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**REGIONALISM VERSUS MULTILATERALISM: THE  
RESPONSE OF THE THIRD COUNTRY**

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# **Regionalism versus Multilateralism: The Response of the Third Country**

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## Abstract

The creation or the expansion of a Preferential Trade Arrangement (PTA), in general, hurts the non-member countries because of trade diversion. This could increase the pressure for protection in the non-member countries and, ultimately, worsen the member countries' market access in those outsiders. The insiders have an incentive to pre-empt this reaction by liberalizing their external trade. Regionalism can help multilateralism.

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## 1. Introduction

During the last two decades, the number of Preferential Trade Arrangements (PTA) has increased at a spectacular rate. Nearly all WTO's 132 members are now party to at least one agreement.<sup>1</sup> Concurrently, this means that any country in the world is an outsider to some existing PTAs. Because of their discriminatory and preferential nature, PTAs are likely to be welfare reducing for the non-member countries as well as for the world as a whole. A trading system divided into a number of competing trading blocs is surely inferior to global free trade. It is therefore perfectly legitimate to worry about whether the current wave of regionalism would generate forces that would slow down the efforts to liberalize the multilateral trading system. This is the type of issue that is dealt with in the so-called "Regionalism versus Multilateralism" debate. So far, the debate has not offered any unequivocal answers as to whether regional integration disposes countries to participate actively in global liberalization.

Two directions are usually considered in this debate. The first direction—the "endogenous bloc expansion" literature—is to determine whether PTAs have a tendency to merge or to expand their membership, and whether this tendency will continue so as to eventually yield global free trade. Papers by Baldwin (1995), Yi (1996), Bond and Syropoulos (1996) and Andriamananjara (1999) belong to this category.

A second direction—the "endogenous protection" literature—is to study the effects of the

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<sup>1</sup> As of November 1998, 103 Regional Trade Agreements have been notified to GATT/WTO and are in force of which 78 are under Article 24, 14 under the Enabling Clause and 11 under GATS Article V. The interested reader can go to the WTO web page (<http://www.wto.org/wto/develop/webrtas.htm>) to see the lists.

establishment of the PTA on the member countries' trade policies with respect to the outsiders. The present paper addresses this second issue. In order to put the contributions of the paper into the right context, it is useful to briefly review the existing works dealing with this issue. Although Winters (1996) argues, in a survey of this literature, that whether PTAs hamper or spurs multilateral trade liberalization is still a relatively open debate, most papers show how regionalism may hinder multilateralism.

Extending the Meade model to include endogenous lobbying, Panagariya and Findlay (1994) show how preferential trading (a FTA more so than a CU) can lead to increased lobbying for protection against non-members. Krishna (1996) uses a three-country oligopolistic-competition model to show that a PTA between two countries reduces the incentives to liberalize tariffs reciprocally with the third country. He also demonstrates that, given sufficient trade diversion, multilateral liberalization that was feasible before the PTA cease to be so afterwards. Cadot, de Melo and Olarreaga (1996) show, using an extension of Grossman and Helpman (1995), that the deepening of an existing regional arrangement can lead to rising protection against non-member imports and thus moves the trading system away from multilateralism. In a median voter model, Levy (1997) argues that regional blocs neither hinder nor promote global free trade in an Heckscher-Ohlin framework, but undermine the political support for multilateral free trade in an increasing-returns-to-scale framework if the blocs offer disproportionately larger gains to agents in the integrating countries. He wrote: "Bilateral free trade can never increase political support for multilateral free trade." Finally, in a trigger-strategy framework, Bagwell and Staiger (1997) find that the formation of a RIA will initially be accompanied by a "retreat" from multilateral policies but in the longer run, these liberal policies can be restored.

At the other end of the debate, Wei and Frankel (1996) build a model where regional blocs may work as a stepping stone toward global free trade. In their model, regionalism can make, previously unfeasible, global free trade feasible by dividing the original opposition force. Cadot, de Melo and Olarreaga (1997) argue that regional arrangements can help sustain multilateralism, especially FTAs with selective liberalization and rules of origin that allow members countries to compensate losers from trade liberalization. They also show that such agreement can be both welfare enhancing and politically implementable.

In this paper, I introduce one aspect of this literature that has been somewhat neglected before. In most of the current debate on regionalism versus multilateralism, the trade policy of the excluded countries is assumed to be exogenously fixed and that they are passive players in the world trading system. However, this need not be the case in practice, and relaxing this assumption can provide additional useful insights.

Unless its effects are believed to be negligible, the creation of a PTA is likely to trigger reactions from the left-out countries. I demonstrate that the creation or the expansion of a trading bloc is likely to lead the excluded countries to become more protectionist—a movement away from multilateral free trade. Fortunately, the PTA members can preempt the excluded countries' response by undertaking MFN trade liberalizations in parallel to the discriminatory ones—a movement towards global free trade. In this case, the world fares much better compared to both the case where the third country did not have the option to retaliate and the case where the PTA members do not anticipate the retaliation of the third country. Hence, we have here an example of how regionalism can foster multilateralism by generating forces that lead the member countries to decrease their external MFN

tariffs.

