—what I have called the "who is whose" question . . . would be considerable even if the rules of origin were unique and uniformly applied. Typical rules of origin require what are called "substantial transformation" tests to decide whether a product is eligible for the preferential tariff rate. Thus, if a Canadian product is to be certified as eligible for NAFTA preferential tariffs when entering the U.S. market, and it uses imported components or raw materials (e.g., Honda in Canada uses

steel that may be imported), the product must generally satisfy one of the following criteria:

1. A change in tariff classification: Under the Harmonized System of Tariffs [HST] (which is also used for other purposes such as trade negotiations, according to transformation by HST categories, at an agreed level of product classification), of the imported component into the final product; or
2. Value content: The domestic content must be no less than a certain proportion of the value of the final product.[11]

But it is immediately obvious that, even when such common rules are imposed, there are impossible ambiguities in application that lead to chaos. Thus, if Canada imports and also produces steel ingots, how do we decide what imports went into the production of Toyota transplants in Canada? Do we apply the required domestic component value to NAFTA, or to Canadian production alone? Even if that were settled, there is the problem that Japanese steel ingots may have used iron ore from the United States and chemicals from Canada; these in turn may have used components from non-NAFTA sources, in an endless regress as one goes back into the product chain. The mind reels as one contemplates the level of ambiguity and the scope for skullduggery and corruption at every stage.

In fact, in the modern age, where multinationals source components from around the world and trade has expanded among many countries, it is a . . . folly to run your trade policy on the basis of preferences. . . . There are in fact numerous cases where such questions have led to disputes that come for resolution before . . . dispute settlement panels. In a classic case, the U.S. Customs Service refused to certify Hondas produced in Ontario, Canada, as "North American," and hence eligible for duty-free exports from Canada to the United States, on the grounds that . . . Canadian Hondas did not meet the local content requirement of more than 50 percent imposed by the Canada–U.S. Free Trade Agreement (CUFTA). Honda countered that its estimates showed that they did. There is no sure-fire, analytically respectable way to determine the truth in such a case: it all boils down to who has greater stamina and whether Honda is willing to put moneys into legal costs.

But the reality also is far more complex than even this neat but sorry situation. For, in practice, the rules of origin vary between members and nonmembers, across different FTAs by the same country, and across different products within each FTA. For instance, the United States generally applies the substantial transformation test to nonmembers, but, as in the Honda case, it uses the value content test for members of CUFTA and other bilaterals.

Again, in nearly all FTAs worldwide, the rules of origin vary by product. The reason, of course, is that while trade is being freed in these products for imports from member countries, the ability to exploit this opportunity is being undercut by imposing cost-raising rules of origin as required by the specific products. In short, the rules of origin . . . vary as necessary to . . . offset . . . the freeing of trade. They take away with one hand what they give with the other. . . .

In fact, the insertion of these extensive product-specific rules of origin, with their deleterious effect on cross-sector uniformity of protection, creates massive treaties that have prompted cynical comments, such as "If NAFTA was really about free trade, you would need only one page, not a document hundreds of pages long." I have seen the NAFTA treaty volume, or I think I have. In some of my debates with the foe of the WTO [World Trade Organization] and free trade Lori Wallach, an articulate and assertive chief of the trade policy division at Ralph Nader's NGO [nongovernmental organization], Public Citizen, she would often carry a fat volume, plonk it down on the table, and announce that it was the NAFTA treaty. Her point was the only one that I wholeheartedly agreed with: that the treaty's bulk reflected the fact that it was freighted with numerous rules of origin and the intrusion of several extraneous issues that had nothing to do with the freeing of trade. . . .

