

# **The Myth Of Preferential Trade Arrangements: Are PTAs Good for Global Free Trade?**

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The number of preferential trading arrangements (PTAs) approved under the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO) has increased significantly, from just one in 1949 to more than 100 today. In fact, PTAs such as the European Union and North American Free Trade Agreement (NAFTA) have more power than the United Nations. In a 1995 study, the WTO Secretariat concluded that, “To a much greater extent than is often acknowledged, regional and multilateral integration initiatives are complements rather than alternatives in the pursuit of more open trade.” However, I raise an opposite point of view in this paper that PTAs actually detract from true liberalization and fragment the global trading system.

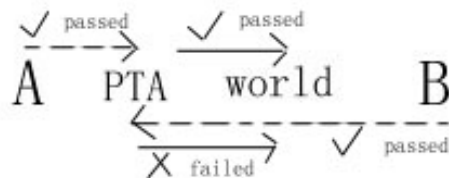
In this paper I'll first discuss what will stop the PTAs from upgrading to global free trade, where PTAs of similar and dissimilar countries are analyzed respectively. Second, I'll look into why global free trade (multilateral) cannot be achieved just by merging all the existing PTAs into one, as is the thought of many scholars. Third, we'll see whether the WTO in itself is powerless in promoting global free trade. Fourth, a weakness of PTAs will be outlined to show that there might be a solution to this paradox.

## **I. Analysis Of PTAs For Similar Countries**

First, we analyze with voter theory the case in which countries to integrate into a PTA are similar in labor-to-capital ratio, productivity and price patterns. As we all know, the European Union (EU) is a PTA of similar countries, and voting is widely adopted in the course of the integration of EU.

I will give you a simple example to demonstrate that the process of globalization and free trade will not follow the optimal track described in economics textbooks. Not only so, to your surprise, but the process can even be changed by the order of the progressive voting stages. Analyzing Levy's median voter model, I find that PTAs can make a previously feasible multilateral liberalization infeasible.

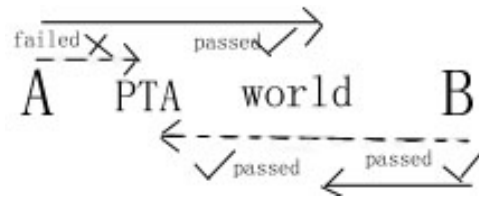
Figure 1



In conventional views, suppose country A and country B are going to integrate into a PTA and A's capital-to-labor ratio is lower than B's. Assume a ratio between A and B will make both countries better off, then both A and B will approve the arrangement in the first round and then turn to the second round of vote, where they will go ahead to multilateralism with a world capital-to-labor ratio. If the world ratio is higher than that of the PTA, voters in A will still favor multilateralism and go ahead, but B will refuse to change. The voting process is showed in the figure, where the dashed line represents the first round of vote while the straight line represents the second round of vote.

However, voters in A foresee this and come up with a trick. They will veto bilateralism in the first round of vote and the second round of vote becomes autarky vs. multilateralism. As we can see in the figure, A fulfills his goal. PTAs will fail and multilateralism is achieved on this assumption.

Figure 2



However, this will not happen in the case of similar countries where both ratios of the countries are almost the same. As long as A and B are identical in capital-labor ratios, there are no price or wage effects while the variety effects still exist, and moreover, there are also external economies of scale and decreasing opportunity cost. These could leave all the median voters better off so as to resist the move to multilateralism, regardless that the latter would have been chosen relative to autarky in the first round of vote.

A PTA can improve the terms of trade of member countries at the expense of non-member countries and give rise to incentives for maintaining or increasing preferences and protection. The more similar the two countries are, the more trade diverting the PTA between the two countries, the greater the backing it receives and the more it reduces the incentive to eventually liberalize with the third country. As a matter of fact, PTA often induces higher tariffs on the rest of the world after they integrate into a PTA. In the European Union, it has been found that internal liberalization always accompanied by more vigorous anti-dumping against outside countries.

According to the Cournot oligopoly model (Andriamananjara, 1988), as the PTA expands, profit of insiders first rise, reach a maximum and then decline. In the meantime, the maximum-profits of outsiders decline monotonically as the PTA expands. Thus, while

outsiders have an increasing incentive to seek entry, insiders shut the remaining outsiders out.

No wonder so many countries will have great incentive to form regional unions but resist or pay less attention to the project of upgrading to global free trade. They get profit from the regional union, and the upgrade to global free trade cannot bring them more gains. Therefore, they don't pay attention to the welfare of the world as a whole. It's not traditional economics, but it is typical politics.

PTA beats multilateralism in this analysis with similar countries. Globalization always stops on a regional stepping-stone before achieving the ultimate goal of free world trade.

## **II. Analysis Of PTAs For Dissimilar Countries**

Then we consider with lobbying theory the case in which countries are dissimilar. NAFTA is a PTA of dissimilar countries and there is great lobbying power in the United States, Canada and Mexico. Let's see what will happen this time. Will the PTAs lead to global free trade? The answer is still "no."