The basic model three-country model is presented in the next section. Section 3 introduces preferential liberalization into the model and discusses its effects. Section 4 studies the excluded country's response to the creation of the PTA. Section 5 examines the case where the PTA members fully anticipate the reaction of the third country and adjust their external barriers downwards. Section 6 concludes.

## 2. The Basic Model

Consider a 3-country world. There is only one firm in each country and all the firms in the world produce goods that are perfect substitutes for each other. As in Brander and Krugman's (1983) reciprocal dumping model, the markets in the different countries are perfectly segmented so that each firm regards each country as a separate market and chooses its optimal quantity for each country separately.

Looking first at the demand side, denote  $q_j^i$  the quantity supplied by firm from  $i$  to  $j$ 's market so that

$Q_j = \sum_{i=1}^3 q_j^i$  is the total sales of the good in country  $j$ 's market. The aggregate utility in country  $j$  is

assumed to have a quasi-linear form:  $U(Q_j) = (AQ_j - Q_j^2/2)$ . It follows directly that the consumer price of the good in country  $j$  can be written as a linear function of the total sales in that country:  $P_j = A - Q_j$ .

On the supply side, denote  $t_j^i$  the specific tariff imposed by country  $j$  on imports from  $i$ , and  $c$  the constant marginal and average costs of production. The specific tariffs simply add on to the marginal costs of firms, whose effective marginal costs of exports then become  $c + t_j^i$ . In each market (or country), the three firms act as Cournot players and maximize their profits taking other firms' output as given, and all the three firms are choosing their quantities simultaneously. Country  $i$ 's firm, when choosing the quantity that it would export to country  $j$ , solves the following problem:

$$\max_{q_j^i} q_j^i [A - Q_j - (c + t_j^i)]$$

which yields the Nash equilibrium output level:

$$q_j^i = \frac{(A - c)}{4} + \frac{\sum_{k=1}^3 t_j^k}{4} - t_j^i.$$

For reasons that will be explained later, the values of  $A$ ,  $c$  and the initial tariff rate will be restricted in such a way that  $(A - c) \geq 6 \cdot t_j^i$ . The total consumption in country  $j$  is therefore given by:

$$(1) \quad Q_j = \frac{3 \cdot (A - c)}{4} - \frac{\sum_{k=1}^3 t_j^k}{4}.$$

The corresponding profit for the firm in country  $i$  selling in country  $j$  is:

$$(2) \quad p_j^i = (q_j^i)^2 = \left[ \frac{(A - c)}{4} + \frac{\sum_{k=1}^3 t_j^k}{4} - t_j^i \right]^2.$$

Finally, Country  $i$ 's welfare is defined as consisting of the domestic consumer surplus, the domestic firm's profits, and the tariff revenue:

$$(3) \quad W_i = CS_i + \Pi_i + TR_i$$

where  $CS_i = [U(Q_i) - P_i Q_i] = \frac{Q_i^2}{2}$ ,  $\Pi_i = \sum_{j=1}^3 p_j^i$ , and  $TR_i = \sum_{j=1}^3 t_i^j q_i^j$ .

In this model, world welfare is maximized under global free trade.

### 3. PTA Formation and effects

PTAs are typically formed over a long transition period—GATT rules only requires that the transition to a complete FTA or CU be accomplished “within a reasonable length of time.” PTAs are generally established through step-by-step decreases in the intra-bloc tariffs. Without loss of generality, assume that Country 1 and Country 2 are potential PTA partners and are planning to gradually give tariff preference of  $\mathbf{a}$  ( $0 \leq \mathbf{a} \leq 1$ ) to each other. Assume further that Country 3 is not offered the option of joining the PTA.

Thus, if Country 1's MFN tariff is  $t_1$ , then  $t_1^2 = (1 - \mathbf{a}) \cdot t_1$  while  $t_1^3 = t_1$ . Similarly,  $t_2^1 = (1 - \mathbf{a}) \cdot t_2$ , while

$t_2^2 = t_2$ . Since Country 3 is not part of the PTA and does not give out any preference,  $t_3^1 = t_3^2 = t_3$ . We

can then write out the welfare of Country 1 as a function of the different MFN tariff rates and the degree of preference:

$$\begin{aligned}
W_1(t_1, t_2, t_3, \mathbf{a}) = & \left[ \frac{1}{2} \left( \frac{3(A-c) - (2-\mathbf{a})t_1}{4} \right)^2 \right] + \\
& \left[ \left( \frac{(A-c) + (2-\mathbf{a})t_1}{4} \right)^2 + \left( \frac{(A-c) - (2-3\mathbf{a})t_2}{4} \right)^2 + \left( \frac{(A-c) - 2t_3}{4} \right)^2 \right] + \\
& \left[ (1-\mathbf{a})t_1 \left( \frac{(A-c) + (\mathbf{a}-2)t_1}{4} \right) + t_1 \left( \frac{(A-c) - (\mathbf{a}+2)t_1}{4} \right) \right].
\end{aligned}$$