The complexity that the spaghetti bowls create for international trade causes distortions in trade and investment. Much energy and many resources must be expended to discover the optimal sourcing of large numbers of components with a view to minimizing the cost of manufacture plus transportation and the differential tariffs and charges levied by origin.[12]

. . . The Hong Kong businessman Victor Fung has written eloquently . . . about the distortions and costs imposed on businesses by the spaghetti bowls:

> Bilateralism distorts the flow of goods, throws up barriers, creates friction, reduces flexibility and raises prices. In structuring the supply chain, every country of origin rule and every bilateral deal [have] to be tacked on as an additional consideration, thus constraining companies in optimizing production globally. In each new bilateral agreement, considerations relating to "rules of origin" multiply and become more complex. . . .[13]

As Fung notes, these problems and costs created by the spaghetti bowl are particularly onerous for small enterprises. But they are appallingly difficult for the poorer countries. . . . Because of the spaghetti bowl, and because hegemonic powers use PTAs to impose a host of expensive trade-unrelated demands on the poor-country partners in PTAs that reflect lobbying demands in the hegemon, PTAs are a particularly unattractive trade option for the poor countries relative to multilateralism.

Trade-Unrelated Issues: Turning the Trade Game into a Shell Game

When poor countries enter into PTAs with one another . . . the agreements almost always address trade liberalization. But when they enter into PTAs with . . . the United States and often the European Union, the lobbies in the hegemon countries insist on inserting into the agreements a number of "trade-unrelated" demands on the poor countries. How and why?

First, the lobbies that wish to advance their trade-unrelated agendas by incorporating them into trade treaties and institutions typically mislead by claiming that their agendas are "trade-related." Thus, intellectual property protection has to do with collecting royalties, not with trade. . . . By inserting the phrase "trade-related" into the agreement on trade-related intellectual property (TRIPs), the pharmaceutical and software lobbies managed to get the U.S. trade representative at the Uruguay Round to get the issue into the newly formed WTO in 1995. . . . The process by which trade-unrelated issues are turned into trade-related matters is a cynical one and an inversion of the truth. In fact, when the phrase "trade-related" is used, you can be sure that the issue is trade-unrelated. . . .

Second, it is noteworthy that the PTAs among the poor countries are almost never characterized by the inclusion of such trade-unrelated issues. They concentrate exclusively on trade liberalization. It is only when the hegemonic powers, especially the United States and occasionally the European Union, are involved that one finds the inclusion of such extraneous matters. When important developing countries such as India and Brazil refuse to accommodate these demands and insist on keeping trade negotiations free from such extraneous issues, the reaction is frequently to dismiss these objections as "rejectionist." When President Lula of Brazil refused to extend the proposed Free Trade Agreement of the Americas (FTAA) to include these lobby-driven issues, Washington lobbies and the U.S. trade representative condemned Brazil as embracing an FTAA Lite. . . .

Third, it has become customary to pretend that these trade-unrelated conditions are being imposed "in your interest," that they are really "good for you." Thus, when the software and pharmaceutical industries were advocating intellectual property protection (IPP) during the Uruguay Round, the U.S. trade representative claimed the existence of a study, seen by no one I know, in which benefits had been empirically established for countries moving to adopt IPP. Not content with such propaganda, U.S. legislators also enacted, as part of the 1988 Omnibus Trade and Competitiveness Act, . . . Section 301 which would legitimate the use of retaliatory tariffs against countries that the United States unilaterally decided were indulging in "unreasonable practices." Part of this legislation was specifically aimed at countries that did not provide intellectual property protection. It was a unilateral measure that had no legitimacy since these countries had not entered into any treaty or even an agreement to adopt such protection.[14]

Finally, the U.S. trade representative made it clear during the negotiations in the Uruguay Round that IPP had to be included in the new WTO if the Uruguay Round was to be concluded. It was a position that all other producers of intellectual property signed on to as in their interest, while pretending publicly that it was also in the interest of the poorer nations themselves, even if they were not producers of intellectual property. Having managed to get TRIPs inserted thus into the WTO, in violation of the fact that royalty collection is not a trade isssue, the IPP lobby proceeded to use PTAs to advance their agendas beyond what the multilateral negotiations had yielded. . . .