As a matter of fact, governments not only deal with the relations among countries, but also are under pressure of the powerful domestic interest groups. Some groups will benefit while others will lose from a trade arrangement to be signed. They will lobby in the opposite directions. Therefore, whether the arrangement is voted or vetoed is ambiguous. Everything is possible; who will win rests on the balance of lobbying power of different interest groups.

In general, consumers find it hard to organize a lobby because producers always dominate lobbying. As a matter of history, weaker, uncompetitive industries are usually the ones that succeed in lobbying against foreign competition. On the pressure of the lobbying

groups the governments make decisions that are often not an economical one.

In Viner's trade creation and diversion model, PTAs create new trade between union members and divert trade from low-cost outside firms to high-cost inside-union firms. The 'profit' of the trade creation effect is hard for a government to judge: it generates surpluses for consumers at home and for exporters in the partner country, but at the same time reduces the welfare of domestic import-competing producers. However, the effect of trade diversion is obvious, it generates neither reduction in profits nor consumer gains. When the members are more dissimilar, the welfare as a whole is reduced because of more trade diversion. Trade diversion is an undesirable and efficiency reducing effect but PTAs still get voted even when trade diversion is the dominant force. As far as political factors are concerned, government will care less about the diversion effect because the consumers group matter less to government than producers group. In term of politics, to your surprise, the more trade diverting a PTA between them, the stronger it's backing. Therefore a PTA again beats multilateralism when countries in the union are dissimilar.

Therefore, if the world attempted to achieve the multilateral free trade through PTA, in most cases, progress would stop at the intermediate stage. It makes no difference whether the PTA is consisted of similar or dissimilar countries.

### **III. Why Not Fulfill Global Free Trade By Merging PTAs?**

Why not? Some people believe that the PTAs will eventually merge into one in the future and global free trade will be achieved at that time. So we turn to the question what makes it impossible to merge all the existing PTAs into one, and eventually lead to global

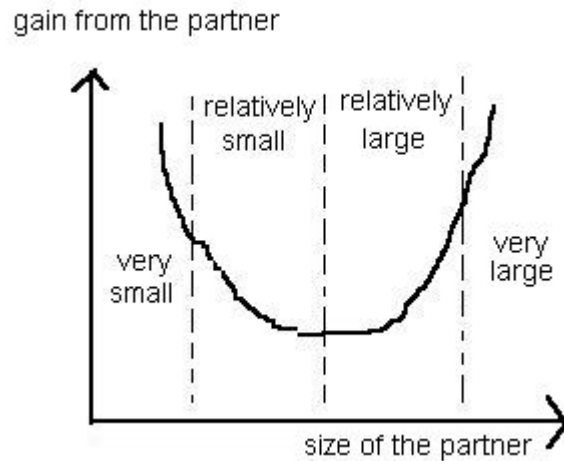
free trade.

Of course, governments are always seeking countries from which it can exploit more to integrate into a PTA. The larger the partner, the more likely is the welfare gain to the home country from the agreement. A larger country is expected to be less specialized and more diversified, and closer in its relative-prices pattern to the rest of the world.

When the partners are large, trade with that country does have an effect on the price at which it is conducted when facing a declining demand curve. But the larger the partner is, the smaller the effect is. So a reduction of the size of the partner, from very large to just relatively large, should lead to a decline of the home country's welfare level because the price the home country has to pay for its imports from partners rises.

But when the partners are small, that is, when the effect of a price increase because of demand pressure is so large that the price of imports from that partner reaches the cum tariff level of the price paid for the imports from a outside country, say C, the smaller the partner, the higher the home country's welfare level should be. When the partner size reach this point, the amounts of imports bought from the partner will fall and complemented by more efficient imports from C, which leads to higher welfare of the home country. The worst case for the home country is where the partner's size is just on the borderline between large and small, as we can see from the graph.

Figure 3



Small countries prefer very large countries and large countries prefer very small countries. As a result, PTA always appears as a hub-like organization, that is, a super power in the core, and several relatively much smaller countries around it. In this form, all the members are satisfied according to the theory above. Suppose that two PTAs are going to merge, then there will be two super powers in one PTA, they are always identical in size so that neither of them will prefer the merge. It is also the fact that the small countries will not be affected much whether the two PTAs merge or not, but their voices don't matter much within the PTA.

#### **IV. The WTO Is Actually Powerless**

After that, we will see why WTO is so inefficient in promoting global free trade. It seems that the WTO and GATT do a good job in promoting global free trade. Is the WTO really so powerful and effective? Let's see take the case of China's accession to the WTO.