The first square-bracketed term on the right hand side (RHS) denotes the consumer surplus, which relates negatively to domestic tariff, and positively to the degree of preference. This means that consumers benefit from both MFN and preferential trade liberalization. The second term on the RHS is the total profits made by 1's producers in the three different markets. Producers gain from an increase in domestic tariff rate but lose from an increase in foreign tariffs. Note though that when  $\mathbf{a} > 2/3$ , the domestic producers gain from an increase in Country 2's tariffs. An increase in the degree of preference decreases profits made in the domestic market but increases those made in the partner's (Country 2) market. Ceteris paribus, the gains from increased preference exceed the losses. The third term on the RHS represents Country 1's tariff revenue which is positively related to the tariff rate (as long as  $t_1 < (A-c)/6$ ) and negatively related to degree of preference. Country 2's total welfare can be written and decomposed analogously.

As for the excluded country's (Country 3) welfare, it is written as:

$$\begin{aligned}
W_3(t_1, t_2, t_3, \mathbf{a}) = & \left[ \frac{1}{2} \left( \frac{3(A-c) - 2t_3}{4} \right)^2 \right] + \\
& \left[ \left( \frac{(A-c) - (2+\mathbf{a})t_1}{4} \right)^2 + \left( \frac{(A-c) - (2+\mathbf{a})t_2}{4} \right)^2 + \left( \frac{(A-c) + 2t_3}{4} \right)^2 \right] + \\
& \left[ t_3 \left( \frac{(A-c) - 2t_3}{4} \right) + t_3 \left( \frac{(A-c) - 2t_3}{4} \right) \right].
\end{aligned}$$

The first term on the RHS denotes the consumer surplus, which is a negative function of the tariff rate,  $t_3$ . The second term on the RHS is the total profits made by 3's producers in the three different markets. Producers gain from increases in domestic tariffs but lose from increases in foreign tariffs. Moreover, an increase in preference between 1 and 2 decreases the profits that Country 3 makes in those markets—a trade diversion (or terms of trade) effect. The third term represents the tariff revenue which is positively related to the tariff rate (as long as  $t_3 < (A-c)/6$ ).

For non-trivial reasons, we abstract the analysis away from optimal tariff considerations. There are a number reasons for not letting the governments to impose optimal tariffs. First, countries, in practice, rarely choose their tariffs for optimal tariff reasons. Also, optimal tariffs derived in economic models have been shown to be much too high compared to the actual observed levels (Krugman, 1991). In the present model, if the excluded country set tariffs optimally, it loses the ability to use them as tools to retaliate against the member countries—that is, it cannot adjust its tariff policy in response to an external shock. In fact, it can be directly seen from the above equation that its optimal tariff is not a function of the degree of preference between the PTA members. The main

results of the paper hold as long as initially  $t_3 < (A-c)/6$ , where  $(A-c)/6$  is the highest initial tariff level that allows the excluded country to adjust its tariff rate in response to a full integration between 1 and 2, in order to keep its welfare at its initial level.<sup>2</sup>

For ease of manipulation, we assume that for some non-economic or political reasons, initial MFN tariffs (i.e., when  $a = 0$ ) for each country are chosen to be:

$$\bar{t}_1 = \bar{t}_2 = \bar{t}_3 = \frac{A-c}{10}.$$

The associated initial welfare levels are:

$$\bar{W}_1 = \bar{W}_2 = \bar{W}_3 = \frac{91.(A-c)^2}{20}.$$

Suppose now that Country 1 and Country 2 start giving preferences to each other and that all three countries are keeping their MFN tariffs fixed at their initial levels. An interpretation of this is that 1 and 2 are abiding by GATT's Article 24,<sup>3</sup> and Country 3 does not react to the increased discrimination.

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<sup>2</sup> In this model the actual optimal tariff is  $3.(A-c)/10$  which violates the restriction.

<sup>3</sup> Article XXIV permits deviation from the GATT's "most-favored-nation" clause under certain conditions. Free Trade Areas and Customs Unions are permitted under two somewhat vague conditions. First, the parties go all the way to free trade on "substantially all" goods that they trade. Second, external tariffs are not "on the whole" more restrictive than the "general incidence of duties and regulations" before the grouping was formed.

The dynamics of the variables of interests (tariffs, welfare and profits) are shown in Figure 1 for both Country 1 (hence, Country 2) and Country 3. A gradual increase in  $\alpha$  leads to a continuous increase in 1 and 2's welfare and profits. Country 1's consumers gain from cheaper price, and producers gain from better access to Country 2's market which more than offsets the domestic profit losses due to more competition. Government loses in tariff revenue but the overall welfare effect is positive.