[Negotiations for an FTA with the Southern Africa Customs Union (SACU) sought] IPP in excess of those agreed to, under de jure and de facto duress in the first instance, at the WTO under the TRIPs agreement. The SACU countries were to be asked to agree on IPP standards "similar to that found in U.S. law" and that exceeded standards agreed to under the TRIPs agreement.[15]

The problem of inclusion of labor and domestic environmental standards in trade treaties is [even] more complex. . . . These are what Robert Hudec and I have called "values-related" demands.[16] . . . Because these demands are "values-based" (e.g., that workers deserve adequate labor standards), it is also easy to present the hegemonic countries' self-serving demands (motivated by the desire to moderate foreign competition) as if they are really demands made for altruistic reasons aimed at benefiting foreign workers. There are in fact a number of bad arguments for bringing these trade-unrelated issues into trade treaties, in one form or another. Such arguments have been floating around for years in the rich-country public domain; they are not compelling and should be rejected.

Take domestic environmental standards (as distinct from international standards, such as to reduce global warming, which involves all nations, or to reduce acid rain, which involves two or more but not all nations).[17] Why does it matter what a producer of steel in Brazil pays by way of a pollution tax for dumping carcinogens in a lake in Brazil that probably no one in the United States has even heard of? . . . Yet if your competitor in Country A pays a lower tax rate than you do, your lobby will insist that this amounts to "unfair trade" and will demand that before trade is freed, Country A must impose an identical burden on your rival.

This sounds reasonable until you spend some time thinking seriously about it. What the pollution tax rate should be (relative to yours) for your foreign rival in your industry cannot be determined except in the total context of the two countries' endowments and preferences. Thus, for instance, even if Mexico and the United States have an identical absolute preference

for doing something for the environment, Mexico may have worse water and better air than the United States. . . . So it may make perfect sense for Mexico to worry about polluted water and for the United States to worry about polluted air. Correspondingly, it would make perfect sense for Mexico to have higher pollution taxes for industries generating water pollution than the United States does, and for the United States to have higher taxes for industries generating air rather than water pollution. To insist then that . . . pollution taxes be equalized for each industry everywhere is to ignore this elementary piece of logic. Even so, it is the principal driver of demands that domestic environmental standards must be forced via trade treaties and institutions to be identical across countries for the same industry.

When it comes to labor standards, the rationale for legitimate cross-country diversity, reflecting different stages of development and differential economic contexts, is equally pertinent. Generally speaking, countries will have different sequences by which they approach . . . labor standards, as well as different needs and capabilities. For example, the AFL-CIO has insisted on inclusion of labor standards in trade treaties, given its huge concern that competition from the poor countries is hurting U.S. workers' wages and threatens their hard-won standards, and bringing foreign countries' labor standards to the level of those in the United States has often been their desire. Yet many have asked: What is so sacrosanct about the labor standards of the United States, where workers' right to strike is badly crippled by half-century-old restrictions, and where the net result has been that union membership has shrunk steadily to almost a tenth of the labor force? It is truly ironic if U.S. labor standards are to be the gold standard for its trading partners.

As it happens, . . . the PTA negotiators of the United States with the developing countries initially settled—on the principle of "getting a foot in the door"—for enacting, despite Mexican hesitations, an agreement in an annex to the NAFTA treaty: that each country would enforce its own standards.[18] This agreement was then moved to the main text in the PTAs with Jordan and Morocco. In . . . PTAs with Peru and Colombia, the U.S. legislators have sought to raise the standards. . . .

But it is pretty clear that, no matter how flawed are the demands to include labor and domestic environmental issues in trade treaties, PTAs with weaker nations offer the best way of getting these demands accepted. And every lobby in Washington, D.C., is playing this game, regardless of the interests of these partner nations themselves. Thus, when the PTAs with Chile and Singapore were being negotiated, the U.S. position was that the use of capital account controls during financial crises ought to be proscribed. This ideological position, favorable to the interests of our financial lobbies, was at variance with even the IMF's [International Monetary Fund's] latest thinking. . . .

