

Preferential Trade Liberalization: The Traditional Theory and New Developments

Arvind Panagariya
Asian Development Bank
Manila, Philippines

PACIFIC ECONOMIC COOPERATION COUNCIL

Trade Policy Forum (TPF)'s Seminar on "Regional Trading
Arrangements: Stocktake and Next Steps"

June 12-13, 2001
Bangkok, Thailand

VERY Broad Outline

- ✦ **Traditional Theory: Viner's "Static" Welfare Question**
 - Trade Creation
 - Trade Diversion
 - Revenue Transfer Effect (Panagariya, 1996)

- ✦ **New Developments: Bhagwati's "Dynamic" Time Path Question**
 - Building Blocs
 - Stumbling Blocs

The Traditional Theory: Two Key Questions

- 1. Viner: When two or more countries form a preferential trade area (PTA), what is its effect on the welfare of**
 - ❖ Member countries taken individually
 - ❖ PTA as a whole
 - ❖ Rest of the world
- 2. Can two or more countries form a PTA such that it makes the union better off and does not make the rest of the world worse off?**
 - ❖ Kemp (1964), Vanek (1965) and Ohyama (1972):
Yes to Customs union
 - ❖ Panagariya-Krishna (2001): Yes to Free Trade Area

PTA and Welfare: Purely Trade Diverting Union

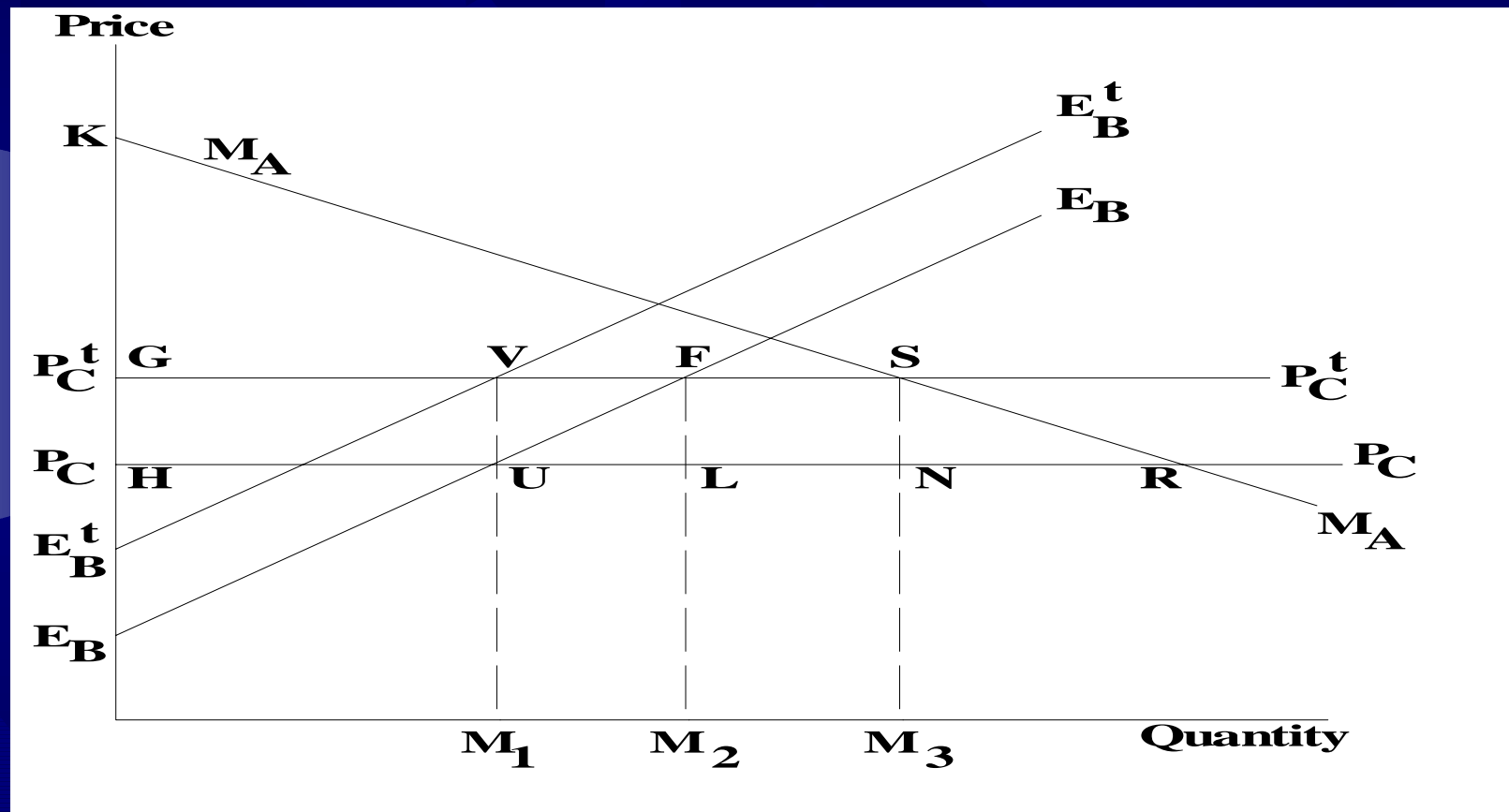


Figure 2. CU: A Preferential removal of a Tariff A leads to a loss of GFLH to itself, a gain of GFUH to Partner B and a net loss to the Union as a whole

Figure 4. FTA: No imports comes from Country C. Preferential Liberation coincides with Non-Discriminatory Liberalization

Transport Costs are NOT Special

- ✱ In a new development, some analysts have argued that low transport costs make PTAs more likely to be beneficial. This proposition is without a sound theoretical basis.
- ✱ In his comprehensive work, Viner (1950) had noted the presence of departures from the MFN principle in commercial pacts between countries within Europe going as far back as the nineteenth century. But he attributed them to 'close ties of sentiment and interest arising out of ethnological, or cultural, or historical political affiliations'. This remains true.

New Developments

I. Number of Blocs and Welfare