On the other hand, the excluded country is hurt in terms of profit as the degree of discrimination against them in the PTA increases. The finding that trade discrimination harms excluded countries is not a new one. Here, the effect of higher level of preference on the excluded country works only through the decrease in the profits that its exporters make in the PTA market. In this "partial equilibrium" setting, neither the consumer surplus nor the tariff revenues of Country 3 are affected by the PTA. More generally, this could be interpreted as the terms of trade effect of the PTA. Although Country 3's consumers are not made worse off and tariff revenues are unaffected, the country's welfare decreases as  $\alpha$  increases.

Thus, this result confirms the fear that even if the insiders strictly adhere to GATT's Article 24 by not raising the level of their external tariffs, the formation of a PTA still can hurt the remaining outsiders. The effects of a PTA on the excluded country have been studied, among others, by Mundell (1964) who shows that preferential liberalization by one member unambiguously improves the other member's terms of trade and deteriorates that of the excluded country. This has, also, been empirically shown by Chang and Winters (1998) in the context of Mercosur. In particular, they find

that the establishment of Mercosur was associated with significant declines in the prices of non-members' exports to Brazil and that these can be largely explained by tariff preferences.

#### 4. Response of the third country

In this section, we continue to assume that while gradually giving preference to each other, Country 1 and Country 2 keep their MFN tariffs fixed at their initial levels. However, we now assume that instead of remaining passive to the formation of the PTA, the excluded country can adjust its trade policy in order to serve or protect its own interests. There are many mechanisms through which a PTA could make the excluded countries more protectionist.

First, trade policy in many countries is the result of complex interactions between import competing industry lobbies (which request protection) on one side and export industry lobbies and consumers (who prefer free trade) on the other side. By deteriorating the non-member countries' terms of trade, preferential trade liberalization shrinks the export sectors in those countries, leading to industrial restructuring and causing resources to reallocate into import-competing activities. The expansion of the import-competing industries is accompanied by an increase in the resources used in lobbying activities to demand protection. The result would be an increase in the excluded countries' trade barriers (vis-à-vis both the PTA members and the other excluded countries)<sup>4</sup> and a deterioration of the PTA countries' (or at least some of their firms') market access.

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<sup>4</sup> This increased protection in turn could lead to retaliation by the PTA members, which would lead to further trade frictions between members and non-members.

Another mechanism that supports this paper’s central premise is that, as Grossman and Helpman (1995), Krishna (1998) and Levy (1993) among others have pointed out, trade diversion plays a key role in the member’s incentives to form or to expand a PTA. This means that PTA members are more likely to grant entry to prospective members that have high tariffs. Hence, if they want to “gain entry”, firms located in the excluded countries would press their own government to *increase* trade barriers.

While one can easily model the two above mechanisms, in this paper, we look at an alternative mechanism and posit that the government in Country 3 looses from any negative deviation from the initial welfare level,  $\bar{W}_3$ . Hence, in response to any negative shock affecting  $W_3$ , the government will (instantaneously) adjust its trade policy—which is the only available policy instrument—to keep welfare at least at its initial level.<sup>5</sup> Note that, while total welfare remains constant, income distribution in Country 3 may be altered following government intervention.

Solving  $W_3(\bar{t}_1, \bar{t}_2, t_3, \mathbf{a}) = \bar{W}_3$  for  $t_3$ , we compute the tariff rate that will keep  $W_3$  constant as the degree of preference between 1 and 2 start to increase:<sup>6</sup>

$$t_3 \Big|_{W_3 = \bar{W}_3} = \frac{(A - c)[15 - \sqrt{5 \cdot (\mathbf{a}^2 - 16\mathbf{a} + 20)}]}{50}.$$

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<sup>5</sup> The restriction,  $t_3 < (A - c)/6$ , ensures that Country 3 can always increase its tariff in order to remain at  $\bar{W}_3$ .

<sup>6</sup> There is another solution that we ignore because it violates the restriction on  $t_3$ .

According to the above expression, the excluded country has to increase its MFN tariff rate in response to an increase in  $\mathbf{a}$  in order to keep its welfare constant. In fact, when  $\mathbf{a}$  goes from 0 to 1, Country 3's tariff goes from  $(A-c)/10$  to  $(A-c)/5$ —i.e., it doubles. Hence, we have here another mechanism through which regionalism might undermine the efforts towards freer global trading system.

The dynamics of the relevant variables, as the degree of preference increases from 0 to 1, are shown in Figure 2. As the partners start giving preference to each other, Country 1 gains in terms of profits in Country 2's market but lose in its own and the excluded country's markets. The overall effect on total profits is still positive. Welfare increases at early stages of the transition period but, at higher level of integration, the tariff revenue losses experienced by the government begin to dominate and welfare starts to decline as the gains in profits and consumer surplus fail to offset them. Eventually, if integration still goes on, beyond a critical  $\mathbf{a}$ , the insiders would become worse off compared to their initial level of welfare as well as compared to the excluded country. Analytically, it can be shown that:

$$W_1(\bar{t}_1, \bar{t}_2, t_3 |_{W_3=\bar{W}_3}, \mathbf{a} = 1) < \bar{W}_1, \text{ and}$$

$$W_1(\bar{t}_1, \bar{t}_2, t_3 |_{W_3=\bar{W}_3}, \mathbf{a} = 1) < W_3(\bar{t}_1, \bar{t}_2, t_3 |_{W_3=\bar{W}_3}, \mathbf{a} = 1).$$

One implication of this is that countries may start a PTA without anticipating the excluded country's response. Once, the latter starts to react, the PTA members will have harder and harder time

pursuing further integration and the PTA will fail to go all the way to full preference. In the case where  $\mathbf{a}$  is the only policy tools available to the PTA members, “partial integration” (i.e.,  $\mathbf{a} < 1$ )—which is a violation of GATT rules—<sup>7</sup> may be their best choice.