Astonishingly, the Australia–U.S. Free Trade Agreement was also witness to lobbying to get Australia's medicine policy, much admired in many

circles, changed under pressure from the pharmaceutical lobby in the United States. Entering into force on January 1, 2005, the FTA has been much criticized within Australia. It contains many intellectual property provisions and others related to altering pharmaceutical regulation and public health policy in Australia, as embodied in its Pharmaceutical Benefits Scheme, which had been designed with a view to ensuring equitable and affordable access to essential medicine.[19]

While the PTAs are clearly being used by lobbies in the United States and, to a lesser degree, by the European Union to secure their agendas in one-on-one negotiations with weak nations, one must also entertain the thought that the aim of these lobbies is surely more ambitious. What they cannot secure immediately at the WTO, because the developing countries are there in greater numbers and can resist the pressure from the hegemonic powers by the sheer force of their numbers and some ability and willingness to take concerted stands in their own interest, the hegemonic powers can hope to secure by breaking away the developing countries one by one through the PTAs. Thus, if a developing country has signed a PTA with the United States that includes labor standards provisions, that country is unlikely to say at the WTO: We will not have labor standards at the WTO. This is in fact a strategy of "divide and conquer." The United States can be interpreted as playing this strategic game, hoping to get its lobbies' agendas on to the WTO by using the PTAs as a mechanism by which the opposition to these lobbies' agendas is steadily eroded at the WTO. Charles Kindleberger wrote about "altruistic hegemons" providing leadership for the world trading system; here we have the strategic behavior of what I have called a "selfish hegemon."[20]

Are PTAs Building Blocks or Stumbling Blocks to Multilateral Free Trade?

Recall that the original embrace of PTAs by the United States in the early 1980s was a result of frustration with the inability to get multilateral talks started under GATT [General Agreement on Tariffs and Trade] auspices. Once the Uruguay Round was launched, the United States should have reverted to its traditional "multilateralism only" doctrine that it adhered to for over 30 years. But it did not. In fact, its leadership, mainly Secretary of State Baker and his deputy, Robert Zoellick, decided that the United States should do both. Their argument was that PTAs would . . . serve as "building blocks" toward multilateral freeing of trade, that the two trade policies were complementary. . . . They would soon call it the theory of "competitive liberalization."

As Zoellick put it eloquently in 2003:

> When the Bush administration set out to revitalize America's trade agenda almost three years ago, we outlined our plans

> clearly and openly: We would pursue a strategy of "competitive liberalization" to advance free trade globally, regionally, and bilaterally. By moving forward simultaneously on multiple fronts the United States can overcome or bypass obstacles; exert maximum leverage for openness, *target the needs of developing countries,* especially the most committed to economic and political reforms; establish models of success, especially in cutting-edge areas; strengthen America's ties with all regions within a global economy; and create a fresh political dynamic by putting free trade on the offensive.[21]

Zoellick thus argued that the United States would use the FTAs to advance a number of trade-unrelated objectives, and (astonishingly) that these issues were in fact addressing the "needs of developing countries," when in fact (as discussed earlier) they were being imposed by the United States as a precondition to signing an FTA with [the developing country]. In addition, Zoellick and his U.S. trade representative deputies also claimed that such initiatives would prompt other countries to seek trade liberalization, first in the shape of FTAs with the United States, and second, by embracing the multilateral system and negotiations at the WTO.