- **Krugman (1991, 1993):** Division of the world into three blocs minimizes welfare. This is based on a model with entirely symmetric countries.
- **Deardorff and Stern (1994)** provide an example in which two blocs can maximize the world welfare.
- **This literature is largely inconclusive and unhelpful.**

New Developments

II. Decision to form FTAs

- **Grosman and Helpman (1995):** Trade-diverting FTAs endorsed but trade-creating FTAs rejected.
- **Krishna (1998):** Same result within the Cournot oligopoly model.
- **Duttagupta and Panagariya (2001):** Rules of origin can make otherwise infeasible, welfare-reducing FTAs feasible.

New Developments

III. Extra-union Tariff

- **Bhagwati (1993):** Hypothesized increased protection against outside countries
- **Panagariya and Findlay (1996)** provided a formal lobbying model in which this hypothesis is validated
- **Krugman (1991)** has a similar effect due to the terms of trade motivation
- **Richardson (1993)** offers the opposite story that exploits tariff revenue competition
- **Empirical Reality:** Increased protection (Mexico, MERCOSUR) and slowdown of unilateral liberalization (Latin America, South Asia)

New Developments

IV. Regionalism Impacting Multilateralism

Two Key Questions

- **Can PTAs make previously infeasible multilateral freeing of trade feasible?**
- **Can PTAs make previously feasible multilateral freeing of trade infeasible?**

The answer to the first question is typically in the negative while to the second may go either way. Levy (1997) and Krishna (1998) answer the second question in the affirmative.

New Developments

V. Multilateralism Impacting Regionalism

- **Multilateral freeing of trade may make FTAs more sustainable (Freund 1998).**
- **Multilateral liberalization among rich countries may make rich-poor country FTAs more profitable (Eithier 1998).**

Policy Judgements

- ✱ **Trade diversion is a serious concern**
- ✱ **The “Spaghetti Bowl” phenomenon is of concern: different phase outs of tariffs and rules of origin**
- ✱ **Proliferation of non-trade issues in FTAs may pave the way for a trade-labor link in the WTO (US-Jordan, U.S.-Vietnam, U.S.-Singapore).**