By design, welfare in Country 3 remains constant as  $\mathbf{a}$  is increased. It must be noted that domestic income distribution has changed in favor of domestic producers (in terms of higher profits) and the government (in terms of higher tariff revenues). The excluded country’s firm loses profits in the PTA but their gain in the domestic market is more than enough to offset those losses. The consumers are in part financing the increased producer gains and the larger tariff revenues through higher prices.

## 5. Open Regionalism

In the previous section, we showed that, if their tariffs are exogenously fixed, the insiders’ best policy choice might be to violate GATT rules by opting for partial integration (as opposed to going all the way to regional free trade). In this section, we show that Country 1 and Country 2 could both abide by GATT rules and fare better if they anticipate Country 3’s reaction and adjust their external MFN tariffs accordingly. Assuming that 1 and 2 can coordinate their external trade policies (i.e., they form a Customs Union), they will do so by decreasing their common external tariffs (CET) in such a way that 3’s welfare remains constant.<sup>8</sup> By solving  $W_3(t_1, t_1, \bar{t}_3, \mathbf{a}) = \bar{W}_3$  for  $t_1 (= t_2)$ , we can compute the

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<sup>7</sup> Free Trade Areas and Customs Unions are permitted under GATT rules if the parties go all the way to free trade on all goods that they trade after a “reasonable” transition period.

<sup>8</sup> Since all the countries are symmetric ex ante, we do not need to make the distinction between an FTA and a CU.

PTA members' external tariff rate that will keep  $W_3$  constant as the degree of preference between 1 and 2 increases:<sup>9</sup>

$$t_1 \Big|_{W_3=\bar{W}_3} = t_2 \Big|_{W_3=\bar{W}_3} = \frac{(A-c)}{10+5a}$$

According to the above expression, the member countries need to decrease their external tariffs as they increase  $a$  in order to keep the excluded country from retaliating. As  $a$  increases from 0 to 1, the PTA's external tariff declines from  $(A-c)/10$  to  $(A-c)/15$ —a decrease by a third. This is very similar to the so-called Kemp-Wan liberalization. Kemp and Wan (1976) showed that PTAs can always be designed in a way that nonmembers' welfare are not affected. In the same vein, McMillan (1993) has proposed changing GATT's Article 24 to require that the trade volume between member and non-member countries does not decrease after the formation of the bloc. In this paper, the Kemp-Wan theorem or the McMillan criterion is endogenized. From this point of view, regionalism—plus the threat of retaliation from the excluded countries—can advance the efforts towards freer global trading system.

The dynamics of the relevant variables, as the degree of preference increases from 0 to 1, are shown in Figure 3. Since the PTA is designed not to affect the third country, this latter will not retaliate. The excluded country's loss from an increase in preference is perfectly offset by the PTA's external liberalization. The producers in 1 and 2 benefits from better access to each other's market in spite of lower tariffs on imports—and hence fiercer competition—from 3. While tariff revenues decline,

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<sup>9</sup> There is another solution that we ignore because it does not satisfy the restriction on  $t_1$ .

consumers gain from cheaper good price as  $\mathbf{a}$  increases. On the whole, the PTA members gain compared to their initial welfare. Analytically, it can be computed that for any  $\mathbf{a}$  larger than zero:

$$W_1(t_1|_{w_3=\bar{w}_3}, t_2|_{w_3=\bar{w}_3}, \bar{t}_3, \mathbf{a}) > \bar{W}_1.$$

More importantly, it can be computed that:

$$W_1(\bar{t}_1, \bar{t}_2, t_3|_{w_3=\bar{w}_3}, \mathbf{a} = 1) < W_1(t_1|_{w_3=\bar{w}_3}, t_2|_{w_3=\bar{w}_3}, t_3, \mathbf{a} = 1),$$

which means that the insiders will be better off adjusting their own external barriers downward rather than letting the excluded country adjust its tariff in order to keep its welfare constant.

Figure 4 compares the three different cases (no-retaliation [N], retaliation [R], and preemption [P]) from the viewpoint of the members of the PTA. In terms of total profit and welfare, the member countries are best off when Country 3 does not respond to the creation of the PTA (Curve N). When the excluded country has the option of retaliating, then the member countries fare much better by conducting external liberalization in parallel to the regional one (Curve P). Thus, open regionalism is good and not liberalizing externally could cost the PTA members, as they could become worse off than their initial welfare.