The former is surely an exaggerated claim, at best. While preferences are a wasting asset as MFN tariffs come down over time, the willingness of the United States to sign more FTAs implies that the preferences earned by signing an FTA with the United States are also a wasting asset, insofar as your close rivals may also join an FTA. Simon Evenett and Michael Meier in fact find far too few public statements by policy makers worldwide to the effect that they would like an FTA with the United States because their rivals have one.[22]

. . . The . . . claim that . . . FTAs . . . advance WTO negotiations is even more problematic. Fred Bergsten, a prominent trade expert in Washington, D.C., is a leading exponent of this view. His principal claim of a positive link between PTAs and multilateral trade negotiations is the assertion that the Uruguay Round was brought to a close because the APEC [Asia-Pacific Economic Cooperation] Summit in Seattle in November 1993 was used by the United States to threaten the recalcitrant European Union [EU] that if the EU did not close the Round, the United States would have a competing alternative: APEC liberalization. I have asked many European trade officials about his claim, and they simply laugh at it. . . . Surely, everyone could see that there was not the slightest chance that APEC, with its many disparate economies and political differences, would turn into an FTA. . . .

The implausibility of the benign Bergsten argument leaves one with a whole range of arguments that suggest instead that the effect of PTAs on the multilateral trade negotiations is malign. . . .

1. Consider that a dollar's worth of lobbying on opening up Mexico under a PTA will get the Mexican market opened to you. But if you spend the same dollar in Geneva, opening up the Mexican market on an MFN basis, your benefit will be diluted by the "free riders," your rivals from EU, Japan, and elsewhere who have not spent any money to open the Mexican market. So you will spend the dollar on PTAs, not on MTN [multilateral trade negation].
2. Although there are any number of routine bureaucrats available to negotiate trade deals, the supply of skilled bureaucrats is always limited. If PTAs are being pursued simultaneously with MTN, you can be sure that the talented bureaucrats' attention will be split, at best. I saw this in Seattle in November 1999 when the WTO meeting erupted under protests. U.S. Trade Representative Charlene Barshefsky arrived just in time, after long trade negotiations with China: her eye was not on the WTO ball.
3. Politicians often equate all kinds of trade deals, so if you nail down a PTA, no matter how negligible in trade volume, that is a feather in your cap. In fact, I was once at a Bureau of Labor function to honor a bureaucrat whom U.S. Trade Representative Mickey Kantor congratulated for participating in negotiations of over 250 trade deals. Of these, one was the Uruguay Round, another was NAFTA (much less important and, in fact, arguably even a mistake), and the rest were trade-restricting, quota-setting textiles deals under the Multi-Fiber Arrangement!
4. Lobbies provide the foot soldiers in the battles to open trade, and I have already documented that several lobbies with trade-unrelated causes also find PTAs, where weak countries can be intimidated into making concessions, a more agreeable way to go. These lobbies use the PTAs to provide templates—"Ah, we now have our agenda accepted as a part of trade liberalization, and that is the way it will be for other PTAs from now on"—and to steadily encircle the WTO to push their agendas. Aside from the AFL-CIO, few groups are spending as much time and money on Doha as on the PTAs with Peru and Colombia.
5. In the United States, given the general anxiety over trade, it has been a mistake to ask politicians (especially Democrats who have unions among their constituents) to repeatedly spend their limited pro-trade political capital on a succession of trivial PTAs, leading to "trade fatigue" that afflicts then the Doha Round as well.
6. Finally, recent empirical analysis by Nuno Limao, using tariff reduction data during the most recent MTN, demonstrates that PTAs by

the United States were a stumbling block to multilateral trade liberalization.[23] The adverse effect operates through the mechanism that the hegemon maintains higher multilateral tariffs on products imported from the preferential trade partner relative to those on similar products imported from the rest of the world. These higher MFN tariffs act virtually as bargaining chips to be used in negotiating PTAs, because the value of the preference increases the higher the MFN tariff is. This provides an incentive not to reduce MFN tariffs relative to the situation where PTAS were not permitted.

It is hard indeed to contemplate the consequences of PTAs with equanimity. The most important item on our policy agenda has to be to devise an appropriate response to their spread and the damage they impose on the multilateral trading system.

