



# Trade creating free trade areas and the undermining of multilateralism

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## Abstract

This paper indicates that the consequences of regional trade agreements for the world trade system may be deceiving—an arrangement's apparent virtue may constitute the source of its drawback. In a model where governments have political, as well as economic, motivations, I show that a free trade area induces its members to reduce protection against the non-members, and to do so sufficiently deeply to generate overall trade creation. Trade creation amplifies the excluded countries' access to the integrating markets, but also reduces their extra gains from multilateral liberalization. Thus, trade creation can reverse the support of the excluded countries to liberalization on a multilateral basis. This is more likely to happen when governments outside the free trade area are more responsive to special interests.

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## 1. Introduction

The recent wave of regional trade agreements has attracted substantial attention from trade economists.<sup>1</sup> The typical concern regarding these preferential initiatives is

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<sup>1</sup>As the WTO reports in its web page, over 100 preferential trade agreements have been notified since 1995; more than 150 preferential arrangements are currently in force.

that, as first suggested by Viner (1950), they may generate “trade diversion”. In this paper, I show that even purely trade creating free trade agreements (FTAs) can be harmful to the world trading system.

Some researchers have indicated that the scope for trade diversion in a free trade area can in fact be very narrow, provided that the endogeneity of the FTA external tariffs is accounted for. The key argument is that members of FTAs have incentives to reduce their external tariffs; since lower external tariffs represent less discrimination against the excluded countries, the potential for trade diversion is reduced as well. Kennan and Riezman (1990) were the first to indicate such a possibility. Subsequently, Richardson (1993), Bagwell and Staiger (1999) and Ornelas (2002) identify distinct and reinforcing motivations for why the members of FTAs might want to reduce their external tariffs. In those frameworks, the reduction in external tariffs is indeed deep enough to eliminate all sources of trade diversion.

Empirical evaluations of the effects of the recent wave of regionalism remain relatively scarce, partially because these preferential arrangements are both new and typically implemented through long phase-in periods (often about 10–15 years). That notwithstanding, the available evidence appears to corroborate the presumption that FTAs induce external tariffs to fall and are mainly trade creating. For example, Bohara et al. (2003) and Foroutan (1998) find that free trade agreements have induced lower external tariffs, while Clausing (2001) and Krueger (2000), as well as the results from computable general equilibrium models (see Robinson and Thierfelder, 1999), indicate that trade creation has been the rule, and trade diversion the exception, in the formation of preferential trading blocs.

If FTAs are in fact authentic trade creating devices, one might be tempted to classify them as inherently helpful arrangements. However, as Bhagwati (1993) argues, this “static” perspective can be misleading; if it is to evaluate the consequences of a preferential agreement, one needs to assess also how it alters the incentives for liberalization on a multilateral basis. Levy (1997), using a median-voter approach, and McLaren (2002), focusing on the role of negotiating and sector-specific sunk costs, show that an FTA may indeed induce its members to obstruct an otherwise feasible multilateral free trade agreement (MTA).<sup>2</sup>

Krishna (1998), in an oligopolistic-political-economy setting, makes a similar point. He argues that, by diverting trade from the excluded countries, an FTA creates rents to its members’ producers. Since global free trade would eliminate those preferential rents, politically motivated governments might then want to withdraw their support to an MTA once they engage in an FTA, in order to preserve the producers’ rents. Hence, Krishna finds trade diversion to be the key element leading to the hindering of global free trade.

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<sup>2</sup>Note, however, that the view of regionalism and multilateralism as antagonistic forms of liberalization is not an established position in the literature. Different views are held, for example, by Ethier (1998), Freund (2000) and Riezman (1999). Riezman indicates that the relationship between preferential trade agreements and multilateral free trade cannot be determined a priori, as it depends on the size distribution of the trading blocs. Ethier and Freund argue that the recent trend toward preferential liberalization is actually a consequence of the *success* of the multilateral trading system, deeming the two forms of liberalization complementary processes.

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