In terms of the world welfare, the highest welfare is attained when the member countries are anticipating the response of the excluded country and reduce their external tariffs accordingly (Curve P). At the other end of the scale, the lowest welfare—which is lower than the initial world

welfare—is achieved when the PTA members are giving each other preference without taking the reaction of the excluded country into account (Curve R).

## 6. Conclusion

In the model presented in this paper, the creation of a PTA, without taking the negative externalities on the non-members, causes the later to raise their tariffs against those that are members of the PTA. By creating or by joining trading bloc, countries can end up losing their market access in the rest of the world. This possibility of “endogenous retaliation” by the excluded countries should be an important consideration for countries contemplating the creation of a trading bloc. This is especially true if the potential outsiders include one’s major trading partners.

One could think of Countries 1, 2, and 3 as respectively the EU, ACP countries, and the USA. The model would then predict that the preferential access granted by the EU to the banana producers from ACP countries under the Lome conventions will lead to threats of retaliation from the US, which in turn will lead to a external liberalization in the EU. In fact, a transatlantic dispute has recently erupted over the EU’s banana import rules which discriminate in favor of Caribbean banana producers and against American distributors. The US has threatened to impose 100% duties on a wide range of European imports [most of which have no connection whatsoever with bananas!] unless a compromise is reached.

Panagariya (1994) offers another illustration of this possibility in the context of the feasibility of an East Asian trading bloc. He argues East-Asian countries such as Japan, Korea or China have been

persistent targets of market-opening actions (structural impediment initiatives or Super 301 threats) by the United States during the last two decades. Initiatives by these countries to form an FTA, which can potentially divert trade from the US, are almost certain to lead to retaliation from the latter. Such retaliation would be extremely costly, especially for Korea and China which both sell about a quarter of their imports to the US.

It should be noted that the word “tariff”, as it was used in this paper, should be interpreted very broadly as reflecting the general level of protection in the receiving country. As Winters (1996) puts it: “In a world of trend liberalization, merely going slowly than you otherwise would is essentially a form of increased protection.” Moreover, many (especially developing) countries have wide gap between their applied tariffs and the maxima committed to in their formal bindings in the WTO. Hence, they can easily increase their duties without violating any WTO bindings.

The retaliatory response of the excluded countries could also take the form of the formation of another trading bloc. There is no (and there would not be) WTO rules preventing the excluded countries from forming their own bloc. The creation of the second bloc, in turn, may lead to an increase in the external tariffs of the original bloc. The results in this paper then suggest that the current wave of regionalism could lead to more regionalism, and that the world trading system may end up being segmented into a number of competing and relatively closed trading blocs.

On the more positive side, the threat of retaliation might lead the PTA members to be more considerate of the effects of their actions on the excluded countries. In fact, the model shows that

they will be better off reducing their external tariffs during the formation of the PTA in order to eliminate the harm that they may cause on non-members. Hence, we have a mechanism through which regionalism could help the efforts towards a more liberal trading system.

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Figure 1. PTA between 1 and 2, no potential response from 3  
 ( $A-c = 10$ )