ENDNOTES

1. This analysis of trade diversion and creation is in a simplified framework, designed to convey the essence of the trade-diversion issues raised by PTAs. For a theoretically tight treatment, the reader is referred to the extended analysis by Panagariya and me in Bhagwati, Krishna, and Panagariya, *Trading Blocs,* chapter 2.
2. I have discussed the reasons for this phenomenon and its consequence for coping with globalization in my book, *In Defense of Globalization* (New York: Oxford University Press, 2007), afterword.
3. This restriction is compatible with trade diversion even when the external terms of trade are inflexible and the damage is to the member rather than the nonmember countries. But the nonmember countries also can be hurt when the terms of trade are variable. The empirical evidence of such nonmember terms-of-trade effects is provided in W. Chang and Alan Winters, "How Regional Blocs Affect Excluded Countries: The Price Effects of MERCOSUR," *American Economic Review* 92, no. 4 (2001). Recent theoretical work by Masahiro Endoh, Koichi Hamada, and Koji Shimomura, "Can a Preferential Trade Agreement Benefit Neighbor Countries without Compensating Them?" unpublished manuscript, Yale University, December 2007, demonstrates in fact that PTAs, unless accompanied by tariff concessions or compensatory transfers, will generally speaking hurt nonmember countries under reasonable restrictions.
4. As Petros Mavroidis has reminded me, when PTAs are formed under Article 24, the members of the PTA are free to raise their external tariffs from the applied levels to the higher bound levels. So the discipline on external tariffs essentially does not operate when the bound levels are higher than the applied tariffs, which is almost always the case, though in varying degrees for different countries.
5. In technical terms, the Frankel–Wei estimating equation uses dummy variables that take a value of 1 if both countries are in Western Europe and zero otherwise. I am grateful to Arvind Panagariya, who took me through the statistical procedures and their rather drastic limitations, in both the original Frankel–Wei analysis and its later variants by themselves, Gary Hufbauer, and others.
6. Some economists have posed the question of the welfare effects directly by using computable general equilibrium (CGE) models to compare the welfare outcomes under different trade policies, such as multilateral free trade under the Doha Round and current and potential preferential trade agreements. Using the Michigan CGE model of world production and trade developed by Robert Stern, Alan Deardorff, and Drusilla Brown, the economists Kozo Kiyota and Stern have calculated that the gains under multilateral trade liberalization dominate significantly those from a policy of PTAs.
7. Paul Wonnacott and Mark Lutz, "Is There a Case for Free Trade Areas?," in Jeffrey Schott, ed., *Free Trade Areas and U.S. Trade Policy* (Washington D.C.: Institute for International Economics, 1989).
8. The following discussion draws on the far more thorough analysis of the "natural trading partner" hypothesis by Panagariya and me in Bhagwati, Krishna, and Panagariya, *Trading Blocs,* chapter 2.
9. This would generally be true, I am sure, even if one were to take the measure just for one individual country with every other country instead of pooling all possible pairs together. I might add that the gravity equation that shows distance to matter for the volume of trade is taking only a "partial derivative," so to speak, with regard to distance; the discussion in the text relates instead, as is proper in the matter of the equation of the "volume of trade" and "geographical proximity" by Krugman and Summers, simply to the relationship between distance and observed trade volumes.
10. The phrase was introduced by President Haruhiko Kuroda of the Asian Development Bank in July 2006 in a speech delivered to the Jeju Summer Forum in South Korea.
11. There can also be some technical requirements for eligibility, such as meeting certain technical standards on safety, but it is obviously rare for such requirements to be imposed differentially against members of the FTA and not against nonmembers.
12. Sometimes the cost of establishing origin is so high for a firm that it decides instead to forgo the process and to pay the MFN tariff. It is not clear how significant this "opting out" is, however.
13. Victor Fung, "Bilateral Deals Destroy Global Trade," *Financial Times,* November 3, 2005.
14. For an analysis of 301 legislation, and the dangers it posed for the world trading system, see Jagdish Bhagwati and Hugh Patrick, eds., *Aggressive Unilateralism* (Ann Arbor: University of Michigan Press, 1991), especially the chapters by Robert Hudec and by me.
15. See Jonathan Berger and Achal Prabhala, "Assessing the Impact of TRIPs–Plus Rules in the Proposed U.S.–SACU Free Trade Agreement," Working Paper, preliminary draft, Center for Applied Legal Studies, University of Witwatersrand, Johannesburg, South Africa, February 2005.