We can see that soon China is going to join the WTO and it will include all the major countries in the world after that. There are really many obstacles on the course of China's accession and among them is the strong objection from some countries such as those from Association of South East Asian Nations (ASEAN). Why do they object to it? The answer is very simple. China will compete with them for markets and sometimes bring about a fiscal drain from them. Certainly, the interest seized by one country is the loss of the other countries in a zero-sum game. That's why the ASEAN countries are hostile to China's accession to WTO. ASEAN will suffer a double loss if China joins the WTO. On the export side, when MFN quotas against textile and clothing exports from China are removed, exports from China increase and ASEAN exports decline. On the import side, low import tariff increases China's import of agricultural commodities, which leads to an increase in the world price of these commodities and results in a deterioration of ASEAN countries' terms of trade.

Actually, it's not WTO who removed the barricade. Let's see what makes ASEAN countries give up. Unwilling as the ASEAN countries are, they have no choice. The big powers will force them to obey. Certainly China will force them with her political influence. And both EU and US will also force them because they want China's market. China and the western countries come to terms this time to suppress the objecting voices of ASEAN countries. It's a game belonging to big powers, and whoever ruins the mood of big players will get penalized. That's what ASEAN countries really fear, not the pressure from the WTO.

The result is good after all. However, Let's have a second thought. What will happen if China does have not the intention to join the WTO? What will happen if the EU and US do not want China to join? We will find that it's the super powers that actually control the



progress of global free trade. Actually, the WTO can do nothing to change the progress no matter it is called World Trade Organization, Super World Trade Organization or Hyper World Trade Organization, etc, so long as it is just an organization without real power, without military forces.

We also see in this case that there must be somebody who gets lost within a PTA. So why don't they refuse to join? The fact is the emergence of regional agreements can create defensive reactions from which there is potential cost of being left out of an integration process. The bus is crowded, but there is only one and no more bus, you have to get in however uncomfortable it is. The latter you get in, the more resistance you receive from the people already in the bus. Surely you can refuse to join, but it's just your own right to commit suicide. The bus' name is modernization of industrialization. Sometimes you just make a second-best decision in order to reduce your loss but not to increase your gain.

## **V. Is There Any Weakness Of PTAs That Can Be Disputed?**

After finding out the many problems of PTAs, it is imminent to find out a solution to pull the world back from this dead end road. In order to stop the PTAs from detracting from global free trade, the main thing is whether we can find some weakness of PTAs from which we can dispute. We can see that there do exist centrifugal forces in PTAs, especially within South-South PTAs.

Let's look into the case of South-South PTAs. South-South PTAs develop to open regionalism when imports from the northern economy are liberalized as well. Liberalization with north brings both benefits from forward linkages and losses from import competition.

The net effect will depend on the size of the country. Generally, larger countries will lose more and smaller countries will earn more because the former have to open their huge markets to developed countries and the latter can gain by getting access to the big markets of northern countries. As a result, larger countries are always insisting on staying in the stage of protective regionalism and unwilling to upgrade to an open one. However, the smaller countries cannot afford to miss the chance of getting profit from further liberalism. This always results in tough conflicts and centrifugal force within PTAs and sometimes leads to the collapse of the vulnerable PTAs. This always occurs when the dominant country happens to have a sharp decline in economic and political power and is unable to offset the centrifugal force any longer. When the big boy gets sick, there is always a reshuffle of the power allocation.

However, as long as the center country is strong enough, the PTA is going to exist, or in other words, the likelihood of global free trade is little. Actually, there are many PTAs in South America in the past, but none of them was able to exist very long. The reason might be that there is lack of a super power in South America. However, this is just an exception. It's a multi-pole world now after the ending of the cold war so that there are plenty of regional super powers. The forming procedure of PTAs is similar to that of raindrops in that a strong PTA must have a super power acting as a core particle to enable moisture to stick to it and then merge into a raindrop. This might be a unique weakness of PTAs. However, it needs further researching to see if there is any possibility to retard the growth of PTAs by removing the core "particle", and how. Or I might suggest a method of homeopathy, that is, to encourage more and more of this kind of "particle" to emerge and then lead to a "pour" so

that all the moisture will eventually gather in the rivers and in the end flow into the “sea”, or global free trade. Though, so far I cannot figure out a scientific and detailed solution about that.

## **VI. Conclusion**

In this paper, PTAs of similar and dissimilar countries is analyzed respectively with median voter theory and lobbying political economics theory. It is found that it is impossible for PTAs to automatically upgrade to global free trade because of the resistance from inside. After that, by analyzing the effect of the integration of countries with varying size, we find that the most steady and robust form of PTA is a hub-like form of PTA in which there is a super power country in the core. Therefore, it is impossible to achieve global free trade by merging the existing PTAs because it will break the balance of power when more than two core countries coexist in one PTA. Then we examined whether the WTO had done a good job or not in promoting the global free trade. It is found out that it is the super powers that actually say the words and the WTO in fact has no real power. The result of the paper is sort of pessimistic, however, in the last part, we do find a weakness of PTAs that we might refute although the solution has not been practically formed yet. As a conclusion of this paper, PTAs actually detract from true liberalization and fragment the global trading system, as is quite opposite to economic sense. Nevertheless, it's the fact.

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