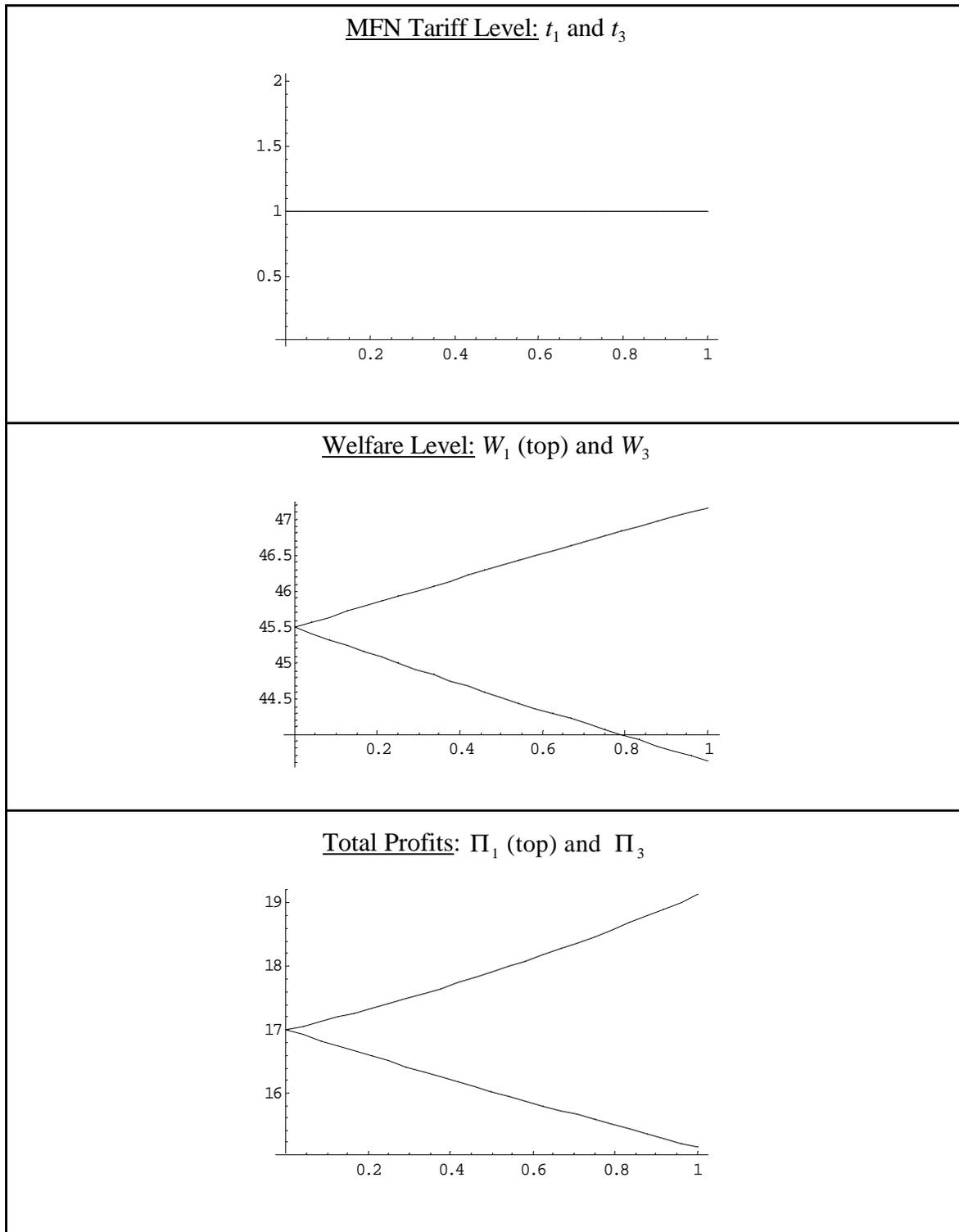




Figure 2. PTA between 1 and 2, with tariff response from 3  
( $A-c = 10$ )