16. There is a huge literature on this subject, which includes several of my writings in the past fifteen years in places as diverse as the *American Journal of International Law* and two substantial volumes based on a research project involving several of the leading international economists and trade jurists today: Jagdish Bhagwati and Robert Hudec, eds., *Fair Trade and Harmonization: Prerequisites for Free Trade?* (Cambridge, Mass.: MIT Press, 1996). See, in particular, the extensive analytical discussion of the issues involved in Bhagwati and T.N. Srinivasan, "Trade and the Environment: Does Environmental Diversity Detract from the Case for Free Trade?" chapter 4 of Vol. I.
17. International pollution raises a different set of analytical issues than domestic pollution and is usually negotiated in self-standing treaties, such as Kyoto on global warming and the Montreal Protocol on the ozone layer. There are implications for the WTO, for sure, but these have little to do with the question of PTAs versus multilateralism. For instance, see Jagdish Bhagwati and Petros Mavroidis, "Is Action against U.S. Exports for Failure to Sign Kyoto Protocol WTO-Legal?" *World Trade Review* 6, no. 2 (2007): 299–310; and Bhagwati and Srinivasan, "Trade and the Environment: Does Environmental Diversity Detract from the Case for Free Trade?"
18. This sounds innocuous but is not. Often, legislation is not expected to be enforced. For that reason, it is often pitched high, with minimum wages, for example, being defined at sumptuous levels that no one expects to pay. Again, laws are left on the books because taking them off would be politically difficult, but no one expects them to be enforced. Thus, there are still laws against adultery in some states, but President Clinton can confidently expect to go to these states without being handcuffed and produced in court because the laws are dormant. Asking developing countries, with their low enforcement ability besides, to enforce their own laws on labor standards is therefore either naive or cynical.
19. Among numerous articles on the subject, I found the following most informative: Thomas Faunce, Evan Doran, David Henry, Peter Drahos, Andrew Searles, Brita Pekarsky, Warwick Neville, and Andrew Searles, "Assessing the Impact of the Australia–United States Free Trade Agreement on Australian and Global Medicines Policy," *Globalization and Health* 15 (2005): 1–10.
20. The phrase and idea of a "selfish hegemon" was introduced by me in "Threats to the World Trading System: Income Distribution and the Selfish Hegemon," *Journal of International Affairs* 48 (1994): 279–285.
21. Cited in Evenett and Meier, "An Interim Assessment of the U.S. Trade Policy of 'Competitive Liberalization,'" emphasis added. It is from a report by the U.S. General Accounting Office on international trade, January 2004. Other such pronouncements by Zoellick are on record as well. Perhaps the most remarkable one is from Zoellick's Op Ed piece, "Our Credo: Free Trade and Competition," *Wall Street Journal*, July 10, 2003: "FTAs break new ground—they establish prototypes for liberalization in areas such as services, e-commerce, intellectual property for knowledge societies, transparency in government regulation, and better enforcement of labor and environmental protections."

22. Perhaps the most dramatic such statements are from New Zealand vis-à-vis the Australia–U.S. FTA and the plaintive worries of Colombia, struggling to get its FTA with the United States, over the fact that Peru has gotten ahead in the queue.
23. Nuno Limao, "Preferential Trade Agreements as Stumbling Blocks for Multilateral Trade Liberalization: Evidence for the U.S.", *American Economic Review* 96, no. 3 (June 2006), 896–914. This paper's brilliant empirical analysis nicely complements the theoretical analyses such as those of Phil Levy and Pravin Krishna . . . on the question of the dynamic time-path issues concerning PTAs.