

## Negotiating free trade <sup>☆</sup>

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### Abstract

We develop a dynamic bargaining model in which a leading country endogenously decides whether to sequentially negotiate free trade agreements with subsets of countries or engage in simultaneous multilateral bargaining with all countries at once. We show how the structure of coalition externalities shapes the choice between sequential and multilateral bargaining, and we identify circumstances in which the grand coalition is the equilibrium outcome, leading to worldwide free trade. A model of international trade is then used to illustrate equilibrium outcomes and how they depend on the structure of trade and protection. Global free trade is not achieved when the political-economy motive for protection is sufficiently large. Furthermore, the model generates both “building bloc” and “stumbling bloc” effects of preferential trade agreements. In particular, we describe an equilibrium in which global free trade is attained only when preferential trade agreements are permitted to form (a building bloc effect), and an equilibrium in which global free trade is attained only when preferential trade agreements are forbidden (a stumbling bloc effect). The analysis identifies conditions under which each of these outcomes emerges.

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## 1. Introduction

One of the most debated issues in international economics is whether regionalism or multilateralism is the most effective strategy for achieving global free trade. According to Bhagwati (1993), the first wave of regionalism took place in the 1960s, and it failed to spread because the U.S. supported a multilateral approach. But the U.S. changed positions, and – starting with the 1980s – has favored regional trade agreements. This led to a second wave of regionalism, which brought about a multitude of such agreements. The gradual enlargement of the European Union, the U.S.–Canada Free Trade Agreement, NAFTA and MERCOSUR, are examples of this trend. Between 1958 and March 2004, the GATT/WTO secretariat received notification of 203 agreements.<sup>1</sup> The recent stalling of the Doha round further suggests that multilateralism, which was the dominant force towards free trade in the first few decades after World War II, is falling out of fashion.

Economists disagree on whether preferential trade agreements are “building blocs” that facilitate the attainment of global free trade, or “stumbling blocs” that derail the process of trade liberalization. The latter view has been forcefully promoted by Bhagwati (1991, 1993), who coined these terms.<sup>2</sup> In this view, even when preferential trade agreements generate static welfare gains they reduce the incentives to seek further trade liberalization. The importance of this “dynamic path” question was clearly laid out by Bhagwati (1993) and Krugman (1993). The latter also showed that in some circumstances welfare reaches a minimum when the world consists of two or three customs unions.<sup>3</sup> The welfare consequences of stalled multilateralism, caused by the rise of regionalism, could therefore be significant.

Other economists, such as Summers (1991), think that preferential trade agreements do not impede global free trade. They argue that partial trade liberalization is better than none, and that the consolidation of a large number of countries into a small number of trading blocs facilitates multilateral negotiations. And Baldwin (1996) argues that a deepening of integration between a subset of countries may raise the incentives of outside countries to seek accession to the free trade area. Under these circumstances preferential trade agreements encourage further trade liberalization and the expansion of the free trading blocs.<sup>4</sup>

Another way to pose the question of regionalism versus multilateralism is to ask whether multilateral bargaining or sequential bargaining are more likely to lead to global free trade. In multilateral bargaining all countries simultaneously participate in a single round of trade negotiations. In sequential bargaining negotiators proceed through several rounds, with different subsets of countries participating at different stages of the process. In this paper we compare these

<sup>1</sup> Many preferential trade agreements are *not* regional. The U.S.–Israel free trade agreement is a notable example. Following Bhagwati (1993, p. 22), we use a terminology in which ‘regionalism’ is “...defined broadly as preferential trade agreements among a subset of nations.” That is, we downplay the geographical nature of preferential trade agreements and emphasize instead the fact that they constitute an agreement between a subset of countries.

<sup>2</sup> See Panagariya (2000) for a recent survey of this literature.

<sup>3</sup> See Deardoff and Stern (1994), Bond and Syropoulos (1996), and Frankel, Stein and Wei (1996) for an analysis of this issue in alternative economic frameworks.

<sup>4</sup> Furthermore, if an existing trading bloc follows a policy of “open” regionalism, by which accession is sequentially granted to all countries that demand it, this sequential process is likely to lead to worldwide free trade. See Yi (1996) for a discussion of “open” versus “closed” regionalism. In complementary work, Ethier (1998) presents a model in which multilateral liberalization among a subset of developed countries raises the incentives of outside (less developed) countries to seek preferential free trade agreements with particular members of the initial group of liberalizing countries.

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