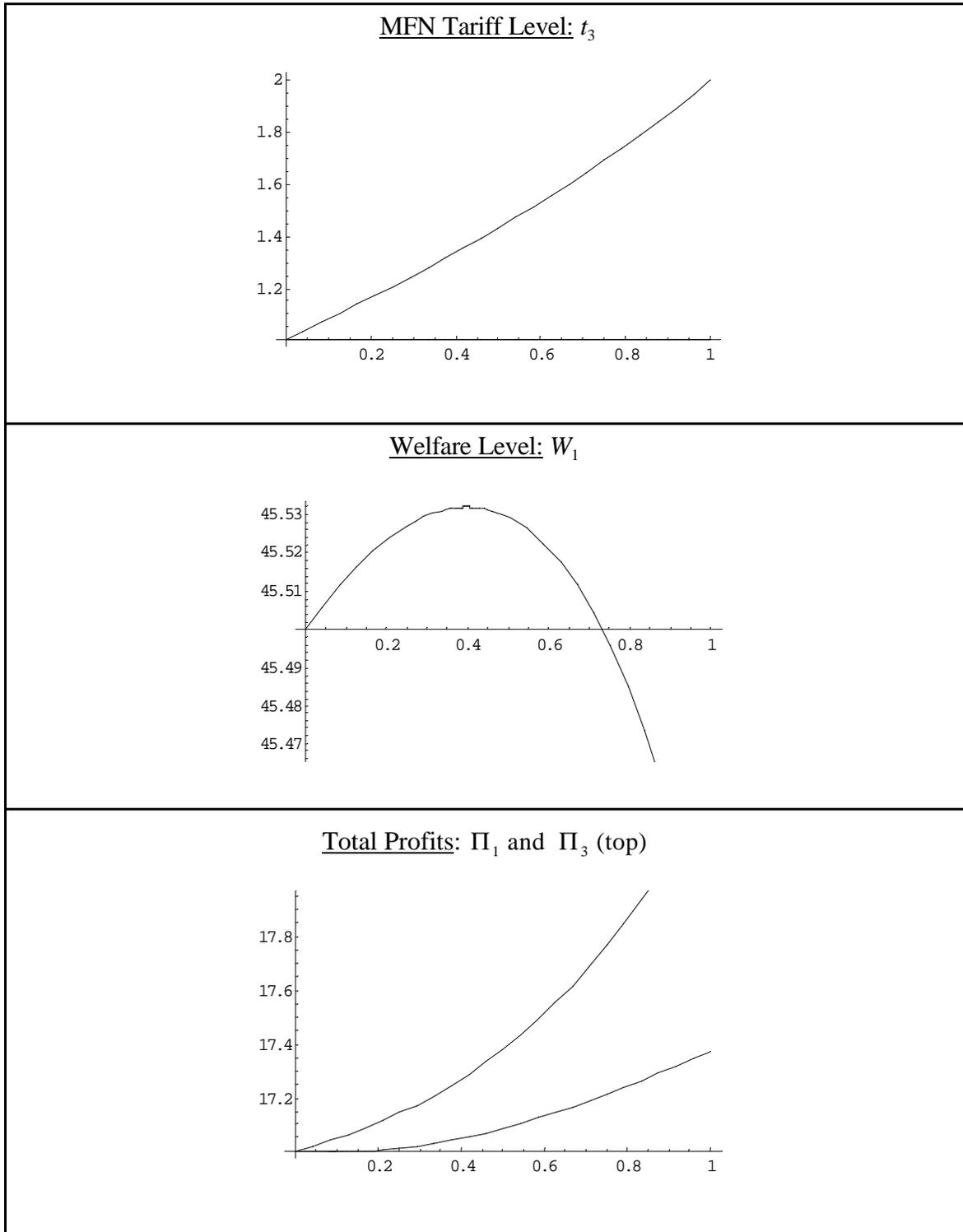


Figure 3. PTA between 1 and 2, anticipating response from 3  
( $A-c = 10$ )

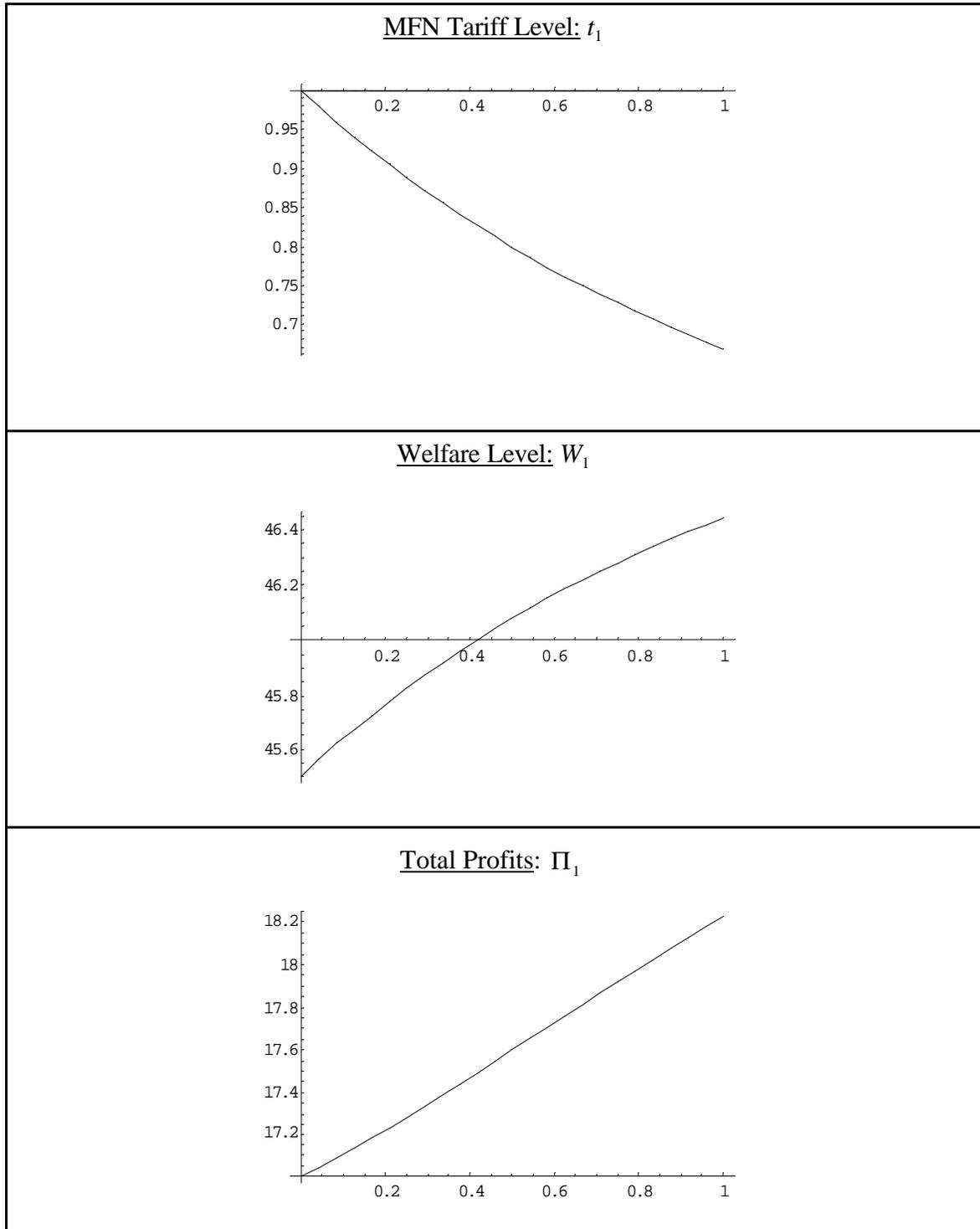


Figure 4. Comparison between the three cases  
 ( $A-c = 10$ )

